The Internal Revenue Service and Bitcoin: A Taxing Relationship

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Abstract

First there was gold, then paper, then plastic, and now bitcoin. Bitcoin is a new, widely-accepted, virtual currency that is currently being used by businesses as a method of payment to minimize costs. But, no matter the form of currency a business or individual chooses to use, where there is money there are taxes. The Internal Revenue Service has now recognized bitcoin as property for tax purposes but has failed to implement proper valuation methods to effectively regulate and tax bitcoin transactions. Because the bitcoin market is unregulated, the Internal Revenue Service’s promulgated methods of reporting the bitcoin at fair market value and the related record keeping will discourage bitcoin users from reporting their transactions. Other countries have developed different approaches for taxing bitcoins with potential benefits. To be competitive internationally, the United States needs to create an effective and efficient way for taxpayers to report and for the Department of Treasury to tax bitcoin transactions.

This Article examines an area so far unexplored in the literature: how bitcoins are used and acquired, how other countries handle bitcoins, how the United States plans to tax bitcoins, and why that approach is destined to fail. In doing so, the Article offers suggestions to both improve taxpayer compliance and ensure the United States does not lose in the global marketplace.

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I. Introduction

Sometimes paper money is not the smartest way to buy what you want. Let us assumethat you need a way to pay for drugs or another illicit activity, and you do not want the payment traced back to you. Should you use the internet? Pay Cash? Use a Prepaid Debit? Well, let me suggest bitcoins! Bitcoins are like trading cards for children and cigarettes for prisoners: a payment method that avoids cash altogether. While many buyers are willing to use credit or debit cards to complete a transaction online, these transactions are traceable. Some buyers want a payment system that cannot be traced. From that desire, bitcoin was formed. While bitcoins are widely known for their historical use in narcotics and weapons sales, bitcoin has now grown into a publically accepted virtual currency that legitimate businesses and taxpayers use because of its minimal transactions costs and efficiency.

With its recent publication, the United States Internal Revenue Service (the Service) has decided to recognize the growing presence of virtual currencies, including bitcoin, and has
explained how taxpayers should report virtual currency transactions and the resulting tax consequences. In Notice 2014-21, the Service instructed taxpayers that virtual currencies will be treated and taxed like other property transactions. However, because the Service decided to tax bitcoins as property, the Service and taxpayers can abuse the newly taxable status of bitcoin. The Service’s procedures create an incentive for taxpayers to not report bitcoin transactions and threaten to further depress the public acceptance of virtual currencies in the future. Further, while the United States’ treatment of bitcoins aligns with most countries’ interpretation and attitudes towards the currency, the few countries that have encouraged the use of bitcoin and other virtual currencies may place themselves at an economic advantage if bitcoin use continues to grow.

In Part II of this Article, I explain what a bitcoin is and how the virtual currency operates. In short, bitcoin is a consensus network that enables payments through digital money, or “cash for the internet.” As the first widely accepted “crypto-currency,” bitcoins are a form of money that is created and used in transactions through cryptography. I also explain that bitcoins are created through “mining” and that the mining process protects the bitcoin community from fraud. Even though bitcoins are entirely virtual, businesses and non-profits have begun accepting bitcoin payments as a way to minimize expenses and to capitalize on the growing number of bitcoin users.

In Part III, I explain the Service’s decision to treat bitcoins as property for tax purposes and to mandate that individuals include bitcoins as income on their tax returns. The Service directed individuals to report bitcoins at their fair market value at the time of receipt. Because of the lack of widespread trading and the variable creation of bitcoins through “mining,” I explain

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2 This Article will only be discussing the potential effects of the taxation of bitcoin for individuals, not businesses.
that it will be difficult for individuals to accurately report the market value of bitcoins and even harder for the Service to validate that market value. Various online currency converters are available to compare bitcoins and the United States dollar, but none of these converters are considered authoritative over each other.

The Service’s lackluster response to bitcoin is not new or surprising to the bitcoin community. The Notice is just one of the many responses to bitcoin internationally. Therefore, in Part IV, I will compare the Service’s treatment of bitcoins to other countries’ treatment of the virtual currency and discuss the potential benefits of each approach.

Finally, in Part V, I conclude that the Service’s attempt to tax bitcoin is less than operational. The lack of accurate valuation methods for bitcoin will create problems for the Service unless the valuation procedures are changed or Congress elects to create legislation allowing the centralized regulation and trading of bitcoins. Alternatively, the Service could treat bitcoins like foreign currency and apply those pre-existing tax regulations to bitcoin transactions. Because of the potential tax revenues, the Service would be better served by creating more manageable tax reporting procedures for bitcoin transaction. But a long-term solution for taxing bitcoin transactions will have to be developed slowly and carefully.

II. What is Bitcoin?

While virtual currencies are not new, bitcoin has been one of the most successful virtual currencies to date. Bitcoin, which is described as “cash for the internet,” is the first


implementation of a “crypto-currency.”6 A crypto-currency is a form of money that uses cryptography to control its creation and transactions instead of a centralized institution.7 In 2008, Satoshi Nakamoto8 implemented Dai’s ideas and published a paper describing the bitcoin protocol in a cryptography mailing list.9 Then, in 2009, Nakamoto released the first version of the bitcoin software and actively participated in the bitcoin community and contributed to mailing lists until the end of 2010.10

Bitcoin is an online, digital currency managed by bitcoin users in a decentralized peer-to-peer network instead of a centralized authority.11 Because of the decentralized nature, a governing authority does not underwrite bitcoins, and, therefore, bitcoins have no intrinsic value.12 Instead, bitcoins are valued based upon supply and demand—essentially, a bitcoin is worth what people are willing to pay for it.

a. How Bitcoins Work

Individual bitcoins, or parts of bitcoins,13 are computer files. Bitcoins can be destroyed or lost, like a .pdf or an .mp3 file. The bitcoin network is a computer program that allows a user to send and receive bitcoins in the form of a digital wallet. Digital wallets, which are electronic files that can store bitcoins, can be kept on a user’s computer, smart phone, or, if more protection is

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6 Id.
7 Bitcoin was first described in 1998 by Wei Dai. Id.
8 The name Satoshi Nakamoto is most likely a pseudonym because his or her identity is unknown. Others have suggested that Nakamoto may not be a single person but instead a group of people. See Who is Satoshi Nakamoto?, COINDESK http://www.coindesk.com/information/who-is-satoshi-nakamoto/ (last visited December 10, 2014).
10 Who is Satoshi Nakamoto?, supra note 8.
11 FAQ, supra note 5.
12 This is different than centrally regulated currencies, like the dollar, the euro, or the yen. For each of those currencies, a centralized government entity value, regulate, and backs the currency with the force of law.
desired, an online wallet service. Each bitcoin contains a public and a private key pair that are used to send a bitcoin as a payment. The key pairs are used together so that the bitcoin owner identifies themselves and the bitcoin using the public key, while a private key is used by the bitcoin owner to authorize a transaction. Each bitcoin owner will have access to both the public and private keys. Additionally, each bitcoin user has a bitcoin address from which to send and to receive payments.

