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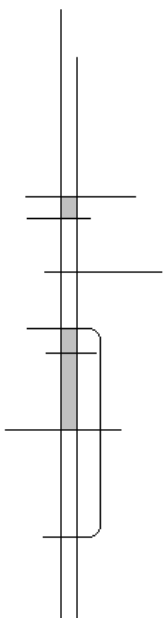
A LAWYER'S TAKE ON  
BITCOIN AND TAXES

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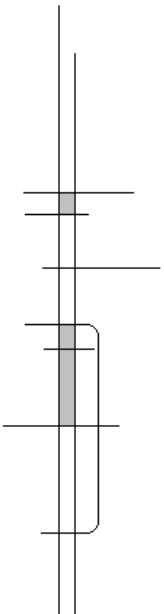
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# Introduction

Bitcoin is a new idea. Nothing like it has ever existed before. Until recently, the value of Bitcoins was not worth mentioning. The dramatic rise in market value has created an even newer problem. How is the IRS going to tax Bitcoins?

Bitcoin transactions are taxable. Unfortunately, the US tax code was not written with Bitcoin in mind. All of the tax rules, regulations, categories, and definitions were created before Bitcoin existed. Bitcoin does not fit neatly into any one of them. Bitcoin shares some characteristics of many types of transactions but does not match all of the characteristics of any one type. This ambiguity can cause stress and uncertainty for Bitcoin users.

Although a handful of other countries have formal approaches to taxing digital currencies<sup>1</sup>, there is almost no guidance from the IRS<sup>2</sup> on how Bitcoin should be treated for tax purposes, even though the IRS<sup>3</sup>, congress and other authorities<sup>4</sup> have known about the taxation problem with digital currencies for many years. It will probably be a very long time before there is any comprehensive policy or approach to taxation of Bitcoin transactions in the

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<sup>1</sup> Adam Chodorow, *Tracing Basis Through Virtual Spaces*, 95 Cornell L. Rev. 283 (2010).

<sup>2</sup> Nina Olson, Nat'l Taxpayer Advocate, 2008 Annual Report to Congress 213-26 (2008), [http://www.irs.gov/pub/irs-utl/08\\_tas\\_arc\\_intro\\_toc\\_msp.pdf](http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf); Flora Graham, *Slapping a Tax on Playtime*, <http://news.bbc.co.uk/2/hi/technology/7746094.stm>

<sup>3</sup> Dustin Stamper, *Taxing Ones and Zeroes: Can the IRS Ignore Virtual Economies?*, 114 TAX NOTES 149 (Jan. 15, 2007)

<sup>4</sup> [http://www.forbes.com/2008/04/15/taxes-congress-virtual-biz-beltway-cz\\_ae\\_0416beltway.html](http://www.forbes.com/2008/04/15/taxes-congress-virtual-biz-beltway-cz_ae_0416beltway.html); <http://www.house.gov/jec/news/news2006/pr109-98.pdf>

US.<sup>5</sup>

Without guidance from the IRS or specific rules enacted by Congress, the best that can be done is to make a good faith effort to apply the current tax laws to specific Bitcoin transactions. Every application of current laws to Bitcoin transactions will require some application of laws in ways that have never been done before.

Tax law sometimes prefers administrative convenience<sup>6</sup> over puritanical application to make tax collection easier for both the IRS and the taxpayer. There are two doctrines that exemplify this point.

The economic substance doctrine allows the IRS to look at the economic reality<sup>7</sup> of a transaction for tax purposes, disregarding the technical form of the transaction. This doctrine of substance over form for tax purposes does not directly address the problem of classifying an item that is difficult to classify for tax purposes, but it does represent an overall principle that the IRS can look to the overall reality of what is taking place, rather than apply rigid rules. When tax law does not deal specifically with a certain type of transaction, the rule that best fits the reality of the overall transaction may be applied. Another doctrine found in several cases is the treatment of foreign currencies like a commodity for tax purposes.<sup>8</sup>

It is not wise for tax payers to neglect a good faith attempt at tax compliance of Bitcoin transactions. Fines and penalties for honest mistakes can be bad enough, but willful failure to make an attempt or fraudulent tax filings can carry very severe civil and criminal consequences.<sup>9</sup>

Complying with the tax code also means that there may be legitimate deductions that are available to Bitcoin users that might reduce their tax

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<sup>5</sup> Adam Reuters, *Virtual Economy Tax 'Would be a Mistake'* – US Rep, REUTERS, Oct. 18, 2006; <http://secondlife.reuters.com/stories/2006/10/18/virtual-economy-tax-would-be-a-mistake-us-rep/>

<sup>6</sup> *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991); *United States v. Centennial Sav. Bank FSB*, 499 U.S. 573 (1991).

<sup>7</sup> *Gregory v. Helvering*, 293 U.S. 465 (1935); *Grodt v. McKay Realty Inc. v. Comr.*, 77 T.C. 1221 (1981); *Falsetti v. Commissioner*, 85 T.C. 332 (1985).

<sup>8</sup> *Gillin v. United States*, 423 F.2d 309 (Ct. Cl. 1970) (“[Foreign currency] is frequently treated, not as the medium of exchange, but as property or a commodity.”); *KVP Sutherland Paper Co. v. United States*, 344 F.2d 377 (Ct. Cl. 1965); *B.F. Goodrich Co. v. Commissioner*, 1 T.C. 1098 (1943); *North Am. Mortgage Co. v. Commissioner*, 18 B.T.A. 418 (1929); *Wheatly v. Commissioner*, 8 B.T.A. 1246 (1927).

<sup>9</sup> Internal Revenue Code (IRC) §§ 7201 et seq.

liability. Failure to attempt to comply with tax law means that these legitimate deductions might not be available.

This guide is to assist Bitcoin users in their tax planning and to alert them to the general tax principles that might apply. Scholars have been debating the taxation of digital currencies for several years, without any consensus as to how they are to be treated for tax purposes.<sup>10</sup> Each circumstance will be different, so each Bitcoin user, with a well qualified tax preparer, should decide which tax position they think is most justified by the facts and law of their unique case, whether that position is explained here or not.

