U.S. TAXATION OF CONVERTIBLE VIRTUAL CURRENCY - IT IS NOT A MYTH!

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There is a pervasive myth that virtual currency exists in a regulatory vacuum – but the Internal Revenue Service (the "IRS"), the U.S. Securities and Exchange Commission (the "SEC"), the U.S. Financial Crimes Enforcement Network ("FinCEN"), the Commodity Futures Trading Commission, and multiple state legislatures and regulators (*e.g.*, blue sky laws, money services business regulations) would beg to differ. For example, (i) certain persons or business entities characterized under applicable law as virtual currency "money transmitters" may be required by the Bank Secrecy Act[1], FinCEN regulations, and state money services business regulations to develop, implement, and maintain an effective anti-money laundering program that, among other things, includes a process for verifying customer identification, (ii) the SEC has recently published a Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 concluding that a virtual currency venture called the DAO was in fact the issuance of unregistered securities, and (iii) the IRS has issued published guidance which describes how the IRS will apply fundamental U.S. federal income tax principles to transactions involving convertible virtual currency. This blog focuses on the manner in which the IRS will apply fundamental U.S. federal income tax principles and information reporting requirements to convertible virtual currency transactions.

There are numerous convertible virtual currencies in existence today, the most prominent of those being Bitcoin. Bitcoin can be obtained in a number of different ways. Bitcoin users can trade bitcoins for other types of currency, *i.e.*, purchase and sell bitcoin, on an internet exchange website.[2] Bitcoin users can also accept Bitcoin from other people in exchange for goods or for the performance of services, such as designing websites. Lastly, Bitcoin can be earned through a process known as "mining." Each virtual currency transaction is verified using open-source software across a network of individual computers all over the world, connected via the Internet. Some of those computers, called "miners," are tasked with adding "blocks" of verified transactions to the "blockchain". The term "blockchain" refers to the shared, encrypted accounting ledger stored on the decentralized global computer network of all Bitcoin users. Each new "block" added by the "miners" contains a group of virtual currency transactions that have been submitted for verification since the previous "block" of transactions were verified. The mining system ensures that new transactions are valid in light of prior transactions, *i.e.*, that a sender has enough bitcoin to fund a later submitted transaction. The "mining" process repeats time and time again, resulting in the creation of a continuous, ever-growing chain of blocks, or "blockchain," that continually updates to represent at any given moment a snapshot of the entire history of Bitcoin transactions. A "blockchain" thus maintains a permanent record of transactions of bitcoin between Bitcoin users.

The "mining" process is competitive, and requires the use of specialized computer hardware optimized for the mining task, which hardware consumes a large amount of electricity and generates an exceptional amount of heat, to the point that any computer not optimized for the mining task (*e.g.,* any computer without a powerful graphics card and processor) would likely take a period of years to mine any bitcoins. Miners use this sophisticated computer hardware to compete with other miners in solving complicated mathematical problems

that incorporate information about prior transfers to validate new transfers.[3] The miner or group of miners that win the race to complete the next "block" of the shared transaction log by generating a valid answer to the complex mathematical problem are paid by the Bitcoin system in newly generated Bitcoins for their work.

In March of 2014, the IRS issued Notice 2014-21 (the "IRS Virtual Currency Notice"),[4] which describes how the IRS applies fundamental U.S. federal income tax principles to transactions involving convertible virtual currency. In the IRS Virtual Currency Notice, the IRS stated its position based on fundamental federal income tax principles: virtual currencies that can be converted into traditional currency are property for tax purposes, and a taxpayer can have a gain or loss on the sale or exchange of a virtual currency, depending on the taxpayer's cost to purchase the virtual currency, *i.e.*, the taxpayer's tax basis.[5] The main thrust of the IRS Virtual Currency Notice is that convertible virtual currency users will be subjected to fundamental income tax principles applicable to property transactions analogous to those applicable to the sale, exchange, or other disposition of real property, stocks, and bonds.

Pursuant to the fundamental income tax principles applicable to property transactions articulated in the IRS Virtual Currency Notice, the following virtual currency transactions are reportable in the manner indicated:

1. If an employee receives wages, salary, or other income from an employer in the form of virtual currency, then any such payments so received are reportable by the employee as ordinary income, and will be subject to employment taxes paid by the employer.[6]
2. If a self-employed individual receives virtual currency from a service recipient in exchange for providing goods or services, then any such payments so received are reportable as ordinary income, and will be subject to self-employment tax. This rule would apply to a person engaged in the trade or business of "mining" virtual currency.[7]
3. If virtual currency is received by a business in exchange for goods or services, then any such payments received are reportable as ordinary income.[8]
4. If virtual currency is exchanged for other property, then any taxable gain attributable to such exchange is generally reportable as a capital gain if the virtual currency so exchanged was held by the taxpayer as a capital asset, and reportable as ordinary income if the virtual currency is property held mainly for sale to customers in a trade or business.[9]
5. If property held as a capital asset is exchanged for virtual currency, then any taxable gain attributable to such exchange is generally reportable as a capital gain.
6. Any payments made in virtual currency are subject to the same information reporting requirements as payments made in property, real currency or instruments denominated in real currency. For example, (i) gains and losses attributable to virtual currency transactions may need to be reported on Form 8949 (Sales and Other Dispositions of Capital Assets), which is attached to Schedule D of a Form 1040; (ii) payments made by a person engaged in a trade or business to an independent contractor using virtual currency for the performance of services may require reporting of such payments to the IRS and to the payee on Form 1099 MISC, Miscellaneous Income; and (iii) payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property, so payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee, and the payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required. Note that a bitcoin is not a "covered security" for Form 1099-B issuance purposes, so bitcoin investors and the IRS don't receive a Form 1099-B from Bitcoin exchanges.[10]

In the view of the IRS, taxpayers who have engaged in such virtual currency transactions and have not properly reported them may be subject to penalties for failure to comply with tax laws. For example, the IRS Virtual Currency Notice provides that (i) underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under IRC Section 6662; and (ii) failure to timely or correctly report virtual currency transactions when required to do so may subject taxpayers to information reporting penalties under IRC Section 6721 and IRC Section 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or

failure to properly file information returns is due to reasonable cause.