When the bitcoin owner decides to use a bitcoin in a transaction, the bitcoin owner will authorize payment from her virtual wallet to a recipient by identifying both herself and the recipient using the public key and the recipient’s bitcoin address. At the same time, the bitcoin owner will enter the private key. Once the bitcoin owner has entered the private key, the bitcoin payment is verified and the bitcoin is sent to the recipient. The recipient must then acknowledge receipt of the bitcoin. When she does, she will receive the public and private key pairs for the received bitcoin. At that point, the transaction will be recorded on the bitcoin public ledger, known as the “blockchain.”

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16 Id.
17 How does Bitcoin work?, BITCOIN, https://bitcoin.org/en/how-it-works. Bitcoin users can have as many public addresses at they want.
19 Id.
20 BITCOIN P2P E-CASH PAPER, supra note 9. The visual below will help describe a bitcoin transaction.
The blockchain uses triple-entry accounting\textsuperscript{21} to document each transaction. In the above example, when the bitcoin user attempts to send the bitcoin to the recipient, the transaction is time-stamped and recorded as an entry on the blockchain with the public key for the bitcoin. By adding the transaction to the blockchain, the bitcoin community is confirming that the transaction is legitimate and verifiable to prevent anyone from spending the same bitcoin twice.\textsuperscript{22}

b. Where to Find Bitcoins

To start transacting in bitcoins, a potential user may purchase a bitcoin from another user or may “mine” for bitcoins. To purchase from another user, potential users may buy bitcoins directly from bitcoin exchanges,\textsuperscript{23} individuals, or in peer-to-peer marketplaces.\textsuperscript{24}

Alternative, a potential user could mine for bitcoins. Mining is the process of verifying and adding bitcoin transaction records to the blockchain.\textsuperscript{25} Transactions made during a set time

\begin{itemize}
\item[21] Triple-entry accounting is a process where a party not related to the sender or the recipient validates and records the transaction so that third parties can view the transaction publically. See Jason M. Tyra, \textit{Triple Entry Bookkeeping With Bitcoin}, BITCOIN MAGAZINE (Feb. 10 2014), http://bitcoinmagazine.com/9969/triple-entry-bookkeeping-bitcoin/.
\item[22] The process of triple-entry accounting and verification takes place through a process called “mining” which will be discussed further within the paper. See Part II.b.
\item[24] Peer-to-peer marketplaces try to match individuals who want to purchase bitcoins with current bitcoin users who want goods from non-bitcoin accepting websites. See Part III.iii.
\end{itemize}
period are turned into a list, called a “block.” A block will eventually become part of the blockchain, which is the public ledger for all bitcoin transactions. When a new block is created, willing individuals, known as “miners,” verify the transactions for the bitcoin community to prevent a bitcoin from being spent twice. To verify these transactions, miners take the transaction information in the block—including the sender’s and recipient’s public address, the bitcoin’s public key, and the time of the transaction—and apply a mathematical formula to the information to convert the transactions into a “hash.” A hash is a formula that turns the transaction information into a seemingly random sequence of letters and numbers to keep the bitcoin users’ identities a secret. Each new hash uses the data from the previous block’s hash in the blockchain so that the new block’s transactions are confirmed as legitimate transactions.

Essentially, the hashes build upon each other to create a verifiable transaction list that prevents double spending of bitcoins. If an individual tries to spend a bitcoin more than once, the new block’s hash does not fit within the hash of the general ledger because the previous transaction using that bitcoin from that user would have already been verified using the user’s name and the bitcoin’s public key.

Once a block is successfully hashed and all the transactions are verified, the block is published on the ledger with the hash formula at end of the block. At that time, other miners then run the proposed hash on the block to confirm that the hash is correct. Once the block and hash are verified, the block is “sealed” and joins the general ledger as a list of all bitcoin verified

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26 Id.
27 Id.
28 Id.
29 Id.
30 Id.
31 Id.
transactions. Once a block is hashed and sealed to the blockchain, it cannot be reversed, and the sender’s and recipient’s bitcoin addresses will become indecipherable.

While the process seems complicated, a block is usually hashed in approximately ten minutes. Because of this short timeframe, bitcoin senders and recipients wait until the block containing their transaction is added to the blockchain before considering the payment as final.

c. Bitcoin Users

Although bitcoins would seem to appeal only to the technologically savvy, bitcoin was originally used by individuals that mistrust governmental monetary systems. However, bitcoin was popularized as the payment style of choice for the international crime community. Perhaps the most notorious online illegal marketplace was the Silk Road. The Silk Road was a website

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32 Id. Please refer to the image below.

34 How Bitcoin Works Under the Hood, YOUTUBE (Jul. 14, 2013) https://www.youtube.com/watch?v=Lx9zgZCMqXE.
that existed in the deep net,\textsuperscript{36} and because of its anonymity, the Silk Road provided a marketplace for individuals to purchase illicit drugs, such as lysergic acid diethylamide (LSD), heroin, and cocaine, among others.\textsuperscript{37} Users purchasing drugs would send payments in bitcoins to dealers and would discreetly receive by mail a vacuum-sealed package of their preferred drugs.\textsuperscript{38} Despite its initial booming success,\textsuperscript{39} the Silk Road eventually collapsed. In the fall of 2013, the United States government shut down the Silk Road, and the Federal Bureau of Investigations seized 144,000 bitcoins, estimated at $28.5 million.\textsuperscript{40}

Despite the virtual currency’s questionable historical beginnings, many online retailers have begun to see bitcoin’s value. For example, Overstock.com was the first major online retailer to accept payments in bitcoins in early 2014.\textsuperscript{41} Within the first three months of allowing customers to purchase goods using bitcoins, Overstock.com reported over one million dollars in

\textsuperscript{36} The deep net is a part of internet that is not accessible by Uniform Resource Locator (URL). \textit{Silk Road: Not Your Father’s Amazon.com}, NPR (June 12, 2011, 3:33 pm), \url{http://www.npr.org/2011/06/12/137138008/silk-road-not-your-fathers-amazon-com}. Instead, deep net websites are only accessible through The Onion Router (TOR). TOR is free online browser software originally developed by the United States’ Navy that allows users to navigate the internet anonymously. TOR stops websites from tracking a user’s movements through the internet by constantly changing the Internet Protocol (IP) address of the computer. \textit{Tor: Overview}, \textsc{TOR Project}, \url{http://www.torproject.org/about/overview.html.en}. An individual may access deep net websites through traditional web browsers (like Google Chrome or Internet Explorer), but her movements would be tracked.