Since there is no overall guidance on how to tax Bitcoin transactions, individual IRS agents will have a lot of discretion in their treatment of Bitcoin transactions. One IRS agent may accept one particular tax position while another IRS agent rejects the same position on a very similar set of facts. The IRS is also not bound by any prior informal statements.<sup>11</sup> However, if a good faith effort was made to comply with the tax code, the penalties and fines will probably be minimized if a taxpayer's position is ultimately rejected.

Even if Bitcoin is made illegal in the US, there will still be potential tax implications. Even illegal transactions are taxable.<sup>12</sup> Also, the decentralized nature of Bitcoin means that it will still exist, and probably be legal, in several other countries around the world. It is very plausible to believe that US citizens will still use Bitcoin in countries where it is legal for them to do so.

The question is how will digital currencies be taxed, at what rate, and when.

## Four Main Approaches To Bitcoin Taxation

There are four main approaches (and one non-approach) that might be taken to begin to answer these tax questions. These approaches are the broad legal foundation for applying a specific tax treatment to specific Bitcoin taxable

<sup>10</sup> Nell Beekman, *Virtual Assets, Real Tax: The Capital Gains/Ordinary Income Distinction in Virtual Worlds*, 11 Colum. Sci. & Tech L. Rev. 152 (2010); Adam Chodorow, *Tracing Basis Through Virtual Spaces*, 95 Cornell L. Rev. 283 (2010); Steven Chung, *Real Taxation of Virtual Commerce*, 28 VA. TAX REV. 733, 763 (2009); Theodore P. Seto, *When Is a Game Only a Game?: The Taxation of Virtual Worlds*, 77 U. CIN. L. REV. 1027 (2009); Bryan Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 *Hastings L.J.* 1 (2007); Leandra Lederman, *Stranger Than Fiction: Taxing Virtual Worlds*, 82 N.Y.U. L. Rev. 1620, 1628-30 (2007)

<sup>11</sup> I.R.C. § 6011; *Parker v. Comm'r*, 365 F.2d 792 (8th Cir. 1966).

<sup>12</sup> *James v. United States*, 366 U.S. 213 (1961); *Comm'r v. Tellier*, 383 U.S. 687 (1966)

events. There is no guarantee that the IRS will accept these approaches, but taking one of them could be used to demonstrate a lack of willfulness to avoid tax compliance.

### **The Barter Club Unit Approach**

The first approach that can be taken is that Bitcoins could be taxed like barter club units. There are barter clubs all over the US where participants agree to exchange goods and services using club units. The difference between Bitcoin and barter club units is that Bitcoin is decentralized and worldwide. The economic substance of the transactions are almost identical. Treating Bitcoins like barter club units for tax purposes means less mental gymnastics than any other approach and there are already well established methods for taxing barter club units.<sup>13</sup>

Although digital currencies do not fit the definition of a barter exchange, the substance of participating in a digital currency is very much like participation in a barter exchange organization.<sup>14</sup> The IRS regularly looks to the economic substance, rather than form, of the transaction for tax purposes.<sup>15</sup> For example, barter club units are treated as income at the time they are received so barter club units can be treated as expenses at the fair market value (FMV) of the units at the time they are incurred.<sup>16</sup> The same treatment could be applied to Bitcoin income and expenses.

Another possible approach would be to treat Bitcoin transactions as direct barter transactions, another area where there is some tax guidance.<sup>17</sup> The difficulty with this approach will be whether to treat the Bitcoins themselves as **property** or to treat access to the Bitcoins as a **service** because there will be different tax implications for the two classifications.

### **The Property Approach**

To tax Bitcoin transactions as bartering for property, a unique digital item like

<sup>13</sup> *Barter Sys., Inc. v. Comm'r*, 59 T.C.M. (CCH) 72 (1990)

<sup>14</sup> I.R.C. § 6045

<sup>15</sup> *Gregory v. Helvering*, 293 U.S. 465 (1935)(note however that this rule generally applies in a different context); *Eisner v. Macomber*, 252 U.S. 189 (1920)(determining what constitutes income).

<sup>16</sup> *Barter Sys., Inc. v. Comm'r*, 59 T.C.M. (CCH) 72 (1990); Treas. Reg. § 1.61-2(d)(1); Rev. Rul. 80-52,1980-1 C.B. 100

<sup>17</sup> Rev. Rul. 79-24, 1979-1 C.B. 60 ; Rev. Rul. 80-52,1980-1 C.B. 100

Bitcoins must first be recognized as property. Tax courts rely on state courts to determine what is property.<sup>18</sup> Once the states determine there is a property right in Bitcoins, the federal tax courts can then determine whether that property is taxable.<sup>19</sup> To date there have been no cases squarely deciding the issue of whether Bitcoin, or any other digital currency, is property.<sup>20</sup>

There have been cases which have decided that an email is property and that computer code is property.<sup>21</sup> By analogy, these property rights already granted in intangible computer code could also extend to Bitcoins. Trading any one of those items of traditional property in a barter transaction would have clear tax effects, and so might trading Bitcoins.

### **The Services Approach**

It is also possible to barter with services. If Bitcoins are not taxable property, providing access to them could be a service and the rules for bartering with services will apply.<sup>22</sup> This classification is potentially easier for a tax court to reach in the near term because they would not have to sail in uncharted legal waters regarding property rights in Bitcoins themselves. The tax effects of bartering the services of providing access to Bitcoins would be very different from the effects of bartering with Bitcoins as property.