Due to an increasing public perception that virtual currency can be used to evade taxes, including at least one instance of open acknowledgement by Bitcoin users that tax evasion is a sought-after feature of using bitcoins, and reports issued in 2013 and 2014 by the Government Accountability Office at the request of the Senate Finance Committee regarding tax compliance issues relating to virtual currencies, the IRS has recently stepped up enforcement efforts to identify U.S. persons who conducted transactions in a convertible virtual currency, and to correct the federal income tax liability of U.S. persons who failed to report and pay applicable federal income taxes attributable to such transactions.

In fact, on November 17, 2016, the United States filed a lawsuit in federal district court requesting an order permitting the United States to serve a "John Doe" administrative summons ("IRS Summons") on Coinbase, Inc., an exchange that deals in convertible virtual currency, operating a bitcoin wallet and exchange business headquartered in San Francisco, CA.[11] The IRS Summons "seeks information regarding United States persons who, at any time during the period January 1, 2013, through December 31, 2015, conducted transactions in a convertible virtual currency as defined in the IRS Virtual Currency Notice."

The takeaway from this blog is U.S. taxpayers that invested in and/or spent convertible virtual currency may have realized and recognized some form of income (or incurred a loss) that should be reported on an appropriate U.S. tax and/or information return. Although the scope of the IRS Summons has narrowed considerably since inception of the litigation, the Coinbase, Inc. case continues to demonstrate the need for taxpayers engaged in virtual currency transactions to be proactive about correcting prior tax returns, if necessary, and in ensuring compliance with the U.S. internal revenue laws on a going forward basis.

Consideration should be given to engaging appropriate tax advisors to assist with these matters.

For more information, please contact Mark Wisniewski on our Business, Finance and Tax Team.

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[1] 12 U.S.C. §§ 1829(b), 1951-1959 (2003); 31 U.S.C. §§ 5311-5322 (2003).

[2] To purchase virtual currency, the purchaser needs to locate someone who already has virtual currency and wishes to exchange it for traditional currency, and to find an intermediary capable of effectuating the exchange. This type of exchange is generally handled through companies engaged in the business of facilitating virtual currency exchanges that trade between virtual currencies and traditional currencies. These exchangers operate in a manner analogous to exchangers of traditional currency.

[3] Mining combines information from previous transactions of Bitcoin system users who have submitted new transactions to the network to ensure that the new transactions would be valid, *i.e.*, that the sender of bitcoin in the new transaction has enough bitcoin to satisfy the funding obligations necessary to consummate the new transaction. The information derived from history of that sender's prior transactions is collapsed into a complex equation with one empty variable. The mining computers use brute force to repeatedly guess that empty variable to generate an acceptable result/answer. The first miner or group of miners to arrive at an acceptable result/answer then circulates the answer/result to other miners for confirmation, and then the block of new transactions are added to the blockchain. Word on the street is the current block reward for Bitcoin is 12.5 bitcoin every 9.5 minutes, or approximately $130,000.00 USD per 9.5 minutes.

[4] IRS Notice 2014-21, 2014-16 IRB ; IR 2014-36, 03/25/2014.

[5] FAQ #5 of the IRS Virtual Currency Notice provides that for U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars, and taxpayers will be required to determine the **fair market value** of virtual currency in U.S. dollars as of the date of payment or receipt. FAQ #5 further provides that if a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied. As a practical matter, none of the virtual currencies are listed on established and regulated exchanges, *i.e.*, the exchanges are all "non-compliant"/illegal, and as a result the

issues of valuation are subject to artful and inconsistent analysis. This is a systemic problem that has not yet been addressed by the IRS.

[6] FAQ #11 of the IRS Virtual Currency Notice provides that the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement. It is important to note that the IRS will not accept bitcoin which complicates payment of these employment taxes, and may require more complex arrangements/conversion into fiat.

[7] FAQ #8 of the IRS Virtual Currency Notice provides that when a taxpayer successfully “mines” virtual currency, the fair market value of the virtual currency obtained thereby as of the date of receipt is includible in gross income, and FAQ #9 provides that if a taxpayer's “mining” of virtual currency constitutes a trade or business, and the “mining” activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax.

[8] FAQ #4 of the IRS Virtual Currency Notice provides that the basis of virtual currency that a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in U.S. dollars as of the date of receipt.

[9] FAQ #6 of the IRS Virtual Currency Notice provides that if the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain, and the taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.

[10] See generally IRC Section 6045. As a practical matter, Bitcoin exchanges do not maintain cost-basis information, and do not provide taxable income reports to users.

[11] Petition Ex Parte for Leave to Serve “John Doe” Summons against All Defendants, In re Tax Liabilities of John Does, 3:16-cv-06658-JSC (N.D. Cal. Nov. 17, 2016).

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