

## Internet Income? IRS Decides Bitcoins are Taxable Property, not Money



*With the increasing use of virtual currencies such as bitcoin, tax officials have started paying attention. Privacy and virtual identity specialist **Niels Vandezande** of the Interdisciplinary Centre for Law and ICT (ICRI) at the KU Leuven – University of Leuven explains the implications of the recent IRS ruling on Bitcoin in the US, arguing that it may undermine the core reasons such virtual currencies were created.*

On 25 March 2014, the US Internal Revenue Service (IRS) issued a **notice** providing some answers to frequently asked questions regarding cryptocurrencies such as bitcoin. With Tax Day just around the corner, the IRS aims to provide cryptocurrency enthusiasts with some guidance on how to treat their transactions involving such virtual currencies for federal tax purposes. Here, it should probably not come as a surprise that the IRS considers certain federal tax principles to be applicable to cryptocurrencies.

### International consensus on internet currency

Other countries have already come to this conclusion as well. The Dutch Minister of Finance, for instance, **declared** that income generated from cryptocurrencies should be treated as any other income for income tax purposes. In supporting this statement, the Minister refers to an earlier policy decision regarding the local currency system Local Exchange and Trade System (LETS).

The German Minister of Finance has made similar statements, **holding** that bitcoin should be considered as 'private money' and can therefore be taxed. While there are still some disagreements between countries on what to make of cryptocurrencies, there seems to be an almost moving consensus on the taxability of their gains.

### Virtual property not virtual income

What is interesting about this notice, is the reasoning applied by the IRS. First, the IRS does recognize that bitcoins can be used to purchase goods or services and can be used as an investment. As such, bitcoins can often resemble 'real currency'. However, because bitcoins – and other cryptocurrencies – do not have the status of legal tender under any jurisdiction, they can only be considered as 'virtual currencies'. Due the possibility of exchanging these virtual currencies for real currencies, cryptocurrencies can be considered convertible virtual currencies. Second, by having excluded cryptocurrencies from being real money, the IRS finds that they should be treated as property. Thus, transactions involving cryptocurrencies become subjected to the federal tax principles concerning property transactions.

This means that when a taxable person calculates his gross income, the fair market value of any bitcoins – or other virtual currencies – received should be included. This fair market value should be expressed in the cryptocurrency's value in US dollars as of the date of receipt, using for instance the rate from an exchange where the currency is listed. Also, the taxpayer would have to declare gains and could potentially deduct losses. The IRS goes as far as allowing that virtual currencies can also serve as capital assets, putting cryptocurrencies in the same basket as stocks and bonds. As a consequence, the more long-term investors may benefit from the rate of capital gains tax, which is lower than general income tax.

### Consequences for small users and businesses



The IRS's findings have some important consequences. Most evidently, gains made from payments received in bitcoins need to be reported. Similarly, employees and contractors paid for their work in virtual currency need to include such gains in their tax filings. The IRS, however, also extends this reasoning to cryptocurrency miners. All miners are now required to include the fair market value of their mined virtual currencies in their gross incomes. This goes for both those who mine for private purposes as those who provide mining services as a business.

There are a few parts in this notice that may cause concern and disruption to the cryptocurrency market. One of the main consequences of this decision is that certain reporting requirements will be imposed. This may already discourage the smaller users and business from still dealing with cryptocurrencies as it makes the whole process more cumbersome. As start-up investor Pamir Gelenbe **said**, the average user does not want to think about capital gains when paying for a cup of coffee.

### **Undermining the underlying goals**

The IRS notice also hurts the technological foundation of cryptocurrencies: the miners. With block difficulties rising, mining has already become the almost exclusive territory of those operating professional mining rigs. Having to file tax reports for the small gains made from dedicating some spare processing power to mining activities, may result in the further exclusion of small-time users from this activity. While originally started as a community effort – take for instance the example of dogecoin –now the large investors and professional service providers seem to be getting the more favourable position, potentially benefiting from lower tax rates and being able to deduct losses.

While more legal certainty on the precise status of cryptocurrencies can certainly be welcomed, the current decision may end up hurting the underlying goals of cryptocurrencies: to provide an easy and virtual decentralized payment method. Categorizing what is intended as payment as a property transaction complicates that system, for both those intending to use it for illegitimate purposes as for those that aim to use it in a legally compliant way.

*This article gives the views of the author, and does not represent the position of the LSE Media Policy Project blog, nor of the London School of Economics.*

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