Cryptocurrency and IRS Enforcement— Get Ready for Uncle Sam to Look into Your Digital Wallet

*By Steven Toscher and Michel R. Stein**

Steven Toscher and Michel R. Stein examine the tax consequences of cryptocurrency, including when currency is bought, sold, exchanged for other currency, received through mining or received in hard fork transactions.

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Cryptocurrency also known as Virtual Currency[1] is drawing increased attention from government regulators—including the Internal Revenue Service ("IRS"), the Securities and Exchange Commission and the Department of Justice and Federal Bureau of Investigation. Huge market valuation increases and dramatic price fluctuations have created intense interest in this area, with estimated market capital invested in virtual currencies approximating $400 to $500 billion.[2]

Taxpayers who have owned virtual currency over the last several years have experienced huge profits, and new a class of virtual currency millionaires and even billionaires have immerged. Investment newcomers may not fare as well as prices level off or decline, but virtual currency winners and losers would benefit from knowing the tax issues that arise from cryptocurrency ownership and related activities. But how do we tax or report something that many regulators are still trying to understand? The answer is that tax returns are due every April 15 (unless extended) and taxpayers and their advisors cannot wait for the dust to settle for more guidance from the IRS.

Virtual currency such as bitcoin has already received widespread acceptance by 100,000's of retail establishments.[3] Coinbase, Inc. ("Coinbase"), the largest U.S.-based virtual currency exchange, is the subject of an IRS "John Doe" summons enforcement proceeding and recently declared at one point that it was signing

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up 100,000's of new users each week.[4] Cryptocurrency appears here to stay and government regulators, including the IRS, are now paying attention.

The IRS has provided some guidance. In 2014, IRS Notice 2014-21 set forth rules treating virtual currency as property. The recent explosion of cryptocurrency has created challenging tax reporting issues with no further guidance from the IRS.[5] Whenever virtual currency is issued, received, spent, bought, sold, traded or given away—there is a potential tax impact. Virtual currency is treated as "property" for tax purposes, which typically means gains or losses when disposing virtual currency—in a realization and recognition event. Anytime virtual currency is used to acquire goods or services, a taxable bartering transaction takes place.

But how do we tax or report something that many regulators are still trying to understand? The answer is that tax returns are due every April 15 (unless extended) and taxpayers and their advisors cannot wait for the dust to settle for more guidance from the IRS.

This article addresses some[6] of the tax consequences of cryptocurrency, including when currency is bought, sold, exchanged for other currency, received through mining or received in hard fork transactions. We do not have definitive answers for all the questions. We, like many tax practitioners, are trying to understand this new form of "property" and applying traditional principles of tax law to come up with some practical conclusions where answers may not exist.

IRS Position on Virtual Currency—IRS Notice 2014-21

The first and only guidance issued by the IRS on the income taxation of virtual currency was in IRS Notice 2014-21. Notice 2014-21 describes how existing tax principles apply to transactions using virtual currency. The notice provides guidance in the form of answers to Frequently Asked Questions ("FAQs"). Much has changed in the virtual currency world since 2014, and clearly much more guidance is needed.

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency—*i.e.*, the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange—except it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currency.

The sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This IRS Notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term "virtual currency" as used in Code Sec. 4 refers only to convertible virtual currency. The IRS left itself some running room recognizing that there might be a proliferation of other cryptocurrencies which might have different characteristics and provided that no inference should be drawn with respect to virtual currencies not described in this Notice.

For federal income taxation purposes, spending or trading virtual currency is really two transactions. That is, there is the disposal of the asset creating tax liability (which is a taxable event) and there is the spending of the dollar equivalent on the new asset (which creates cost basis). Since virtual currency is treated as "property," general tax principles applicable to property apply to transactions using virtual currency. For example, taxpayers who receive virtual currency as payment for goods and services must report on their income tax return the fair market value of virtual currency as of the date or payment or receipt. Transactions using virtual currency must be reported in U.S. dollars on an income tax return.

The basis of virtual currency that a taxpayer receives as payment for goods or services in Q & A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt.[7]

Transactions using cryptocurrency must be reported in U.S. dollars. Therefore, taxpayers must determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. 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

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rate, in a reasonable manner that is consistently applied.