\textsuperscript{38} \textit{Id}.

\textsuperscript{39} The site was estimated to have generated over $1.2 billion between 2011 and 2013. James Rogers, \textit{Darknets: Murky recesses of the hidden web}, \textsc{FOXNEWS} (Oct. 25, 2014), \url{http://www.foxnews.com/tech/2014/10/25/darknets-murky-recesses-hidden-web/}.

\textsuperscript{40} Kathleen Caulderwood, \textit{Silk Road Closure: Darknet Economy Thriving a Year Later}, \textsc{International Business Times} (Oct. 10, 2014, 8:30 AM) \url{http://www.ibtimes.com/silk-road-closure-darknet-economy-thriving-year-later-1702543}. The FBI was able to stop the website because of a software misconfiguration that accidentally revealed the location of its server. James Rogers, \textit{Darknets: Murky recesses of the hidden web}, \url{http://www.foxnews.com/tech/2014/10/25/darknets-murky-recesses-hidden-web/}. The federal government recently shut down the Silk Road 2.0, an updated version of the original Silk Road that was managed by an associate of the Silk Road’s original founder. See Donna Leinwand Leger, \textit{Feds shut down Silk Road 2.0, arrest San Francisco man}, \textsc{USA Today} (Nov. 6, 2014, 4:04 PM) \url{http://www.usatoday.com/story/news/nation/2014/11/06/feds-shut-down-silk-road-copycat/18591155/}.

\textsuperscript{41} Press Release \textsc{Overstock.com} (Jan. 9, 2014), \url{http://investors.overstock.com/phoenix.zhtml?c=131091&p=irinewsArticle&ID=1889670}.
bitcoin sales.\textsuperscript{42} Dell also announced in July 2014 that it would accept bitcoins for online sales.\textsuperscript{43} Later that same year, Expedia began accepting bitcoin payments from United States customers for hotel bookings.\textsuperscript{44} Despite bitcoin’s increasing popularity, other retailers, like Amazon.com, currently refuse to accept bitcoins.\textsuperscript{45}

Even though most of the general population does not use bitcoins, online merchants who accept bitcoin payments are reaping the benefits. Because of the cryptocurrency’s decentralized nature, bitcoins reduce costs for merchants. Currently, when a customer uses a credit or debit card to pay for goods or services, processing fees are charged to the merchant for each transaction. These fees are estimated to fall between two to five percent of each transaction total.\textsuperscript{46} However, merchants incur minimal, if any, transaction costs when they accept bitcoins.\textsuperscript{47} Additionally, merchants are charged fees for chargebacks.\textsuperscript{48} In contrast, the bitcoin payment process does not allow consumers to seek a chargeback, unlike credit card transactions.\textsuperscript{49}

\textsuperscript{45} Daniel Cooper, Why Amazon is right to steer clear of Bitcoin, ENGADGET (Apr. 15 2014, 5:00 PM), http://www.engadget.com/2014/04/15/amazon-bitcoin-currency/. Amazon has stated that it decided to not accept bitcoin because it did not see enough interest in this payment option from its customers. http://www.coindesk.com/amazon-exec-company-decided-against-accepting-bitcoin/
\textsuperscript{47} While some retailers may accept bitcoins and convert it to dollars independently, some companies will charge nothing to automatically convert bitcoin payments into dollars. See e.g. BITPAY, https://bitpay.com/pricing and COIN OF SALE, https://coinofsale.com/faq. For a fee, these companies provide more support or more developed software to handle complicated transactions. \textit{Id.}
\textsuperscript{48} A chargeback is when a credit card company withdraws money from a merchant’s account and deposits the money in a consumer’s account after a dispute. The merchant is charged a chargeback fee as well. \textit{What is a Chargeback?}, CONSUMERIST, http://consumerist.com/2007/04/09/what-is-a-chargeback/.
\textsuperscript{49} As discussed earlier, because the payment is made directly between consumers and merchants and then finalized when the transaction is added to the blockchain, the consumer is unable to obtain the bitcoins used as payment unless the merchant voluntarily sends the bitcoins back to the consumer. \textit{See infra} Part II.a.
Non-online businesses recognize the benefits of accepting bitcoin payments as well. Several restaurants in the San Francisco area now allow customers to pay for meals with bitcoins. Currently, seventy-nine restaurants throughout the United States accept bitcoin payments. Additionally, almost 600 sellers on Etsy, an online marketplace filled with individual sellers of unique or handmade goods, accept bitcoin payments.

Non-profit entities have begun to take advantage of Bitcoin’s reduced transaction costs and its growing popularity. To illustrate, Georgia Institute of Technology announced that it will accept bitcoin payments at concessions stands. The Massachusetts Institute of Technology is also accepting bitcoins in its bookstore. Simon Frazer University was the first Canadian university to accept bitcoin donations. Shortly thereafter, the United Way announced that it would accept bitcoin donations as well.

Because of its low transaction costs and the growing number of retailers that accept it, Bitcoin will likely continue to increase in popularity despite its questionable beginnings. If the United States intends to tax bitcoins, the Service must create a viable way to tax bitcoin transactions as the use of the virtual currency continues to grow.