### **The Foreign Currency Approach**

Another plausible approach is that Bitcoins could be treated as a foreign currency. Although it is not clear whether digital currencies fall under the definition of foreign currency, functional currency, or non-functional currency,<sup>23</sup> the overall similarity of Bitcoin transactions to foreign currency transactions may support tax treatment as such. Some commentators have suggested that a foreign currency approach is the best approach for digital

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<sup>18</sup> *United States v. Craft*, 535 U.S. 274 (2002)

<sup>19</sup> *Morgan v. Comm'r*, 309 U.S. 78 (1940)

<sup>20</sup> *Bragg v. Linden Research, Inc.*, 487 F. Supp. 2d 593 (E.D. Pa. 2007) (Settled before property issue could be decided by court)

<sup>21</sup> *Intel v. Hamidi*, 71 P.3d 296 (Cal. 2003); *Hancock v. State*, 402 S.W.2d 906 (Tex. Crim. App. 1966)

<sup>22</sup> Treas. Reg. § 1.61-2(d)

<sup>23</sup> I.R.C. § 988



currencies.<sup>24</sup>

### **The “Cash Out” Method Is A Non-Approach**

There is another non-approach that is nonetheless probably on the minds of many. Some might be tempted to believe that digital currency transactions are not taxable until they are ultimately exchanged for cash. There may be some very weak support for the “cash out” method,<sup>25</sup> and it is easy to see why many would be enticed to apply it. If income in Bitcoins is not taxed until it is exchanged for cash, then recognition of income, and therefore income tax, can be deferred,<sup>26</sup> potentially indefinitely. The allure of never having to pay income tax is probably too good to be true. The legal justification for such an approach is extremely weak when compared to other positions and does not reflect the economic reality of the transactions. It is almost a non-position.

Once a taxpayer has chosen an approach, they need to apply the rules of that approach to all taxable events. Each approach will affect a wide range of taxable transactions in many different ways. Individuals and businesses will be affected differently depending on the approach and transaction. Even different types of businesses will have different tax treatments for similar transactions. There will undoubtedly be some transactions that would be more beneficial to treat under one approach while a different transaction would be more beneficial under another approach. Do not yield to the temptation to mix approaches. It will undermine the credibility of your arguments supporting your approach and could lead to tax adjustments, fines and penalties.

Following is a practical examination of the major tax issues for individuals and businesses that use Bitcoins and how they might plan their tax approach. Taxes and how they are applied to any situation is a highly complex task. There is no way to apply this general overview of possible tax implications and principles to any single situation. Each individual should consult directly with a tax professional for advice on their own situation and to prepare their taxes.

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<sup>24</sup> Steven Chung, *Real Taxation of Virtual Commerce*, 28 VA. TAX REV. 733 (2009); Leandra Lederman, *EBay’s Second Life: When Should Virtual Earnings Bear Real Taxes?*, 118 YALE L.J. POCKET PART 136 (2009)

<sup>25</sup> I.R.C. § § 109, 1031; Treas. Reg § 1.61-2(d)(1); William D. Terando et al., *Taxation Policy in Virtual Worlds: Issues Raised by Second Life and Other Unstructured Games*, 6 J. LEGAL TAX RES. 94 (2008); Dustin Stamper, *Taxing Ones and Zeroes: Can the IRS Ignore Virtual Economies?*, 114 TAX NOTES 149 (Jan. 15, 2007)

<sup>26</sup> Timothy Miano, *Virtual World Taxation: Theories of Income Taxation Applied to the Second Life Virtual Economy*, ExpressO, Available at: [http://works.bepress.com/timothy\\_miano/1](http://works.bepress.com/timothy_miano/1)

# The Record Keeping Problem

Records are not just important to double check and verify tax information, you are required to keep adequate tax records.<sup>27</sup> Credit card, checking and bank transactions create numerous records automatically. Cash transactions can take place with no record at all. Bitcoin transactions fall somewhere in between and have some records, but very few, created automatically.

Tax compliance and accuracy increases when a third party is reporting tax information.<sup>28</sup> Even conscientious taxpayers can benefit when they have the records of a third party to double check their own tax records. When accounts or transactions are not automatically reported to the IRS and they are accidentally overlooked by the taxpayer, they are very rarely discovered by the IRS, even in an audit.<sup>29</sup>

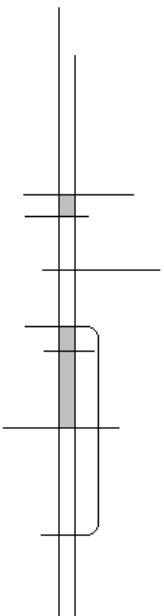
Bitcoin accounts and transactions are not recorded and reported to the IRS. Unlike banks, Bitcoin exchanges and electronic wallet services are almost entirely unregulated so there are no applicable IRS reporting requirements for those service providers. Because Bitcoins are not restricted by borders or language, even if third party information reporting was required, many third parties would be outside of US jurisdiction where they do not have to comply with reporting requirements and would be hard to compel.

<sup>27</sup> I.R.C. § 6001

<sup>28</sup> See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 Stan. L. Rev. 695 (2007).

<sup>29</sup> Bryan T. Camp, *The Play's The Thing: A Theory of Taxing Virtual Worlds*, 59 Hastings L. J. 1 (2007).

There is no guarantee that third parties will even be able to provide sufficient records for tax purposes if they were asked. They may not keep track of records or the records might be anonymized. This means that US taxpayers who use Bitcoins will be responsible for their own adequate documentation of transactions with tax implications.



# Income Taxes

Income earned anywhere in the world, in any form, from any source is taxable in the US.<sup>30</sup> The only requirement is that someone receives and can exercise control over something of value.<sup>31</sup> Worldwide income includes income from virtual sources.<sup>32</sup> Bitcoin income is taxable. Exactly how to recognize income and the applicable rate will depend on the approach that is taken.

## Bitcoins as Barter Club Units

Barter club units are taxable as income at their fair market value (FMV) in the year they are received.<sup>33</sup> If Bitcoins are treated as barter club units for tax purposes, they will also be taxable as income, at their FMV, in the year they were received.