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. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.[8]

The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or business are examples of property that is not a capital asset.[9]

Since every virtual currency transaction is taxable as a property transaction, there are three relevant considerations: (1) acquisition (whether by mining or exchange); (2) basis, determined by fair market value virtual currency in U.S. dollars as of the date the property acquisition (either long term or short term); and (3) disposition. Disposition raises several more considerations, including (1) when income is realized from any gains on the property; (2) how gain or loss is measured by change in dollar value between cost basis (purchase price) and gross proceeds from disposition; and (3) the tax rate to apply depending on a holding period.[10]

Record Keeping Is Key

The key to proper reporting is record keeping, and this can be problematic when dealing with virtual currency. Maintaining records is essential for accurately measuring virtual currency-related income. We anticipate the IRS will make allowances for reasonable approaches to record keeping, but taxpayers should not depend on it.

Code Sec. 6001 sets forth record keeping requirements for income tax purposes in general. That code mandates that every person shall keep such records as the Secretary prescribes. This means that proper record keeping is needed to support return positions for income, losses and basis figures. There are helpful web-based software programs for importing data and calculating gains and loss that can be purchased online, such as BitcoinTaxes,[11] LibraTax[12] and add-ons for Quickbooks.

On February 2, 2018, Coinbase posted Tax FAQs on its website. The notice reminds customers of their income tax obligations and IRS Notice 2014-21. Coinbase says it will issue Form 1099-K to customers who received at least $20,000 in cash sales, related to at least 200 transactions in a calendar year. If a taxpayer meets both criteria, the aggregate amount of transaction will be reported on that form.

Coinbase also reminds customers that account transaction history records are available online to assist with computing gains and losses. In addition, beginning in March 2018, Coinbase said that it will be providing reports (in beta development) reflecting cost basis for tax purposes, but that only purchases and sales will be reported. Transactions sending currency in or out of a Coinbase wallet will not be captured and for many traders—this is where the action is—so taxpayers are pretty much left on their own for good record keeping.

These recent postings by Coinbase are probably a response to IRS pressure surrounding the summons enforcement proceedings, when Coinbase was ordered to produce records of its U.S. customer records. As IRS enforcement intensifies, we can expect other currency exchanges to follow suit, if they have not done so already.

Coinbase Summons Enforcement Proceedings

On November 28, 2017, the U.S. District Court for the Northern District of California ordered Coinbase to produce documents on approximately 14,000 of its customers, in response to the IRS' petition to enforce its summons.[13] In support of its summons enforcement petition, the IRS submitted the declaration of a Revenue Agent who stated that while Coinbase (America's largest platform for exchanging bitcoin in U.S. dollars) had 5.9 million customers and served $6 billon exchanges in Bitcoin, the IRS only had record of 800 to 900 persons who electronically filed a Form 8949 that included a property description that likely related to Bitcoin. This resonated with the Judge, who ordered Coinbase to produce accounts with at least the equivalent of $20,000 in any one transaction type (Buy, Sale, Send or Receive) in any one year between 2013 and 2105, and to include the taxpayer's (1) tax identification number; (2) name; (3) birth date; (4) address; (5) records of account activity; and (6) all periodic statements of account.

The ordered release of this information is clear warning to all cryptocurrency customers that the IRS has the tools, means and fortitude to seek out and make an example of those who are not in compliance.

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Businesses Dealing in Cryptocurrency

Business transactions in virtual currency are subject to the normal rules for sales, withholding, and information reporting.

Employers paying virtual currency as remuneration for services constitute wages for employment tax purposes and are subject to federal tax withholding. Virtual currency payments are subject to the same information reporting as other payments (*i.e.*, Forms W-2, 1099, 1042, *etc.*). Payments made by virtual currency are subject to back-up withholding rules to the same extent as other payments. Payors must solicit Tax Identification Numbers ("TIN") from payees, as required by the rules. Of course, this raises concerns regarding privacy. After all, a clear motivating factor for some holders of virtual currency was the ability to anonymously trade in virtual currency, and we anticipate some back-up withholding issues on these transactions.

