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## Corporate Close-Up: Income Taxation and Cryptocurrencies

We have all heard of virtual—or crypto—currency, but the big question remains: How do these intangible concepts result in tangible currency, and what does it mean come tax day? "Mining"[1] aside, there are several ways to acquire cryptocurrency, the most common of which is the exchange of physical currency for virtual coins or part of a coin through a broker.[2] Much like the purchase and sale of stock, one way to make money on such cryptocurrency exchanges is to buy low and sell high.

News of a single Bitcoin climbing past a record-breaking $11,800 valuation this

weekend, almost three times its value a mere three and a half months ago, has attracted droves of taxpayers to the cryptocurrency market. But what these taxpayers may not know is that something as simple as buying a sandwich with virtual currency may trigger a taxable event. With all the confusion surrounding the taxability of virtual exchanges, and the potential risks involved in failing to comply with income recordation and reporting requirements, taxpayers need to stay abreast of potential tax triggers come tax day.

### Top Players in the Cryptomarket

Bitcoin, a highly recognized open-source virtual currency released in 2009, utilizes peer-to peer technology to operate on a public platform without the use of a centralized banking authority.[3] Every coin spent in a Bitcoin transaction is recorded on the platform's blockchain, which is a shared, trusted, public ledger that everyone can inspect but no single user controls. There are many other alternative virtual currencies on the market (collectively known as Altcoins) that utilize a similar economic model or coin distribution method to Bitcoin, the most popular of which are Ether, Ripple, and Litecoin.

Ethereum, created in 2014, is a distant rival to Bitcoin but is swiftly gaining in popularity. Ethereum is a decentralized blockchain-based platform, like the Bitcoin platform, but with the additional functionality of running applications. Ether is the virtual coin utilized on the Ethereum platform and

is currently the second largest cryptocurrency on the market.

## Federal Taxation of Cryptocurrency

Taxpayers' newfound ability to convert their traditional income to digital income, minus all the formal regulations and fees that come with traditional banking institutions, leaves open the potential for the realization of untaxed income. The treatment of the gain realized from these digital transactions is a controversial topic policy makers have been grappling with.

In an attempt to thwart tax evasion, the IRS released Notice 2014-21 in 2014, providing guidance on the taxation of transactions involving virtual currencies. The notice officially treats virtual currencies that are "convertible" as property. For federal tax purposes, any virtual currency "that has an equivalent value in real currency, or that acts as a substitute for real currency," is deemed convertible.[4] Accordingly, each exchange of virtual currency (whether for investment and trading purposes or for buying goods and services) is a potentially taxable conversion.

Because virtual currency is treated as property and not legal tender, taxpayers receiving virtual currency as a payment for goods and services must include the fair market value (FMV) of the virtual currency received, as of the date of the exchange, in their gross income. The FMV as of the payment date is dependent on the market rate at the time of the exchange, which could vary widely from day to day, and

even minute to minute. The difference between the FMV of the goods or services received and the buyer's adjusted basis in the virtual currency exchanged results in taxable gain to the buyer.[5]

Further, an exchange of convertible virtual currency for services could potentially trigger the additional burden of having to withhold and pay employment taxes for services received. Generally, wages paid to employees using virtual currency are taxable to the employee and must be reported by an employer on a Form W-2. Contrastingly, exchanges made to independent contractors and other service providers are subject to general self-employment taxes as reported on Form 1099.

### State Taxation of Cryptocurrency

Some say that the federal tax treatment of convertible virtual currency places unrealistic recordation and reporting requirements on taxpayers and, as CNBC puts it, serves to "stifle the development and growth" of the current cryptocurrency ecosystem. However, with the growth that this multi-billion dollar market has seen across the last several years, it seems the federal guidelines have yet to make a dent in popularity or use.

With all the money being made on cryptocurrency, it comes as no surprise that states have begun to jump on the conformity train for the taxation of income generated off of virtual exchanges.

#### *Corporate and Individual Income*

New York and New Jersey are among the first states to adopt the federal cryptocurrency tax regime. These states expressly conform to the tax treatment of convertible virtual currency for corporate and individual income tax purposes. This means that both state and federal taxation is triggered when virtual currency is exchanged for tangible property, or for services rendered by independent contractors. Taxation is also triggered when employers use virtual currency as remuneration for employee services.

New Jersey imposes an additional requirement on wages paid in the form of virtual currency to be converted into legal tender before being subjected to the state withholding requirements. This process may create a disincentive for employers utilizing virtual currency as remuneration and could potentially hinder the general adoption of cryptocurrencies in the state.

### *Sales and Use*

New York and New Jersey treat convertible virtual currency as intangible property for sales and use tax purposes, which means taxpayers are not subject to sales and use tax on the purchase or use of virtual currencies. However, for goods exchanged or services rendered in a qualifying virtual exchange, sales and use taxes are owed based on the fair market value of the virtual currency at the time of transaction.

## What Does This Mean for Me?

The great appeal of the cryptomarket lies in the user having ultimate control over their digital currency. Regardless

of the platform used, virtual coins generally operate much the same. Virtual trades are recorded on a blockchain that eliminates the need for third-party intermediaries and reduces the concern of censorship or fraud; generally producing a more secure transaction with little to no fees.

Despite all the income generated off of these revolutionary concepts, many states have chosen silence when it comes to the imposition of state income taxation on cryptocurrency. Lack of enforcement and compliance concerns made possible by the anonymous environment surrounding cryptocurrency exchanges have caused many to doubt the success of the federal regime and are also likely the main reason for the general lack of state conformity.

However, with the total market capitalization of virtual currency soaring past $300 billion, Bitcoin alone seeing returns of over 900 percent since the start of the 2017 tax year, states are starting to engage in the regulatory discussion surrounding the taxation of cryptocurrency, and formal legislation is bound to follow.

Continue the discussion on Bloomberg BNA's State Tax Group on LinkedIn: What states do you think will formalize their taxation of income generated off of the cryptocurrency market next?

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[1] *Miners* are taxpayers who acquire new virtual currency by utilizing software to solve complex algorithms (a process that both validates the platform mined and the blockchain utilized).

[2] Some of the most popular Cryptocurrency brokers include Coinbase, Kraken and CEX.IO.

[3] More than 40,000 vendors—Bloomberg included—have begun to accept bitcoin. Other big names include, Overstock.com, USAA, Dish, Virgin Galactic, Tesla, and the list is growing daily.

[4] Bitcoin is directly cited by the agency as an example of convertible virtual currency because it can be digitally traded between users and be purchased for, or exchanged into, U.S. dollars and other real or virtual currencies. Examples of nonconvertible virtual currencies, those that can only be utilized digitally, can be seen in any videogame where players who acquire virtual currency through gameplay are allowed to purchase goods or services within the game.

[5] Taxpayers should be aware that they will be required to realize capital gain or loss on the exchange of virtual currency deemed to be a capital asset.

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Mariam Ahmadi contributes to the "Corporate Close-Up" blog series, which covers current events and hot topics related to corporate income tax at the state level. Mariam is a State Tax Law Editor at Bloomberg BNA, where she works on maintaining existing products, developing new products, and covering current events in state corporate income tax. She holds a J.D. from Southwestern Law School, and a B.A. from the University of California, Santa Barbara.

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