III. The Service’s Treatment of Bitcoin

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a. The Service Speaks

In March of 2014, while the number of merchants accepting bitcoins was dramatically increasing, the Service issued and subsequently published Notice 2014-21 ("Notice") describing how the Service intended to apply preexisting general tax principles to transactions using virtual currency. In the Notice, the Service initially defined several key terms, including "virtual currency" and "real currency." The Notice defined "virtual currency" as a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value. Additionally, the Notice defined "real currency" as an item that is designated as legal tender, circulates, and is usually used and accepted as a medium of exchange in its issuing country, like the coin and paper money of the United States. The Service stated that the Notice is applicable only to "convertible virtual currency." "Convertible virtual currency" is a currency that can be easily valued and exchanged into real currency or that acts as a substitute for real currency. Further, the Notice referred to bitcoin as an example of convertible virtual currency.

In the Notice, the Service stated that convertible virtual currencies would be considered property and would be taxed as such upon transfer. Because property is includible in an

57 Notice 2014-21, 2014-16 I.R.B. 938. See I.R.M. § 32.2.2.3.3 ("A Notice is a public pronouncement by the Service that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.").
58 Id. It may be easier to think of virtual currency as a debit card with an account balance that can be spent at anytime and anywhere instantaneously on the internet. The money in the account may be accepted by anyone over the internet, but the fair market value of the account in currencies, like dollars or euros, will vary depending upon demand.
59 31 CFR §1010.100 (m).
individual’s gross income, the recipient of a payment in convertible virtual currencies, like bitcoin, must include the payment in the recipient’s gross income; the recipient must report the bitcoin’s value at the fair market value of the virtual currency in United States dollars as of the date that the payment was received. Because convertible virtual currency is treated like property, the basis of the currency will be the reported fair market value of the payment in United States dollars as of the date of the receipt.

Taxpayers must individually value any receipt of convertible virtual currency in this way, whether the taxpayer received the bitcoins as wages or whether the taxpayer “mined” the virtual currency. Payments made in convertible virtual currency are subject to information reporting and backup withholding like other payments in property. Additionally, if a taxpayer mines virtual currency as a trade or business as self-employment, then any earnings in convertible virtual currency will constitute self-employment income and be subject to self-employment tax.

Further, the Service stated that it would allow individuals to report a loss on convertible virtual currency, depending on how the currency was held. If a taxpayer held the convertible virtual currency as a capital asset, like stocks or bonds, then the taxpayer may realize a capital gain or loss on the sale or exchange of the convertible virtual currency. If the taxpayer is not holding the convertible virtual currency as a capital asset, the taxpayer may realize only an ordinary gain or loss on the sale or exchange of the currency.

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64 Id.
65 Id.
66 Id.
67 Id. As with other payments in property, payors must ask for and report the taxpayer identification number (TIN) from the payee and backup withhold from the payment if a TIN is not provided. Id.
68 Id.
69 Id.
70 Id.
71 Id.
However, the Service expects the taxpayer to value each payment of convertible virtual currency and keep records of each convertible virtual currency transaction. A taxpayer must determine the fair market value of the convertible virtual currency when received. According to the Notice, a taxpayer may value the convertible virtual currency using an exchange rate if the convertible virtual currency is listed on an exchange for a value in United States dollars or another currency that may be converted into United States dollars.\textsuperscript{72} All of the recording and valuations must be done in a “reasonable manner that is consistently applied.”\textsuperscript{73}

b. The Service Remains Silent

The Treasury believes the Notice to be authoritative to the same extent as a Revenue Ruling or Revenue Procedure.\textsuperscript{74} While the Notice appears to make it simple for a taxpayer to comply with the Internal Revenue Code (the “Code”), the procedures provided in the Notice have several flaws that may make it difficult for taxpayers to abide by the Code and that create the opportunity for significant taxpayer abuse. Primarily, the Notice fails to adequately address issues with the following: (i) valuation of bitcoins, (ii) the mining of bitcoins, (iii) withholdings from bitcoin payments, (iv) the use of bitcoins in peer-to-peer trading, (v) the use of bitcoins as capital assets, (vi) the use of bitcoins as gifts or donations, and (vii) the verification of bitcoin transactions. I explain each problem in detail in the following sections. In light of these problems, the Service should reevaluate its current treatment of bitcoins to adequately address these issues.

\textsuperscript{72} Id.
\textsuperscript{73} Id.
\textsuperscript{74} See I.R.M. § 32.2.2.3.3 (“A Notice is a public pronouncement by the Service that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law.”); Rev. Rul. 90-91, 1990-2 C.B. 262 (1990).
i. **Valuation**

The fundamental problem with the procedures for bitcoin that the Service identified in the Notice is that taxpayers cannot accurately value a bitcoin at any specific time. Pursuant to the Notice, taxpayers are required to report bitcoin receipts as income and report the fair market value of the bitcoins at the time of the receipt. Yet, because bitcoin is not actively traded on a regulated market, like stocks, taxpayers lack an authoritative resource to determine the value of their bitcoin. There are several website currency converters for bitcoin that appear to represent the fair market value of a bitcoin, but these converters only look at the online exchange price of a bitcoin, which is the current average amount of dollars, for example, that a wholly unidentified individual is willing to pay for a bitcoin. Currency converters do not account for the fact that individuals may purchase bitcoins through peer-to-peer trading marketplaces or may mine bitcoins when the converters determine the current value of a bitcoin. Further, these websites all operate individually and without communicating (at least visibly) with each other. Each converter simply reports what its individual program has calculated to be the current fair market value of bitcoin.

Because of this valuation problem, taxpayers will be unlikely to defend against or respond to any possible challenge made by the Service. Each taxpayer is likely to pick a fair market value from one of the several online currency converters, depending upon which value is

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75 *Id.; see* Treas. Reg. § 1.61-2(d)(1) (2014) (“the fair market value of the property taken in payment must be included in income as compensation.”).


77 As of December 15, 2014, 2:43 PM, CoinDesk reported that a bitcoin was worth $346.75, Preev reported $348.70, and Bitcoin Exchange Rate reported $351.45.
the most beneficial for that taxpayer. However, were the Service to challenge this fair market value in an ensuing audit, the taxpayer would have trouble defending this value because the Service could reject the taxpayer’s chosen converter as invalid.

For example, assume a taxpayer receives bitcoins and reports the fair market value of those bitcoins as determined by the CoinDesk currency converter. Later, the Service audits our hypothetical taxpayer. The Service then challenges the reported value of the bitcoin, claiming that the appropriate value for taxpayer’s bitcoin was the value determined by Google’s currency converter. Even if our taxpayer complies with all substantial Code requirements and maintains all required records, the taxpayer will likely be unable to produce the “credible evidence” required to challenge the Service’s tax decision because bitcoin lacks an authoritative valuation system.78 From this example, we can see that because bitcoin does not have a regulated market and because the Notice gives the Service the ability to challenge every bitcoin valuation. The Service can simply point to another online currency converter that differs from the taxpayer’s identified converter, essentially giving the Service a fool-proof strategy to challenge any reported bitcoin fair market value. This possibility of being challenged creates significant uncertainty for the taxpayer when he files his taxes and would appear to increase the chance of being audited.