## Bitcoins as Barter Property or Service

Bartering can create taxable income.<sup>34</sup> Barter income is earned any time goods or services are exchanged instead of a currency. The FMV of the goods or

<sup>30</sup> I.R.C. § 61; Treas. Reg. §1.61-1 (2007); *Helvering v. Horst*, 311 U.S. 112 (1940); *Clark v. Comm'r*, 95 T.C.M. (CCH) 1265 (2008)

<sup>31</sup> *Helvering v. Horst*, 311 U.S. 112 (1940); *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); Treas. Reg. § 1.1001-1(a) (2007)

<sup>32</sup> *Clark v. Comm'r*, 95 T.C.M. (CCH) 1265 (2008)

<sup>33</sup> I.R.C. § 451; *Barter Sys., Inc. v. Comm'r*, 59 T.C.M. (CCH) 72 (1990); Treas. Reg. § 1.61-2(d); Treas. Reg. § 1.451-1(a); Rev. Rul. 80-52, 1980-1 C.B. 100; Rev. Rul. 79-24, 1979-1 C.B. 60-61; Rev. Rul. 70-331, 1970-1 C.B. 14 (including “prize points” in income)

<sup>34</sup> Rev. Rul. 79-24, 1979-1 C.B. 60; *see also* Treas. Reg. §1.61-1, 2

services received (minus the cost paid)<sup>35</sup> is the amount of income that must be recognized.<sup>36</sup> If both parties to a barter transaction are subject to US taxation, both need to report the fair market value of the goods or services received as income.

If Bitcoins are treated like **property** or a **service**, receipt of Bitcoins would be treated as income, if their value exceeds the value of property or services exchanged for them.

### **Bitcoins as Foreign Currency**

Taxation of foreign currency transactions can be very complex.<sup>37</sup> For small businesses and individuals with some income, but not all, in a foreign currency, a short hand approach to the complex rules is that foreign currency income needs to be translated to its US dollar value at the time of receipt.<sup>38</sup> Bitcoins act much like a foreign currency so they might be considered a foreign currency for tax purposes.<sup>39</sup> As a foreign currency, the value of Bitcoin income needs to be translated into their US dollar value at the time of receipt and included as income.

Like most traditional foreign currencies, there is no official exchange rate for Bitcoins. A well known Bitcoin exchange, or a Bitcoin exchange that the taxpayer actually uses, needs to be used for the exchange rate. There are several Bitcoin exchanges which publish a value of Bitcoins in US dollars.<sup>40</sup>

### **Non-Taxable Income**

There are some types of income that are not taxable. Some non-taxable income includes receiving a loan or inheritance, among many others.<sup>41</sup>

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<sup>35</sup> This is a rough description of the concept of Basis, an essential element of the overall tax liability of any taxpayer using this approach. Basis is more fully described below.

<sup>36</sup> *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960); Rev. Rul. 79-24, 1979-1 C.B. 60

<sup>37</sup> I.R.C. §§ 911, 985, 987, 988, 989

<sup>38</sup> See Publication 54; <http://us.kpmg.com/microsite/ies/taa2007/content/chapter6.htm>

<sup>39</sup> Steven Chung, *Real Taxation of Virtual Commerce*, 28 VA. TAX REV. 733, 763 (2009); See Black's Law Dictionary (9th ed. 2009) ("An item (such as a coin, government note, or banknote) that circulates as a medium of exchange.").

<sup>40</sup> See <http://bitcoincharts.com/markets/>

<sup>41</sup> I.R.C. § 102

Following are some issues regarding non-taxable income that may be common among Bitcoin users.

### **Self Transfer**

Transfers from yourself to yourself are not taxable events, unless some type of gain is realized. Only the original receipt of that income is taxable in the year it was received. For both convenience and security, many people have several Bitcoin wallets. Transfers from one of your own wallets to another wallet that you own are not taxable.

### **Gifts**

Receipt of a gift is not taxable.<sup>42</sup> The gift must truly be a gift that proceeds from the detached and disinterested generosity of the giver.<sup>43</sup> The intent of the giver<sup>44</sup> must be to give a true gift and not as compensation or in exchange for something.

It is common in the Bitcoin community to ask for donations to a specific payment address as gifts. Receipt of such donations, if they are truly intended as gifts, are not taxable income.

Giving a gift does not reduce your income for income tax purposes. Only giving gifts to bona fide charities could result in a tax deduction.<sup>45</sup> The giver of a gift must pay tax on a gift (or gifts) worth more than \$13,000 to one person in a year (unless the gift is to a spouse<sup>46</sup>, etc.).<sup>47</sup> You can give as many gifts as you want for an infinite aggregate amount without any tax consequences if you don't give more than \$13,000 to any one person. There are also other considerations, like the lifetime exclusion amount, which gift givers should discuss with their tax preparer.

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<sup>42</sup> I.R.C. § 102; Treas Reg. § 1.102

<sup>43</sup> *Commissioner of Internal Revenue v. LoBue*, 352 U.S. 243 (1956)

<sup>44</sup> *Bogardus v. Commissioner*, 302 U.S. 34 (1937)

<sup>45</sup> I.R.C. § 2522

<sup>46</sup> I.R.C. § 2523

<sup>47</sup> I.R.C. §§ 2501, 2502, 2503

# GAINS

Gains can be taxable income.<sup>48</sup> Selling or exchanging property for more than its basis, essentially its cost, is a taxable gain unless some special exemption applies.<sup>49</sup>

The rate at which gains are taxed depends on several factors.<sup>50</sup> The type of activity that produces the gain, the type of property traded for a gain, and the length of time the property is held can all effect the tax rate.<sup>51</sup> Gains and losses can be extremely complex to determine for tax purposes. You should consult a tax professional to do so. The following principles are to help determine if you might have gains.

## Barter Club Units

Barter club units don't usually fluctuate in value relative to the dollar, so there are few, if any, examples of how to treat gains in barter club units that do. If you are treating Bitcoins like barter club units, any gains will probably be treated the same as either gains on barter for **property** or foreign currency gains.

<sup>48</sup> *Eisner v. Macomber*, 252 US 189

<sup>49</sup> Basis is discussed at more length later; See I.R.C. §§ 1(h),61, 1001, 1012, 1221; Treas. Reg. §§ 1.61-6, 1.1001-1; Rev. Rul. 76-249, 1976-2 C.B. 21.