Self-employment income includes all gross income derived by an individual from any trade or business carried out by the individual other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.[14]

The medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, 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.[15]

Information Reporting and Back-Up Withholding

A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities and compensation.

Generally, a person who is in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, *Miscellaneous Income.* Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC.[16, 17]

Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number ("TIN") from the payee. 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.[18]

Third-Party Settlement Organizations

In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, *Payment Card and Third Party Network Transactions,* if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000. When completing Boxes 1, 3, and 5a-i on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settled payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

Miners of Virtual Currency

The mining process can be described as validation of transactions in exchange for a reward, such as bitcoin or other virtual currency. When a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income.[19] 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.[20]

Ordinary and necessary business expenses of the nature described in Code Sec. 162 associated with mining should be allowable as a deductible business expense, but IRS Notice 2014-21 is silent on this point. It is also unclear whether any costs of acquiring virtual currency need to be capitalized.[21]

Code Sec. 1031 Exchanges of Cryptocurrency

For pre-2018 transactions, an extremely important issue is whether the exchange of virtual currency for virtual currency can qualify for Like-Kind Exchange treatment under Code Sec. 1031. This is important since many have exchanged virtual currency for other virtual currency without recognizing it was a taxable event. In fact, many virtual currencies do not allow for the sovereign currency purchase but instead require purchase with another virtual currency, which makes this provision extremely pertinent.[22] This issue is relevant for only Pre-2018 transactions, since the Tax Cuts and Jobs Act of 2017 eliminated future "like-kind" exchanges for anything but real estate transactions.

Code Sec. 1031 is a non-recognition provision, that is an exception to the rule that all realized gains must be recognized. Basically, the idea behind this section is that when an individual sells a property to buy another of like kind, no economic gain has been achieved. There has simply been a transfer from one property to another. Certain assets such as inventory, stock, bonds, other securities, and partnership interests have been excluded.[23] Since virtual currency is considered property under Notice 2014-21, it can fall within the exchange provision.

We consider the exchange of one virtual currency for another virtual currency to be an open question, but one for which the IRS should allow deferral. The tax code contains no definition. Reg. §1.1031(a)-1(b) hints that the term "like kind" refers to "the nature of character of the property and not to its grade or quality." The Regulations only state that "[o]ne kind or class of property may not be exchanged for property of a different kind of class."

One can draw some historical comparisons. While livestock can qualify for like-kind exchange treatment, livestock of different sexes will not qualify as like-kind.[24] According to statute, real property located in the United States and real property located outside the United States are not property of like kind.[25] Silver bullion cannot be exchanged for gold bullion since they are not treated as like kind,[26] but gold bullion can be exchanged for gold bullion. Rev. Rul. 79-143 disallowed a §1031 exchange of U.S. $20 gold coins (numismatic-type coins) for South African Krugerrand gold coins (bullion-type coins) concluding:

> Similarly, in this case, although the coins appear to be similar because they both contain gold, they actually represent totally different types of underlying investment, and therefore are not of the same nature or character. The bullion-type coins, unlike the numismatic-type coins, represent an investment in gold on world markets rather than in the coins themselves. Therefore, the bullion-type coins and the numismatic-type coins are not property of like kind.

Rev. Rul. 82-96 allowed the exchange of gold bullion for Canadian Maple Leaf gold coins concluding:

> Because the Canadian Maple Leaf gold coins are bought and sold for their gold content, they are bullion-type coins. Therefore, the nature and character of gold bullion and the Canadian Maple Leaf gold coins are the same, and they qualify as "like-kind" property as that term is used in section 1.1031(a)-1(b) of the regulations.

Can it be said that one cryptocurrency is of the same nature and character of another so that it can be "like kind" to another for purposes of the code? Perhaps a true understanding of the inner workings of each virtual currency blockchain is required, as compared to a broader recognition that by dealing with the "virtual world of currency" a taxpayer is basically in the same economic position whether that person holds a dollar's worth of Bitcoin, Ethereum or Litecoin. Nonetheless, the IRS simply may not consider one virtual currency as the same "nature and character" of another for purposes of Code Sec. 1031.