To encourage taxpayers to report bitcoins in their federal income tax returns, the Service could either identify an online currency converter or converters as reputable resources for taxpayers to use when reporting bitcoin values. Individual states have already issued licenses for Coinbase, a startup U.S. currency exchange for bitcoin, to legally operate as a regulated bitcoin

78 See 26 U.S.C.A. § 7491 (a) (2014) ("if...a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.")
exchange. By having a regulated exchange, the state taxing authorities have a way to verify reported bitcoin values. Additionally, a regulated exchange helps to protect consumers from hackers and security breaches and will provide an accurate exchange rate for bitcoin transactions. Alternatively, the Service could establish its own bitcoin exchange for taxpayers to use to report their bitcoin transactions. With the success of Coinbase and the growing interest in officially licensed bitcoin exchanges, the Service would be able to create an exchange modelled after the already successful or growing examples. Regardless of whether the Service chooses to direct taxpayers to a specific currency converter or creates its own exchange as the benchmark for reported bitcoin values, either of these options will help the Service encourage taxpayers to report their bitcoin transactions and to lay the foundation for more effective and efficient taxation of bitcoin transactions.

ii. Mining

Additionally, miners will have difficulty valuing bitcoins received from their mining efforts. Although mining is a vital part of the bitcoin network, the Service did not fully address the issues related to mining. As explained above, an individual mines for bitcoins by processing bitcoin transactions and verifying the transactions on the blockchain. This process is highly competitive and for each successful “mine,” an individual will receive twenty-five bitcoins. If an individual working alone completes the mining process, then, pursuant to the Notice, upon the receipt of any mined bitcoins, the individual has received the bitcoins as income.

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81 See Part II.b.
82 How Bitcoin Mining Works, supra note 25.
and must report that income at the current fair market value of the date when the bitcoins were received.

However, multiple individuals may work together to participate in mining pools. Mining pools split the mining work among several individuals and allot each miner a percentage of the block to mine. If the pooled mining group successfully mines the block, then the mining pool receives the bitcoins and subsequently splits the bitcoins among the participants.

Yet, under the Notice, it is unclear how the mining pools would account for receipt of the bitcoins. Possibly, the mining pool might be considered a pass-through entity and, as such, would simply transfer the bitcoins to the involved miners. If the mining pool is considered a pass-through entity, like a partnership, miners would potentially have to report this income individually. Conversely, a mining pool might be considered a separate entity from its members, like a corporation of limited liability company. If so, the mining pool would have to account as an entity for the receipt of the bitcoins and then account for the payment of those bitcoins to the individual miners. If the mining pool is a separate entity, the mining pool may incur a tax liability when receiving and subsequently distributing bitcoins. Because there is the risk that the value of the bitcoins could fall or increase after receipt by the mining pool but before being paid to the miners, the mining pool may be subject to additional tax consequences.

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85 Ideally, this would work similarly to partnerships. See I.R.C. § 701 (2014).
87 These activities would be similar to a corporation, whereby the corporation would account and report income, and dividends received by shareholders would additionally be subject to personal income tax. I.R.S. § 61 (a) (7) (2014). Here, the mining pool would account for the receipt of bitcoins, report the receipt at the fair market value as income, and then pay bitcoins to the miners. Then, the miners would have to report the item as income on their personal income tax returns.
For instance, assume that after a successful mining operation, the mining pool received bitcoins in the morning when a bitcoin was valued at $200. However, later that day, before the bitcoins can be distributed, a bitcoin’s value increases to $300. In this hypothetical but realistic situation, it is unclear from the Notice whether the mining pool would have to report a gain because the bitcoin appreciated. In this situation, miners would potentially have to report the bitcoins at the higher value instead of the value when the coins were originally earned, thereby increasing each miner’s potential tax liability and complicating each miner’s basis in the bitcoins. Alternatively, the mining pool could arguably be paying wages in the form of bitcoins to the miners. If the Service interpreted mining pools as employers, then the mining pools may be forced to withhold parts of the bitcoin for payroll and similar taxes like most employers must do.\textsuperscript{88} The Service’s Notice does not address and resolve these issues.

iii. Peer-to-Peer Trading

The use of bitcoins in peer-to-peer trading markets further adds to the valuation issues. Bitcoins are incredibly popular in online peer-to-peer trading marketplaces. These marketplaces seek to bring together individuals with specific and complementary needs. Most commonly, these marketplaces try to match bitcoin users who want to buy items online from retailers that do not accept bitcoins and individuals who would like to purchase bitcoins with a credit or debit card.\textsuperscript{89} In these marketplaces, a bitcoin user will post her wish list for an online retailer, for example Amazon.com. She will also state the discount she would like to receive on the goods in

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\textsuperscript{88} In the Notice, the Service states that the bitcoins may be subject to withholdings. This is discussed \textit{infra} Part III.b.iii.
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\textsuperscript{89} PurseIO is one of the more popular sites that provides this service. \textit{See} PURSEIO, \url{https://purse.io/} (last visited October 8, 2014).
\end{flushright}
exchange for her bitcoins.\textsuperscript{90} Then, an individual who wants to purchase bitcoins with a debit or credit card can review different posts from bitcoin users. When he finds a posting that matches the amount of bitcoins that he wishes to purchase, he will accept the trade, purchase the goods on Amazon.com, and request that the goods be delivered to the bitcoin user’s address. At the same time, the bitcoin user will put the allotted amount of bitcoins in escrow with the marketplace. Once the goods are delivered, the bitcoin user will notify the marketplace to release the bitcoins from escrow and to send the bitcoins to the individual, minus a small transaction fee for the marketplace.\textsuperscript{91}

Because bitcoin users are able to set their personal discount rate, every transaction will result in a different purchase price for bitcoins, calculated by adding the cost of the goods, the discount rate, and the fee from the marketplace. As a result, a bitcoin will not have a standard price, thereby exponentially increasing a taxpayer’s difficulty to keep an accurate record of the bitcoin’s fair market value and the basis. Because a taxpayer’s basis in property has traditionally been the cost of that property,\textsuperscript{92} individuals who purchase goods and pay the discount rate and fees in exchange for bitcoins would normally be required to report the total costs incurred as their basis in the bitcoins received. However, the Notice ignores the possibility that taxpayers will purchase bitcoins in peer-to-peer marketplaces. For determining basis, the Notice refers only to the fair market value of a bitcoin on a currency exchange.\textsuperscript{93} If the Service fails to recognize

\textsuperscript{90} The discount is taken off the total price that the bitcoin user is willing to pay. For instance, if the bitcoin user wants a book from Amazon that costs thirty United States dollars and wants to charge a twenty percent discount, then she is only willing to pay the equivalent of twenty-four United States dollars in bitcoin for the book. The remaining six dollars will be a cost that the other party will pay.