<sup>50</sup> I.R.C. § 1001; Treas. Reg. § 1.1012

<sup>51</sup> *Id.*

## Barter for Property

A gain in the value of property is only taxable when there has been a realization event. The act of selling or exchanging property is a realization event.<sup>52</sup> A gain can be recognized in a barter situation if the FMV of goods or services received in exchange for property exceeds its basis.<sup>53</sup>

Almost all property that an individual or business owns is subject to capital gains tax.<sup>54</sup> The tax rate for capital gains is different depending on the length of time the property was held.<sup>55</sup>

Short term capital gains, those assets held for one year or less, are taxed at a maximum rate of 35%. Long term capital gains, anything held for more than one year, are taxed at 15%. The actual tax owed, or loss incurred, will be calculated after netting all short term and long term capital gains and losses in the proper manner.<sup>56</sup>

Although some have argued that all digital currency gains should be taxed as ordinary gains at the same rate as ordinary income,<sup>57</sup> if Bitcoins are treated as **property**, they would be subject to capital, rather than ordinary, gains because there are very few exceptions to the capital treatment of property. The taxpayer will then have to determine whether the Bitcoins are subject to the short-term or long-term rates, which can be very complex and is beyond the scope here.

There may be an exception to the capital treatment of gains for Bitcoin exchangers and dealers. When an asset is held for sale to customers, any gain is an ordinary gain.<sup>58</sup> Although digital items are usually not counted as inventory for sale to customers, Bitcoins are materially different from other digital items. Bitcoins are each unique and are not capable of exact

<sup>52</sup> I.R.C. § 1001; *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); Treas. Reg. § 1.1001-1, 2;

<sup>53</sup> I.R.C. § 1001

<sup>54</sup> I.R.C. § 1221; *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1976); Treas. Reg. § 1.1221-1(a) (noting that the term capital assets includes all classes of property not specifically excluded by section 1221)

<sup>55</sup> I.R.C. §§ 1(h), 1222, 1223, 1231

<sup>56</sup> I.R.C. § 1222

<sup>57</sup> I.R.C. §§ 1(c), (h); Nell Beekman, *Virtual Assets, Real Tax: The Capital Gains/Ordinary Income Distinction in Virtual Worlds*, 11 Colum. Sci. & Tech L. Rev. 152 (2010)

<sup>58</sup> I.R.C. § 1221(a)(1), (3); *Bielfeldt v. Comm'r*, 231 F.3d 1035 (7th Cir. 2000); Treas. Reg. § 1.1221-1(c)



duplication. Thus a Bitcoin dealer or exchanger might treat Bitcoin gains as ordinary, rather than capital gains.

### **Barter for Services**

There are no gains realized on the increased value of services. Thus, if access to Bitcoins is the **service** bartered for, there would be no gains applicable to their appreciation in value.

### **Foreign Currency**

Foreign currency gains, when engaged in business or investing activities, are ordinary gains.<sup>59</sup> Foreign currency gains of individuals engaging in personal activities are capital gains if the gain is over \$200.<sup>60</sup> Individual, personal gains of less than \$200 are not taxed.<sup>61</sup> The gain is only recognized when the foreign currency is converted back into US dollars. Individuals do not need to report a gain when they use their appreciated foreign currency to purchase things directly.<sup>62</sup>

A Bitcoin investor, or a Bitcoin dealer, would be engaged in business or investing activities and needs to report Bitcoin gains as ordinary gains. An individual or small business that receives Bitcoins would only be taxed on gains if and when they convert their Bitcoins into US dollars. If an individual buys a yacht directly with Bitcoins that have appreciated in value \$1 million since they were acquired, that gain is not taxable.

<sup>59</sup> I.R.C. § § 988(a)(1)(A) and 988(e)

<sup>60</sup> I.R.C. § 988(e)(3)

<sup>61</sup> I.R.C. § 262

<sup>62</sup> Treas. Reg. § 1.988-1(a)(9)(ii)

# BASIS

Determining a basis in a digital currency can be very complex.<sup>63</sup> There are different ways to calculate it based on whether you paid cash, whether you received units as a gift,<sup>64</sup> in exchange for goods or services, or if you have sold any units at a gain or loss.

Basis is usually the cost of the item.<sup>65</sup> If an item was received in a barter transaction, the basis is the fair market value at the time.<sup>66</sup>

Basis in Bitcoins may be very difficult to calculate. Each Bitcoin might have a different basis, and when a Bitcoin is spent, there is no way to know which one with which basis was spent. There is some support for allowing taxpayers to follow an aggregate basis of all of their Bitcoins.<sup>67</sup> Using the average basis has been disapproved of in other contexts.<sup>68</sup>

In some cases taxpayers may use a Last In First Out (LIFO)<sup>69</sup> method, or a

<sup>63</sup> I.R.C. §§ 109, 1011(a), 1012, 1016, 1019; Treas. Reg. §§ 1.61-2(d)(2)(i), 1.1012-1(a)

<sup>64</sup> I.R.C. § 1015; Treas. Reg. § 1.1015-1(a)

<sup>65</sup> I.R.C. § 1012

<sup>66</sup> *Phila. Park Amusement Co. v. United States*, 126 F. Supp. 184 (1954)

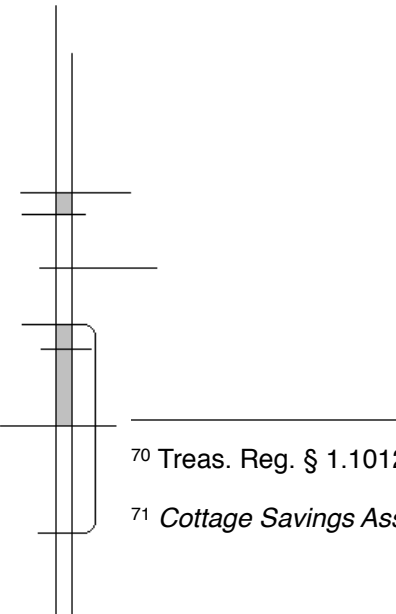
<sup>67</sup> Treas. Reg. § 1.61-6(a); Rev. Rul. 84-53, 1984-1 C.B. 159.