Taxpayers claiming like-kind exchange treatment should make sure they comply with all reporting and disclosure requirements—including the filing of Form 8824 required for all like-kind exchanges. Thought should also be given to reporting the transaction on a Form 8275 in order to mitigate penalty exposure because we have some difficulty at this time concluding there is "substantial authority" for the position that the exchange is like kind.

Tax Treatment of Hard Forks

For our purposes, a Hard Fork is when virtual currency is split into two or more coins with a shared history. This can be done, for example, to significantly increase the number of transactions the network can handle, also called the "block size" limit. For example, a Hard Fork occurred

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in 2017 when Bitcoin holders received Bitcoin Cash in addition to original Bitcoin coin. As a result, large holders of virtual currencies experiencing Hard Fork receipt of new coin could face considerable tax consequences.[27]

With Hard Forks, the taxpayer appears to be gaining a new coin, along with the original coin, and the question is what is the tax treatment of the Hard Fork. There are several ways to the transaction.

Can new cryptocurrency created from Hard Forks be likened to Stock Split or Dividend, similar to that discussed in the Supreme Court case of *Eisner v. M.H. Macomber*?[28] In that case when dealing with a *pro rata* stock dividend, the shareholder received no actual cash or other property and retained the same proportionate share of ownership of the corporation as was held prior to the dividend with a basis split. There the Court held that it was not taxable income to the shareholder.[29] Probably not, since Bitcoin's Hard Fork yielded a new asset "Bitcoin Cash," which created new wealth traceable to a distinct virtual currency without a split or decrease in the underlying value of Bitcoin.

Next, can Hard Fork created currency instead be viewed like a whole new asset analogous to the mining of virtual currency? In this case, there would be ordinary income with a basis equal to the fair market value of the new coin. This would be a harsh result since ordinary income would stem from a capital asset with no corollary receipt of cash. Moreover, there would be a question as to how to value the Hard Fork asset, since there may not be an instantaneous marketable value for hours or even days later, until the market has a chance to discover the price.

Lastly, and perhaps for administrative convenience, could the Hard Fork created virtual currency be treated as a new asset with a zero basis? If so, it would not be taxed when received, but instead taxed when disposed. This is probably the most prudent approach since tax compliance would be easier when the valuation of the Hard Fork assets is fixed and more certain.

Hard Forks remain an open question and one which IRS guidance is needed.

Accounting Methods for Virtual Currency

What accounting method is most appropriate for the disposition of cryptocurrency? This seemingly straight forward question remains unanswered by the IRS, and additional guidance is needed in this area.

Generally, there are three acceptable methods for computing gains and losses—First In, First Out ("FIFO"), Last In, First Out ("LIFO"), and Specific Identification. Which approach should be used for virtual currency? This can be a particularly important issue if the IRS takes the position that the exchange of one cryptocurrency for another does not qualify for a like-kind exchange.

For stock transactions, the IRS automatically assumes stock is sold on the FIFO method.[30] If a taxpayer wants to sell shares in an order other than FIFO, he should provide his broker with specific written instructions, detailing which actual shares should be sold. For virtual currency, although not treated as stock, FIFO is probably the method the IRS would want the taxpayer to follow—especially in a rising market. This would create more income in an increasing market and would produce less income in declining a market.

LIFO is what clients want if they purchased virtual currency over a prolonged time period in a rising market with different purchase prices. This way, the higher basis assets would be sold or exchanged first. However, the taxpayer should document this approach in writing or use a segregated wallet. Of course, documenting virtual currency sales in writing could be difficult, particularly when no mechanism to do so regularly exists with the currency exchange used. A contemporaneously prepared letter or memorandum to oneself or the exchange may suffice as documentation.

The AICPA suggests specific identification is needed in the absence of specific guidance,[31] but for the IRS to accept the identification, it would need to be supported by appropriate recording keeping or segregated accounts. For some, this may be impossible given the level of sales activity.

Until specific guidance is issued, a reasonable, well documented and consistent approach for accounting should be used and this should be acceptable to the IRS.