\textsuperscript{91} See PURSEIO, supra note 89.

\textsuperscript{92} I.R.C. § 1012 (a) (2014) (“The basis of property shall be the cost of such property…”); Treas. Reg. § 1.1012-1 (a) (“…the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.”).

\textsuperscript{93} Notice 2014-21, 2014-16 I.R.B. 938.
the ability of taxpayers to purchase bitcoins through peer-to-peer markets, taxpayers may be forced to report a fair market value that does not accurately reflect the taxpayers’ actual cost of purchasing bitcoins.

iv. Withholdings

Because the Service treats bitcoin as property, payments in bitcoin are subject to withholdings. If bitcoins are paid as wages, the Notice explains that the fair market value of the virtual currency paid would be subject to federal income tax withholdings.\textsuperscript{94} The Notice further explains that virtual currency payments are subject to backup withholding like other payments in property.\textsuperscript{95} Therefore, the Notice instructs taxpayers making payments in virtual currency to request a taxpayer identification number (TIN) from the recipient either to report the transaction or to withhold a portion of the payment if a TIN cannot be acquired before the payment is made.\textsuperscript{96} These requirements demonstrate that the Service does not understand (or does not care about) the anonymous nature of bitcoin. While it would be wonderful if each taxpayer requested and obtained a TIN for each transaction, it does not seem likely. The hash and the blockchain hide the real identity of the users by using bitcoin public keys as the only identifying marker between users. Additionally, because bitcoin users can generate a different address for each transaction, no one would be able to identify each bitcoin user in each transaction or to verify the users’ identities even if users started providing a TIN. Unless the Service believes it can track each bitcoin payment and address, the withholding requirement does not seem feasible and should be abandoned.

\textsuperscript{94} Notice 2014-21, 2014-16 I.R.B. 938.
\textsuperscript{95} How Bitcoin Mining Works, supra note 25.
\textsuperscript{96} Id.
v. Capital Asset Issues

In addition to the problems with the valuation of bitcoins, the Service states that bitcoins may be held as capital assets. However, the Notice stops short of explaining any preferred process or procedure for documenting these capital asset transactions. A capital asset is defined as property held by a taxpayer that is not specifically excluded by the Tax Code.97 A taxpayer treats the gains and losses recognized from the sale of capital assets differently than the gains and losses recognized from the sale of ordinary assets.98 Short-term capital gain is the gain from the sale of a capital asset held for less than a year, while long-term capital gain is the gain from the sale of a capital asset held for over a year.99 Long-term capital gains are generally taxed at a lower rate than ordinary income is taxed.100 By taxing long-term capital gains at a lower rate, taxpayers are able to keep more of the gain for their personal use rather than use it to pay taxes.

Despite the fact that a bitcoin could be held as a capital asset, taxpayers may have a difficult time defending any gain or loss reported on bitcoins held as capital assets. Because the Notice explains that a bitcoin is taxed as property, each time a bitcoin is received, a taxpayer must scrupulously document her basis as the bitcoin’s fair market value, and she must also keep track of her basis in each individual bitcoin.101 While taxpayers must already keep these records for other capital assets, the valuation problem with bitcoin will make taxpayer compliance difficult or impossible. Because there is no definitive source for valuation, a taxpayer could shop

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97 I.R.C. § 1221 (a).
99 I.R.C. § 1222.
101 This applies to parts of bitcoins as well. See supra note 13.
around to find the best quoted value for her bitcoin. Moreover, each time a bitcoin is used to purchase goods or is sold, the taxpayer will have to record and report a gain or loss, depending on the transaction. If taxpayers have to keep a record of the receipt and use of each bitcoin or parts of bitcoins, this recordkeeping will create an onerous process that will create unnecessary costs for the taxpayer. Further, as noted earlier, the taxpayer would find it difficult to defend a challenge from the Service as to the value of a capital asset at the date of receipt or sale because of the lack of an authoritative resource to determine the fair market value of a bitcoin.

vi. Bitcoins as Gifts or Charitable Donations

There is yet another problem with the Service’s approach. The Notice is unclear regarding how a taxpayer should document the receipt of bitcoins received as a gift or document bitcoins donated to charity. Taxpayers are allowed to give gifts up to a certain amount tax free, and the gifts are valued not at the donor’s basis but at the fair market value on the date of the gift.

However, the Service has not clarified how bitcoins should be valued when received as a gift. Even though the Notice states that bitcoins must be valued at the fair market value at the time of receipt, one section of the Treasury Regulations provides that gifts should be valued at the fair market value of the property or the amount the property would be sold for if the gift is “generally obtained by the public in the retail market.”

There are two problems with this directive. First, there is a significant question whether bitcoins are generally obtainable by the public, let alone if there is a “retail market” for bitcoins. If the Service claims that bitcoins are

102 See Part III.i.
103 I.R.C. § 2503 (b) (1) (2014).
not generally obtained, then gifts of bitcoins could arguably be treated like hard to value assets. If bitcoins are treated as hard to value assets, then the Service would be unable to defend its position that bitcoins should be reported at their fair market value. Instead, the Service would need to provide other means of valuing a bitcoin or be willing to review taxpayer submitted appraisals for the value of each bitcoin received. With the growing amount of bitcoin users and transactions, taxpayer submitted appraisals would likely overwhelm the Service.

