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# Bitcoin, Litecoin, Dogecoin and Other Cryptocurrencies Now Taxable Income



Whether you say “Vires in Numeris” or “To the Moon” your future with virtual currencies will change because of the taxman. In Notice 2014-21, 2014 I.R.B. 938 (4/14/2014), the IRS issued its first set of guidance on how virtual currency transactions will be taxed. The issue of how to treat cryptocurrency, for tax and other legal purposes, is not a new or solely domestic concern. Both the European Central Bank and the Government Accountability Office have produced reports detailing the logistics of virtual currencies and their potential for abuse. Virtual currencies have

populated the news recently, ranging from Josh Wise's top 20 finish at Talladega Superspeedway in his crowd-funded No. 98 Dogecoin Ford, the Winklevoss (yes, the same Winklevoss' from The Social Network and Facebook fame) Bitcoin Trust, to the catastrophic failure of Bitcoin exchange Mt. Gox.

The IRS has decided it wants a piece of the action on virtual currencies. There are many virtual currencies including Bitcoin, Litecoin, Dogecoin, Darkcoin, Ripple, Digitalcoin, Worldcoin, Vertcoin, and Peercoin. It seems that all you have to do is think of a word, then add "coin" to it and *voila* you have a math-based cryptocurrency. The IRS adopted the strategy of the Financial Crimes Enforcement Network (FinCEN) and classified Bitcoin, and its counterparts, as a virtual currency and not a "real currency." Bitcoin does not reach the level of a "real currency" because it is not recognized as legal tender of a government. The IRS is aware that virtual currencies are used to pay for goods and services, held for investment, and are mined (often requiring expensive, dedicated machines) to ensure network security.

Notice 2014-21 treats virtual currencies as property for federal tax purposes and general tax principles for property transactions apply. Treating virtual currencies as property results in favorable tax treatment. Taxpayers will be able to claim either capital gains or losses on transactions if they hold virtual currencies as investment property similar to stocks and bonds. However, taxpayers will recognize ordinary gain or loss if they hold virtual currency as inventory mainly for sale to customers in a trade or business. Like other capital assets, taxpayers will need to know the basis in order to compute gain or loss. The IRS takes the position that the value of virtual currencies must be reported in U.S.

dollars (USD) and the fair market value is determined on the date of payment or receipt. There are dozens of virtual currency exchanges each with some degree of variance. For Bitcoin (currently the most widely used virtual currency) the major exchanges include Bitstamp, BTCe and BTC China. The Notice does not specify which exchange taxpayers must use to determine value in USD and thus taxpayers may “shop” for the best price. While this might seem inconsequential to small investors, a 10% or greater variance between exchanges will provide definite benefits to institutional investors, such as the Winklevoss Bitcoin Trust.

Virtual currencies can be acquired by purchasing them on exchanges or by “mining” them. For Bitcoin, miners download free software used to solve complex equations and verify the public ledger. When a person successfully solves the equation they are rewarded with 25 Bitcoins. Bitcoin users mine to verify that transactions are legitimate and to prevent hackers using botnets and malware from manipulating the Bitcoin algorithm. The Notice states that the fair market value of mined virtual currency as of the date of receipt is includible in gross income. The rationale for why mined virtual currency is immediately taxable is not explicitly stated but it is likely hinged on §83. Section 83 deals with an exchange of property for services rendered. The IRS takes the position the users who mine Bitcoin are effectively being compensated in property in return for performing services for Bitcoin. While this rationale may seem sound, there is potential controversy because there is no “employer” in the §83 sense. Section 83 applied whether the payee is an employee or independent contractor. A problem arises because when the Bitcoins are awarded because there is not a

traditional payor. Whether you receive property in exchange for services from the corporation that employs you, or whether you receive the same for mowing your neighbor's lawn, there is a payor. The problem with Bitcoin, and other cryptocurrencies, is that Bitcoin is an algorithm. There is no Bitcoin corporation, nor is there a single person or group of people controlling Bitcoin. Bitcoin is simply an idea. There is no one in charge of Bitcoin and when the maximum supply of 21 million Bitcoins have been issued there will be no "new" Bitcoins.

The Notice continues to use the §83 framework to detail virtual currency informational reporting. Bitcoin miners will be subject to self-employment taxes. Along this vein, virtual currency paid as remuneration for services constitutes wages for tax purposes and are subject to federal tax withholding, Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, and must be reported on Form W-2, *Wage and Tax Statement*. So, in instances where Bitcoins are paid for successful mining, someone is responsible for the federal tax, FICA, and FUTA withholding and for issuing W-2's. But the who is unclear. Under the IRS' rationale, Bitcoin itself is responsible since it is the closest thing to an employer. Despite this guidance, it is still unclear how tax withholding and information reporting will be implemented.

The IRS left open the possibility that virtual currency miners may be engaged in a trade or business. A person who in the course of a trade or business is required to give the payee a Form 1099-MISC, *Miscellaneous Income*, for payments over the equivalent of \$600 USD. A trade or business is not a defined term and is determined based on the

facts and circumstances. But in order to be a trade or business, and not a for profit activity, the taxpayer must have a good faith intention of making a profit and the activity must be regular and continuous. If a taxpayer is considered to be in the trade or business then they could ordinary and necessary expenses. Ordinary and necessary expenses would likely include the cost of purchasing Bitcoin mining machines, the ratable portion of energy used to run the machine, renting expenses, repairs and maintenance, and compensation related expenses. Taxpayers also would be able to depreciate their mining equipment.

The IRS does not appear to apply this guidance retroactively. But taxpayers may be subject to penalties for not complying with this notice in future virtual currency transactions and mining operations. The major problem with the Notice lies with its enforceability. Despite popular claims, virtual currencies are not anonymous, they are pseudonymous. Virtual currency is held in a wallet through a complex unique address. Users may own virtual fortunes (many users easily have in excess of \$10 million USD equivalent) and never use their virtual currency to purchase items or convert it to USD. While virtual currencies can be traced through the public ledger to individual users, there are many "masking" programs that will create tens of thousands of fake transactions to hide the identity of the true holder. The methods for collection and enforcement are light years behind the cryptocurrency pioneers and adopters. Every day new businesses are launched that either use virtual currencies or implement them in previously unknown ways. People who have built virtual fortunes in currencies like Bitcoin can easily mask their wealth. This would be similar to the Major League Baseball of 1998 trying to test the players of today for steroids

with 1998 technology. The result would be futile, considering Major League Baseball has a hard enough time catching steroid users with modern technology.

Guidance was needed for virtual currency transactions, but the guidance should not be over. There are many problems with both the enforcement of virtual currency taxation and the rationale for considering mined virtual currency as compensation for services rendered. If the goal was to tax virtual currencies as soon as they were mined, classifying awarded Bitcoins as gifts would provide a stronger rationale. Given the facts as currently constituted, mining Bitcoin is most closely analogous to mining gold or any other precious metal. Like gold, there are a limited supply of Bitcoins, and a person can only mine it if they know where and how to extract them. But treating the act of mining Bitcoins like that of mining gold fails in terms of revenue raising because gold is not taxed as it is pulled out of the ground. It is only taxed when it is exchanged or transferred, thus following the longstanding tax principle that there must be a realization event. The current taxation of Bitcoin mining fails this tax principle.

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