Wash Sales Rules Under Code Sec. 1091

A wash sale is a transaction where an investor sells stocks or securities for a loss but then repurchases the same stocks or securities within 30 days.[32] An investor wants to claim a capital loss for tax purposes, but he or she is in essentially the exact same economic position. The loss only exists on paper, nothing else about the investors position has changed. Wash sales are prohibited by Code Sec. 1091. If a transaction qualifies as a "wash sale," it is essentially disregarded and the investor is not allowed to use the loss it generated. The wash sales rules under Code Sec. 1091 do not technically apply to the sale of virtual currency, since the rules under Code Sec. 1091 apply only to "shares of stock or securities."

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Nevertheless, one needs to be wary of the "economic substance doctrine," which states that a transaction must have economic significance aside from its tax effects.[33] A transaction that only generates a tax benefit is invalid under this doctrine. Since a virtual currency wash sale leaves one in the same economic position, the IRS could use it to invalidate wash sales of virtual currency that would not otherwise fall within Code Sec. 1091.

Stolen Virtual Currency Under Code Sec. 165

As virtual currency trading has become more popular, the number of incidents of thefts, scams, and fraudulent activity regarding crypto has also increased. By way of example, Mt. Gox, a popular virtual currency exchange that became defunct, caused millions of dollars of losses for investors in 2014.[34] Another example was in 2016, where nearly 120,000 Bitcoin was stolen from customer accounts at the exchange platform Bitfinex in Hong Kong, valued at the time to be approximately $70 million.[35]

How does the IRS view stolen or lost virtual currency for transaction occurring before enactment of the Tax Cuts and Jobs Act of 2017? We think that these can be deductible under Code Sec. 165 for years before enactment of the Tax Cuts and Jobs Act 2017.

A theft is the taking with the intent to deprive the owner of it. Virtual currency is treated as property, so the theft of virtual currency could qualify as a theft loss. The deduction for a theft loss is an itemized deduction on Schedule A, and the Taxpayer should use Form 4684 to compute the losses and report them on Form 1040, Schedule A, subject to Schedule A Limitations (10% of AGI).

Under the Tax Cuts and Jobs Act of 2017, theft losses are no longer allowable for years after 2017.

Lost Cryptocurrency

Would the IRS allow a loss deduction under Code Sec. 165 for a lost private key for years before 2018—pre-enactment of the Tax Cuts and Jobs Act of 2017?

As way of background, anyone with access to the Blockchain can see that virtual currency exists. But the access to the Blockchain is protected by a private digital key that the owner possesses. Only the person with the digital key can transfer virtual currency. If the owner loses the private key, the virtual currency cannot be accessed by anyone. It is estimated that a quarter of all Bitcoin has been lost.[36] Unfortunately, the IRS reaction may not be beneficial to the investor who has lost their virtual currency.

Not all property damage counts as a casualty loss. The IRS defines a casualty as "the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual," such as that from "fire, storm, shipwreck, or other casualty."[37] To be tax-deductible, a casualty loss must occur as a result of a sudden and unpredictable or unusual event.[38] The event must be one that happens in a single instance such as a car accident and cannot have happened over an extended period of time. There must be an element of chance or some sort of natural force involved. Losses incurred due to progressive deterioration, such as erosion, drought, decomposition of wood or termite damage, are not considered casualty losses.

Is losing a private key a covered loss? Probably not. If a virtual currency holder accidentally loses or deletes the private keys that provide access to coins they mined for themselves, that holder would not be able to write off those losses. The IRS would likely challenge the misplaced key as foreseeable or in your control.

Under the Tax Cuts and Jobs Act of 2017, casualty losses are no longer allowable for years after 2017.

Whether or not our system of income taxation and enforcement is ready for cryptocurrency, the revolution is upon us and we all need to cope with the many difficult issues which are presented.

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Foreign Financial Asset and Bank Account Reporting

U.S. persons are required to file an FBAR that includes those with a financial interest in or signature authority over at least one financial account located outside of the United States if the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year. The reporting obligation may exist even if there's no associated taxable income. If one fails to file an FBAR, you risk hefty penalties: up to $10,000 per violation for non-willful violations and up to $100,000 or 50% of the balance in the account for willful violations.