Second and alternatively, the fair market value of a bitcoin for gifts could be determined as the price at which two individuals would exchange the property if both have reasonable knowledge of the relevant facts and if both are not under any compulsion to buy or sell. Yet, it would be difficult to value a bitcoin in terms of a willing buyer and seller because of the variety of ways to obtain bitcoins, such as conversion websites, peer-to-peer trading, and mining. Finally, even if bitcoin could be treated like stocks or bonds in this situation, each of the available options in the relevant treasury regulations seems to depend on the fact that there is a single reliable and recognized market for the property being gifted.

Nevertheless, if the Service still insists that bitcoins must be reported at the fair market value, gifts of virtual currency should arguably be treated like gifts of stocks and bonds. By treating bitcoin gifts similarly to stocks and bonds, the Service would provide taxpayers with several different methods of valuing a bitcoin aside from a currency converter’s given value as of the date of the gift.

108 Treas. Reg. § 25.2512-2 (a) (2014). If bitcoins are going to be valued like stocks and bonds if given as gifts, then there will be more options as how to value the gift instead of the fair market value at the date of the gift, including
In addition to inadequately addressing how bitcoin gifts should be treated, the Service does not adequately address how a bitcoin should be treated when given as a charitable donation. Charitable donations are allowed as a deduction in the taxable year the donation is made,\textsuperscript{109} and the value of the donation is generally the fair market value of the property at the time of the donation.\textsuperscript{110} Yet, there are numerous exceptions regarding how to determine the fair market value of the donation. For example, a donor could report the value of a donation as the price at willing buyer and seller would agree upon with reasonable knowledge and under no compulsion to buy or sell.\textsuperscript{111} Additionally, if the donor makes a donation in property of a type that the taxpayer sells in the course of business, then the property would be valued at the price of the property in the usual market in which the taxpayer customarily sells it.\textsuperscript{112} Bitcoin users would struggle with either of these valuation methods both because there is no central authority to value a bitcoin and because bitcoins are mined. Hence, the Service needs to address these deficiencies as well.

vii. The Services Lacks the Ability to Verify any Bitcoin Transactions

In addition to the problems listed above, the anonymity of bitcoin transactions will severely impede the Service’s ability to enforce the procedures set out in the Notice. While the Service generally relies upon taxpayers to keep records of all taxable transactions, the Service will have difficulty verifying bitcoin values and transactions when conducting an audit unless the

\textsuperscript{109} I.R.C. § 170 (a) (1) 2014
\textsuperscript{111} Treas. Reg. § 1.170A-1 (c) (2014).
\textsuperscript{112} Id.
taxpayer keeps immaculate records. The Service expects the taxpayer to meticulously document receipt of each bitcoin, the fair market value of the bitcoin at the time of the receipt, and the eventual sale price or value of the goods received in exchange for the bitcoin. As I explained earlier,\textsuperscript{113} because there is no way to determine the fair market value of bitcoins, even if the taxpayer keeps meticulous records of the receipt and payment of bitcoins, the taxpayer will be unable to defend her reported valuations of bitcoins if the Service challenges these valuations.\textsuperscript{114}

Additionally, the anonymity of bitcoin transactions would continue to complicate the Service’s ability to verify each transaction. Taxpayers do not have any incentive to comply with the regulation and have every incentive to hide transactions from the Service. Bitcoin makes hiding a transaction simple because of its self-regulating qualities. As I explained earlier,\textsuperscript{115} the general ledger for bitcoin transactions only shows where and when each bitcoin was used. The identities of the two parties are completely hidden and are unable to be recovered after a block of transactions is mined into hashed ledger entries. Because of this anonymity, the Service will struggle to verify a taxpayer’s bitcoin receipts for income tax, employment tax, and withholding purposes.

While ideally a taxpayer would keep these types of records, the amount of work involved in the documentation process and the complexity of the valuation issue would most likely encourage taxpayers to underreport bitcoin receipts or to simply not report the receipts at all, both to avoid the paperwork and the potential tax liability. Additionally, because the blockchain is hashed and the identities of the bitcoin users are hidden, the Service will be unable find bitcoin owners on its own.

\textsuperscript{113} See Part III.i supra.  
\textsuperscript{114} See Part III.i supra.  
\textsuperscript{115} See Part II.a supra.
In short and in sum, the Service’s approach to making bitcoins fit within the Code simply does not work. The fair market valuation does not accurately reflect the bitcoin market and the different ways that bitcoin users can obtain the virtual currencies. The Service cannot incentivize bitcoin users to withhold portions of payments of bitcoins because of the blockchain’s anonymity. Further, the Notice does not adequately address the treatment of bitcoins as capital assets, or use of bitcoins as gifts or charitable donations. The anonymous nature of bitcoin further emphasizes these problems and demonstrates that the Service’s approach is far from comprehensive and enforceable. Perhaps there is guidance to be found in other country’s approaches.

IV. Comparing Bitcoin’s Treatment Globally

While the United States has half-heartedly accepted bitcoins and their use, bitcoins have received mixed reactions throughout the world. Some countries have forbidden the use of bitcoins in most transactions or have imposed strict requirements on their use. Specifically, China has forbidden financial entities from dealing in bitcoins.116 Stating that bitcoins were not a currency but rather a “virtual commodity,” the Chinese government stated that bitcoins should not be circulated and used as a currency.117 Because bitcoins are not currency, financial and

117 Id.
payment institutions may not price services in bitcoins, trade bitcoins, or provide bitcoin-related services to customers.\textsuperscript{118}

Russia also is less than thrilled with the idea of bitcoin. Despite having widespread public interest in bitcoin,\textsuperscript{119} Russia’s Ministry of Finance has issued a report explaining that the country plans to ban bitcoins by 2015 and will begin to fine individuals who use bitcoins in transactions.\textsuperscript{120} Recently, an updated proposal for the ban lowered the amount of legal fines charged to individuals and government officials using bitcoins, but the decrease in the penalties are nominal at best.\textsuperscript{121}

Other nations have welcomed the virtual currency and have attempted to regulate and monitor transactions using bitcoins. For example, Brazil enacted laws allowing for the regulation of bitcoin and other crypto-currencies and created a mobile payment system through authorized payment institutions.\textsuperscript{122} While Brazil’s taxing authority has taken a similar stance to that of the United States’ Internal Revenue Service by taxing digital currencies as property and imposing a capital gains tax, Brazil has created exceptions to encourage the use of bitcoins. Most importantly, bitcoin users who sell bitcoins with a value of less than 35,000 reals (approximately