<sup>68</sup> Rev. Rul. 71-234, 1971-1 C.B. 148

<sup>69</sup> I.R.C. § 472(a)

First In First Out (FIFO)<sup>70</sup> method. Each of these is a fiction adopted for administrative convenience<sup>71</sup> rather than an exact description of what is really happening. If, however, the convention that a digital item cannot be treated as inventory, both the LIFO and FIFO method may not be a proper approach.

Determining basis may be a very complex task, no matter what method is chosen. Consult with a tax professional to determine potential basis in digital currencies.



<sup>70</sup> Treas. Reg. § 1.1012-1(c)

<sup>71</sup> *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991)

# RECORD KEEPING FOR INCOME

There is no explicit requirement to keep records of income. There are, however, numerous information returns which must be prepared by taxpayers and by third parties to verify the accuracy of reported income.<sup>72</sup> The threat of an audit, the secret process of audit selection, and the potential invasiveness of an audit<sup>73</sup> are all tools to ensure accurate reporting of income.<sup>74</sup> It is up to each taxpayer to truthfully account for their income<sup>75</sup> and to make a reasonable attempt to comply with the income tax provisions.<sup>76</sup> The burden of proof often rests on taxpayers.<sup>77</sup>

Although these record keeping rules are more often enforced regarding items that are not income, like credits, exclusions and deductions, because there is such a high requirement to accurately report taxes, taxpayers should make sure there are meticulous records of their taxable activity. Simple mistakes in reporting income can have severe penalties.

In many cases, the information returns prepared by third parties, like W-2 forms and 1099 forms, help taxpayers accurately report income. Also, the bank transactions, credit card transactions and receipts produced help keep

<sup>72</sup> I.R.C. §§ 6031-6053

<sup>73</sup> Treas. Reg. § 601.105(b)(3)

<sup>74</sup> I.R.C. § 6103(b)(2)

<sup>75</sup> I.R.C. § 7202

<sup>76</sup> I.R.C. § 6662

<sup>77</sup> *Mary Frances Allen v. Commissioner*, 16 T.C. 163 (Tax Ct. 1951)

track of financial activity.

Keeping good records is especially important when there is an item of income that is not taxable, such as loan proceeds, gifts or inheritance. Since income is defined so broadly,<sup>78</sup> all income is essentially taxable unless the taxpayer can prove otherwise in deficiency actions.

Individuals who give Bitcoin gifts who are not subject to the US tax system may not understand the importance of keeping good records when they do so. The recipient should ask for a note or an email from the giver indicating clearly that the Bitcoins they have received are a gift without expectation of something in return, or whatever the case may be. This is especially true if the giver is a foreign person or entity. The recipient of gifts worth more than \$100,000 combined from foreign persons requires filling out an information return for those gifts.<sup>79</sup> Failure to file the information return could lead to penalties.

Carefully document what Bitcoin wallets you had at what time. Transfers between several of your own wallets needs to be proven. If an inspection of those records is done, and you have failed to disclose that one of those wallets is yours, a transfer from that wallet may be erroneously included as income.

Bona fide loans should be provable by a record of the loan. Emails to and from the lender describing the loan and its terms or a drafted document can help prove the source of non-taxable loans. Evidence of loan payments can also be helpful proof that the loan is not overlooked income.

You should also keep a very accurate ledger of when Bitcoins are acquired and sold, the price for each and the amount, to make sure that you have an accurate record of your basis in digital currencies to calculate potential gains. If you purchase an existing wallet from another individual, you should record the proper information since taxing authorities will have no knowledge of that transaction without your reporting of it.

The IRS claims the right to inspect all tax records,<sup>80</sup> so make sure that your records accurately reflect the reality of your financial transactions.

<sup>78</sup> I.R.C. § 61

<sup>79</sup> I.R.C. § 6039F; Form 3520

<sup>80</sup> I.R.C. § 7602

# DEDUCTIONS

Both businesses and individuals can deduct certain expenses from their taxes.<sup>81</sup> The actual deductions allowable will depend on the exact situation. Business expenses must be ordinary and necessary to be deductible.<sup>82</sup> Business deductions can be taken as long as you have a hope of profit from some activity that you have expenses for. There is no need to be operating a formal business to take a business deduction.<sup>83</sup>

## **Barter Club Units, Barter for Property and Barter for Services**

Although there is no official guidance on how to treat expenses incurred in any barter situation, the law does not limit recognizing expenses to those incurred in currency and does not prohibit deducting expenses incurred in barter transactions.<sup>84</sup> If the FMV of a **service** or **property** received as barter

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<sup>81</sup> I.R.C. §§ 161 et seq., 211 et seq., 262 et seq.

<sup>82</sup> *Commissioner v. Groetzinger*, 480 U.S. 23 (1987); *Welch v. Helvering*, 290 U.S. 111; I.R.C. § 162; Treas. Reg § 1.162

<sup>83</sup> Treas. Reg. § 1.212-1

<sup>84</sup> Note that there is serious confusion as to the deductibility of barter items. IRS Publication 535 claims that only the basis or out of pocket costs are deductible while a memorandum from the National Office of Technical Advice dated August 14, 2001 claims that barter expenses can be deductible expenses. Neither of those sources can be cited as precedent, and the IRS does not have to follow its own publications, so the only authority is code sections and regulations. See generally IRS National Office of Technical Advice Memorandum Number 200147032, August 14, 2001 - <http://www.irs.gov/pub/irs-wd/0147032.pdf>; Office of Chief Counsel of the IRS Memorandum Number 200411042, March 12, 2004 - <http://www.irs.gov/pub/irs-wd/0411002.pdf>; <http://www.irs.gov/businesses/small/article/0,,id=188095,00.html>; see *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960); and I.R.C. § 6110(k)(3).

is recognized as income, the corollary that an ordinary or necessary business expense paid in **property** or **services** is deductible at the fair market value of the goods or services received.<sup>85</sup>