For purposes of the FBAR, a financial account is defined as a bank account, such as a savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution or other person engaged in

the business of a financial institution. It also includes an account set up to secure a credit card account; an insurance policy having a cash surrender value is an example of a financial account; securities, securities derivatives, or other financial instruments account; mutual funds and similar accounts in which the assets are held in a commingled fund and the account owner holds an equity interest in the fund.

During a 2014 webinar, Ron Lundquist, a senior program analyst for the IRS Small Business/Self-Employed Division, indicated bitcoins were *not* reportable for the then current (2013) season, but left open the question for future years. He followed up by saying that "FinCEN has said that virtually currency is not going to be reportable on the FBAR, at least for this filing season." No further guidance has been provided. The income tax treatment of assets is not the same as the reporting requirements for FBAR purposes.

There are several ways to hold virtual currency in a "foreign account," and two main approaches include using an online wallet and through a bank or exchange account. Online wallets allow the storage of personal virtual currency keys providing a way to quickly access your currency using a smartphone or computer so you can use them to purchase or trade. The virtual currencies themselves remain in the owner's possession. In contract, a bitcoin bank or exchange allows personal bitcoins to be deposited and withdrawn as needed to transact business. The significant difference between the two systems is virtual currency is deposited and withdrawals are not the same bitcoins as you deposited. Bitcoin banks and exchanges treat the individual bitcoins as fungible.

Lundquist's comments are not to be considered official guidance. In fact, there isn't yet any official written guidance. The IRS has been slow to issue definitive guidance on both the taxation and reporting of Bitcoin, which has been confusing for taxpayers. And it could get more confusing: Lindquist cautioned that FBAR reporting requirements for virtual currency could change "as we monitor what happens in the future."

For FBAR purposes, those virtual currency held individually in a wallet should not be reportable. Think of it like gold: Gold coins, other precious metals or foreign currency held directly are not reportable for FBAR purposes.

Virtual currency exchange accounts situated in a foreign country *do* need to be reported. This would be consistent with the IRS treatment of gold and foreign currency held in accounts. Converting those assets from directly held assets to accounts makes them reportable.

This nuance is important when it comes to the rules for precious metals and similar assets and it likely extends to virtual currency. The due date for the 2017 FBAR is April 17, 2018 (FinCEN allows for an automatic extension under October 15, 2018). Since there is no definitive guidance, those that hold virtual currency in exchanges or in other forms will have to make some important decisions about disclosure and reporting. It is a discussion you should absolutely take place with your tax professional: among the considerations are those draconical FBAR penalties.[39]

When in doubt however, err on the side of disclosure. One cannot get in trouble for disclosing something that does not need to be disclosed.

Conclusion

Whether or not our system of income taxation and enforcement is ready for cryptocurrency, the revolution is upon us and we all need to cope with the many difficult issues which are presented. In resolving many of the issues, traditional principles of tax law will serve as comfortable guideposts—but for many others, we will be left on our own—wandering in the Legend of Zelda. We will figure it out—we always do.

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ENDNOTES

* The authors would like to thank Benjamin Toscher and Jeremy Toscher for their contributions to this article. The authors can be reached by email at *stein@taxlitigator.com* and *toscher@taxlitigator.com*.

1 Throughout this article we will use the terms cryptocurrency and virtual currency interchangeably.

2 *See* Data from CoinMarketCap.com. As of March 4, 2018, Bitcoin's market cap (the largest) was around $193 billion and the second largest currency Ethereum was $84 billion.

3 *See* Wikipedia on Bitcoin.

4 Robert Alter, *The Taxation of Crypto Virtual Currencies: IRS Enforcement Initiative*, New Jersey Law Journal (Dec. 25, 2017).

5 For background information on this, *see* Treasury Inspector General for Tax Administration, *As the Use of Virtual Currencies in Taxable Transactions Become More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance* (Sept. 2, 2016) and Report to the Committee on Finance, U.S. Senate, *Virtual Economies and Currencies, Additional IRS Guidance Could Reduce Tax Compliance Risks* (May 2013).

6 We anticipate one or more additional articles addressing issues on the taxation of cryptocurrency not addressed here, including Initial Coin Offerings and Voluntary Disclosures.

7 *See* Publication 551, *Basis of Assets*, for more information on the computation of basis when property is received for goods or services.