### **Foreign Currency**

Individuals who do not qualify as a QBU can translate their deductible expense into US dollars at the time of the transaction.<sup>86</sup> Foreign currency losses, discussed more in depth later, are not deductible.<sup>87</sup>

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<sup>85</sup> *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960); Rev. Rul. 79-24, 1979-1 C.B. 60; See I.R.C. § 421; see also Treas. Reg. §1.61-1

<sup>86</sup> See I.R.C. § 985(a); see Publication 54; <http://us.kpmg.com/microsite/ies/taa2007/content/chapter6.htm>

<sup>87</sup> I.R.C. §§ 165, 988 (e)(3); See also *Quijano v. United States*, 93 F.3d 26 (1996); Treas. Reg. §§1.165-1, 1.988-1T; and Rev.Rul.90-79,1990-2C.B.187 [dealing with gain and loss on foreign currency loan].

## RECORD KEEPING FOR DEDUCTIONS

The burden is on the taxpayer to provide sufficient documentation to prove deductions.<sup>88</sup> The documentation required will vary depending on the item, however it will generally include such items as the amount, time, place, business purpose, use, a description and the business relationship.<sup>89</sup>

Record keeping may be difficult in the Bitcoin economy where transactions are occurring all over the world. Many people who live in countries with different tax codes may not create sufficient records of bills, invoices or receipts, and may not create any records at all. The Bitcoin network itself does not maintain a sufficient record.

Preparing your own record at or near the time of the transaction has a high degree of credibility regarding the deductions claimed.<sup>90</sup> Keeping a regular log or diary of expenses, statements issued to suppliers and creditors of your own accounting, and an account book can be used along with other documentary evidence such as emails from suppliers and service providers, and other records of dealings could be sufficient. Computer records are perfectly acceptable.

If you do not have sufficient documentation, your own oral or written statements after the fact could serve to supplement the documentation that you

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<sup>88</sup> *Andrews v. Commissioner*, 931 F.2d 132 (1st Cir. 1991); I.R.C. § 274; Treas.Reg. § 1.274-5T

<sup>89</sup> Treas.Reg. § 1.274-5T

<sup>90</sup> Treas. Reg. § 1.274-5T(c)



do have.<sup>91</sup> Oral statements carry much less weight than written or electronic records because written or computer records are considered less subject to error.

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<sup>91</sup> Treas. Reg. § 1.274-5T(c)

# LOSSES

Gains and losses are very complex. If you have a possibility of gains or losses, you should consult a tax professional. Following are some helpful guidelines to alert you to possible issues.

Losses are recognized by a business or a person transacting for profit<sup>92</sup> when an asset is sold for less than its basis.<sup>93</sup> Losses could be ordinary or capital losses. Capital losses can be either short or long term. Each will be taxed differently depending on the situation and netted against gains.<sup>94</sup> You can only deduct a maximum of \$3,000 capital loss in one year, but losses exceeding \$3000 can be carried forward and deducted in future years.<sup>95</sup>

If digital currencies are treated as **property**, they will be subject to losses. If they are considered capital assets,<sup>96</sup> they will be subject to capital loss treatment.

Some losses are deductible from taxes. When you sell an asset like a digital currency for less than your basis (basically less than you bought them for) you have a loss. If you held the digital currency units sold for more than one year it is a long term capital loss. If you held them for less than one year it is a

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<sup>92</sup> I.R.C. § 165

<sup>93</sup> I.R.C. § 1001; Treas. Reg. § 1.61-2(d)

<sup>94</sup> I.R.C. §§ 165, 1211, 1212, 1222

<sup>95</sup> I.R.C. §§ 1211, 1212, 1222

<sup>96</sup> Treas. Reg. § 1.1221-1(a) (noting that the term capital assets includes all classes of property not specifically excluded by section 1221)

short term capital loss. Digital currency dealers will recognize an ordinary loss if they treat units as inventory.<sup>97</sup>

If Bitcoins are treated as foreign currency they would be subject to currency rules. Individuals cannot deduct any foreign currency losses that result when converting currency back into US dollars.<sup>98</sup> If digital currency is used to purchase goods and services directly and there is a loss on the value of the digital currency, the loss will not be deductible.<sup>99</sup>

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<sup>97</sup> *Bielfeldt v. Comm'r*, 231 F.3d 1035, 1037 (7th Cir. 2000); I.R.C. § 1221(a)(1),(3); Treas. Reg. § 1.1221-1(c);

<sup>98</sup> I.R.C. §§ 988 (e)(3), 987(3)(B)

<sup>99</sup> Treas. Reg. § 1.988-1(a)(9)

## CASUALTY

Losses from the damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual, may be deductible. This is probably most applicable to Bitcoin, where each user is responsible for their own wallet. If you lose your Bitcoin wallet or your Bitcoin wallet becomes damaged or destroyed due to a fire, flood, earthquake, volcano, Godzilla or vandalism, you may be able to deduct the loss.<sup>100</sup>

Losses that are not deductible are things that are not considered sudden, unanticipated or unusual. Forgetting your password, spilling coffee on your hard drive, losing your laptop, or if your dog eats your USB drive that holds your Bitcoin wallet, will probably not be considered a deductible casualty.

## RECORD KEEPING FOR CASUALTY

Your records must show the type of casualty that occurred, the date that it happened, and whether there is any claim for reimbursement, like insurance. You must have been the owner of the property and the loss must be a direct result of the casualty. You may be required to fill out Form 4684.<sup>101</sup>

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<sup>100</sup> I.R.C. § 165(h); 26 CFR § 1.165-7

<sup>101</sup> Form 4684 - [www.irs.gov/pub/irs-pdf/f4684.pdf](http://www.irs.gov/pub/irs-pdf/f4684.pdf)

# THEFT

A theft of your digital currency might also be deductible if it was from a sudden, identifiable, unusual event. A hacked account with a third party wallet or exchange might be unusual enough. If your own Bitcoin wallet gets hacked, that might not be unusual enough to deduct the theft.<sup>102</sup>

Losses for theft are probably the FMV of the stolen Bitcoins.

# RECORD KEEPING FOR THEFT

Your records should show when you discovered that your property was missing, that the property was stolen, that you were the owner of the property and whether there is a possible reimbursement for the loss. File Form 4684.

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<sup>102</sup> I.R.C. § 165(c); Treas. Reg. § 1.165-8

## MISCELLANEOUS

The IRS requires taxpayers to file reports of certain transactions. This is often so that they can double check to make sure that all parties to a transaction are accurately reporting their taxes.

**\$10,000 Cash** - If you receive \$10,000 or more in cash from a single person in a transaction (or series of transactions) you must file Form 8300.<sup>103</sup> Since digital currency acts very much like cash, this report will probably need to be filed when you receive over \$10,000 worth of digital currency from a US person.

There are significant issues with preparing this form as it relates to Bitcoin. The form asks for significant information about the payor, such as a taxpayer identification number, birthdate, address verification, etc., as part of the form. The only exceptions to providing a taxpayer identification number are when the payor has no US tax obligations. It may be very difficult to determine the nationality of a person when the only information known is the Bitcoin address and maybe an email address. The other information required may also be very difficult to ascertain. In these cases, the recipient may be required to report the transaction as a suspicious transaction to the IRS or FinCEN for any incomplete Form 8300 that they file.

**\$600 Goods/Services** - If your business pays more than \$600 for goods or services to the same US person in a year, you need to file a Form 1099 with

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<sup>103</sup> I.R.C. § 6050I; Form 8300 - [www.irs.gov/pub/irs-pdf/f8300.pdf](http://www.irs.gov/pub/irs-pdf/f8300.pdf)

the IRS and send one to the person.<sup>104</sup> If you sell more than \$600 worth of goods or services to a business in one year, that business will send you a copy of the filed 1099 form.

Non-US independent contractors doing their work in a foreign country do not need to be issued a 1099. Foreign payers may not send a 1099 to US goods or service providers or to the IRS. You must report this income anyways if you earn it.

This again raises the problem of knowing the nationality and US tax obligation of parties in Bitcoin transactions. There is usually no way to know this so there may be issues with filing this form.

**Sell Bitcoins** - Whenever you dispose of **business property** during the year, like Bitcoins, you will probably need to file Form 4797.<sup>105</sup> This form is the report of your gains and losses on the sale.

**FBAR** - US citizens who have more than \$10,000 cumulatively in foreign financial accounts must report those accounts to the IRS every year. The accounts only have to have \$10,000 or more in them for 1 second. Anyone who stores their Bitcoins in a foreign wallet service, or who has an account with a Bitcoin exchanger in a foreign country, like Mt. Gox (Japan) or TradeHill (Chile), who meets the limit will probably need to file a Form TD F 90-22.1.<sup>106</sup> This may apply if you hold Bitcoins in your Mt. Gox or TradeHill trading account, but it will certainly apply if you hold a sufficient amount of dollars or other national currency in those accounts.

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<sup>104</sup> I.R.C. §§ 6041, 6041A; Form 1099 - [www.irs.gov/pub/irs-pdf/f1099msc.pdf](http://www.irs.gov/pub/irs-pdf/f1099msc.pdf)

<sup>105</sup> Form 4797 - [www.irs.gov/pub/irs-pdf/f4797.pdf](http://www.irs.gov/pub/irs-pdf/f4797.pdf)

<sup>106</sup> Form TD F 90-22.1 - [www.irs.gov/pub/irs-pdf/f90221.pdf](http://www.irs.gov/pub/irs-pdf/f90221.pdf)

## FINANCIAL STATUS AUDIT<sup>107</sup>

One problem that Bitcoin participants may face is the lack of third party records to double check their own tax filings for accuracy. It is possible that some item of income might be overlooked or not properly recorded. There may be some expense that is forgotten about. There are some indicators that the IRS uses when looking at cash heavy businesses to see if there might be a mistake in the income reported. Looking at those same indicators can be helpful for individual and business filers with digital currency income or expenses to catch their mistakes before they file.

Your income should fit your neighborhood and lifestyle. If you live in Beverly Hills and own a plastic surgery business, you would be expected to declare a sizable income. Also, failing to take certain deductions that would be normal for your business can arouse suspicion. Double check your tax forms to make sure your income and claimed deductions are in the right ballpark for your lifestyle. If not, you may have missed something and should review your records.

Check to make sure that the deductions you claim are not disproportionate to your income. If you claim \$100,000 in deductions but only have \$15,000 in income, you may have missed some items of income or misclassified deductions.

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<sup>107</sup> I.R.C. § 7602



Don't let your largesse surpass your business prowess. If your charitable contributions are out of balance with your declared income, you are either too generous or you are probably missing something.

Beware when you sell large assets. If you sell a home for \$1.2 million but you have only had \$20,000 of income for the past 10 years, the IRS will wonder how you made such a shrewd deal in such a tough real estate market. You will have to either document how you made such a great deal, document that you received the home as a gift or inheritance, or you might be missing an item of reportable income.

If you have raised red flags in the amount of income you report, or lack of income you report, the IRS may conduct a financial status audit. The missing income is often a gift, inheritance, loan, or some other non-taxable source. Unless the gift or loan is well documented, the IRS might force you to declare it as income instead. That is a costly error for simply failing to keep records.

Specific industries have different items that have a potential to be overlooked and not reported correctly. Check your own industry to see what to look for to make sure you are accurately reporting your taxes.<sup>108</sup>

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<sup>108</sup> IRS Guidelines - <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>

## CONCLUSION

Earning income in digital currency or incurring expenses in digital currency has tax consequences, just like cash. To avoid civil or criminal penalties for not properly recording and reporting income, make sure you follow proper principles of tax reporting. Be sure to consult with a tax professional because digital currencies are new and there may be legitimate arguments for different tax treatments. You will want to select the strongest defensible position that fits your unique situation for your own tax reporting.