8 *See* Publication 544, *Sales and Other Dispositions of Assets*, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

9 *See* Publication 544 for more information about capital assets and the character of gain or loss.

10 *See* discussion by William Perez, *How Bitcoins Are Taxed*, The Balance (Apr. 7, 2017).

11 *See https://bitcoin.tax*.

12 *See https://app.libratax.com*.

13 *See Coinbase, Inc.*, 2017 U.S. Dist. LEXIS 196306, Case Number 3:17-cv-01431-JSC, November 28, 2017.

14 *See* FS-2007-18, April 2008, *Business or Hobby? Answer Has Implications for Deductions*, for information on determining whether an activity is a business or a hobby.

15 *See* Publication 15 *(Circular E), Employer's Tax*

Guide, for information on the withholding, depositing, reporting, and paying of employment taxes.

[16] *See* the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more Information.

[17] For payments to non-U.S. persons, *see* Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*

[18] *See* Publication 1281, *Backup Withholding for Missing and Incorrect Name/TINs,* for more information.

[19] Notice 2014-21, IRB 2014-16, 938, Q & A-8; *see also* Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income.

[20] Notice 2014-21, IRB 2014-16, 938, Q & A 9; *see also* Chapter 10 of Publication 334, *Tax Guide for Small Business*, for more information on self-employment tax and Publication 535, *Business Expenses*, for more information on determining if expenses are from a for-profit business activity.

[21] *See* AICPA Comments on Notice 2014-21 (June 10, 2016).

[22] Lindsay Marie, *Brace Yourselves Cryptocurrency Investors; Taxes Are Coming*, TOWNHALL (Jan. 2, 2018).

[23] Code Sec. 1031(a)(2).

[24] Code Sec. 1031(e).

[25] Code Sec. 1031(h)(1).

[26] Rev. Rul. 82-166, 1982-2 CB 190.

[27] The authors want to acknowledge and thank the Virtual Currency Sub-Committee of the ABA Tax Section for their thoughts and ideas for this section.

[28] *Eisner v. M.H. Macomber*, SCt, 1 USTC ¶32, 252 US 189, 40 SCt 189 (1920).

[29] *See also* Code Sec. 305 dealing with stock dividends.

[30] Reg. §1.1012-1(c).

[31] *See* AICPA Comments on Notice 2014-21, dated June 10, 2016.

[32] Code Sec. 1091.

[33] Now codified under Code Sec. 7701(o).

[34] *See, e.g., Mt. Gox Creditors Seek Trillions Where There Are Only Millions*, NEW YORK TIMES (May 25, 2016).

[35] *See, e.g., Bitcoin Worth $72 Million Was Stolen in Bitfinex Exchange Hack in Hong Kong*, REUTERS (Aug. 2, 2016).

[36] *See* David J. Shakow, *The Tax Treatment of Tokens: What Does It Betoken*? TAX NOTES (Aug. 3, 2017).

[37] Code Sec. 165(c)(3).

[38] *See* IRS Publication 547, *Casualties, Disasters, and Thefts* (2016); Rev. Rul. 75-592.

[39] For an in depth analysis of the substantive requirements and history of FBAR enforcement, *see* Toscher & Stein, *FBAR Enforcement Is Coming*! J. TAX PRACTICE & PROCEDURE, Dec.–Jan. 2004, at 27; Toscher & Stein, *FBAR Enforcement—An Update*, J. TAX PRACTICE & PROCEDURE, Apr.–May 2006, at 57; Toscher & Stein, *FBAR Enforcement—Five Years Later*, J. TAX PRACTICE & PROCEDURE, June–July 2008, at 37; Toscher & Stein, *FBAR Enforcement, Appeals and Collection Procedures in the Post-Amnesty World*, J. TAX PRACTICE AND PROCEDURE, Dec.–Jan. 2012, at 61; and Toscher & Stein, *The Continuing Evolution of FBAR Enforcement*, J. TAX PRACTICE AND PROCEDURE, Apr.–May 2016, at 49.

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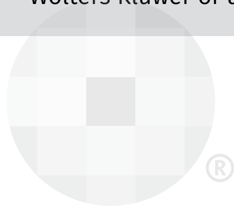
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