\textsuperscript{118} Id.
\textsuperscript{119} In 2013, Google search statistics reported that Russia has the largest amount of internet searches for the term “bitcoin” in the entire world. Cameron Fuller, \textit{Bitcoin Around the World: How Virtual Currencies Are Treated In 40 Different Countries}, \textit{INTERNATIONAL BUSINESS TIMES} (Feb. 5, 2014, 4:16 PM), \url{http://www.ibtimes.com/bitcoin-around-world-how-virtual-currencies-are-treated-40-different-countries-1553532}.
\textsuperscript{120} Caleb Chen, \textit{Russian Bitcoin Ban Plans to Fine Digital Currency Users}, \textit{CRYPTOCOINS NEWS} (Oct. 4, 2014, 6:25 AM), \url{https://www.cryptocoinsnews.com/russian-bitcoin-ban-plans-to-fine-digital-currency-users/}. It is interesting to consider how Russia will plan to enforce this ban despite the fact that bitcoin transactions are anonymous and that bitcoin users may use trading websites or online exchanges based out of any country.
\textsuperscript{121} Pete Rizzo, \textit{Russia Lowers Proposed Penalties for Bitcoin Activities}, \textit{COINDESK} (Nov. 10, 2014, 9:00 PM), \url{http://www.coindesk.com/russia-lowers-proposed-penalties-bitcoin-activities/}.
\textsuperscript{122} Lei No. 12.865, de 9 de Outubro de 2013, D.O.U. de 10/10/2013 (Braz.) (available at \url{http://www.receita.fazenda.gov.br/legislacao/leis/2013/lei12865.htm}).
$16,000 in the United States) will not have to pay a capital gains tax.\(^{123}\) By not requiring the capital gains tax for smaller transactions, Brazil has made it easier for consumers and small businesses to start using and accepting bitcoins as payments, almost encouraging the use and development of the bitcoin use within the country.

Other nations have hesitantly attempted to tax and recognize the use of bitcoins. Notably, Australia and Canada have created tax schemes for bitcoin transactions that treat bitcoin as property. However, while both countries require that the value of the bitcoins be reported at the fair market value, neither country explains where or how to determine a fair market value for bitcoins.\(^{124}\) Alternatively, the United Kingdom and Germany have issued statements that bitcoins are “private currency” and “private money,” respectively.\(^{125}\) This treatment is a step towards legitimizing bitcoins because bitcoin transactions will be taxed and will be treated like transactions in other currencies.

Finally, there are other countries that have left the bitcoin question for another day. Most notably, despite the news uproar created when the Swiss Parliament considered a postulate to treat bitcoins like other foreign currencies,\(^{126}\) Switzerland has announced that the economic


impact of crypto-currencies like bitcoin is “fairly insignificant.”\textsuperscript{127} Therefore, the Swiss government will not create legislation relating specifically to bitcoin or other digital currencies. Additionally, Denmark rejected bitcoins as a currency and decided to not regulate bitcoin transactions.\textsuperscript{128} Only businesses that trade bitcoins as their primary function must report their gains and losses to the Danish taxing authority.\textsuperscript{129}

Even with the varied responses to bitcoins internationally, there is incredible potential for the use of bitcoins. Because of the struggles of real currencies in the developing world, including banking costs and currency volatility, bitcoin transactions may be welcomed faster than expected.\textsuperscript{130} Additionally, bitcoin payments provide an alternative way for foreign workers to send international remittances to family and friends in their home countries.\textsuperscript{131} Because transferring bitcoins between users is free, a bitcoin transfer would be cheaper and faster than using traditional wire transfers.\textsuperscript{132} While some critics may claim that legitimizing bitcoin will just exacerbate the problems with currency volatility, the growing acceptance and use of bitcoins may force countries to recognize and adapt to the public’s use of bitcoins. For this reason, the United States should alter its approach to encourage the use of and the development of bitcoin.  

As for taxing bitcoins and bitcoin transactions, the Service should first create a definitive valuation system for bitcoins, whether by recognizing one or several online currency exchanges as reasonable and accurate reports of a bitcoin’s fair market value or by creating its own bitcoin valuation system.\textsuperscript{133}

\textsuperscript{129} Id.  
\textsuperscript{130} Alternative cashless payment options, like M-Pesa, have already had significant success in the developing world. BitPago and Moneero are bitcoin payment startups based in Latin America that have gained significant traction in local markets.  
\textsuperscript{132} Id.
to currency converter. By having a clear valuation method, the Service would make it easier for taxpayers to report their bitcoin transactions and to comply with the Notice’s directives. In this way, the Service can work with the United States government to foster bitcoin use and thereby become a leader in virtual currencies, the likely currency and preferred payment method of the future.

V. Conclusion

Despite its illicit history, bitcoins have grown into a publically accepted virtual currency that legitimate businesses and taxpayers use because of its minimal transactions costs and efficiency. Bitcoin is a virtual currency that enables payments through digital money, or “cash for the internet,” with its roots in cryptography. A self-regulating currency, bitcoins are entirely virtual, but businesses and non-profits have begun accepting bitcoin payments as a way to minimize expenses and to capitalize on the growing number of bitcoin users.

The Service recognized the growing presence of virtual currencies, including bitcoin, and published Notice 2014-21 to explain how taxpayers should report virtual currency transactions and the resulting tax consequences. In doing so, the Service stated that virtual currencies will be treated and taxed like other property transactions. The Service directed individuals to report bitcoins at their fair market value at the time of receipt. Because of the lack of widespread trading and the variable creation of bitcoins through “mining,” individuals will have difficulty accurately reporting the market value of bitcoins, and it would be even harder for the Service to validate that market value. Google, CoinDesk, and other bitcoin-to-currency converters are unable to accurately value bitcoins because of the variety of exchanges allowed with bitcoins, and none of these converters are considered authoritative over each other. As a result, taxpayers will report the value of their bitcoins according to the currency converter that provides a value
that best serves each taxpayer’s situation. While self-reporting is not new in the tax arena, because bitcoin lacks a centralized market, the Service may be able to challenge and reject a taxpayer provided valuation.

Additionally, by deciding to tax bitcoin as property, the Service and taxpayers are capable of abusing the newly taxable status of bitcoin. The Service’s procedures create an incentive for taxpayers to not report bitcoin transactions and threaten to further depress the public acceptance of virtual currencies in the future. Further, while the United States’ treatment of bitcoins aligns with most countries’ approach and attitudes towards the currency, the few countries that have encouraged the use of bitcoin and other virtual currencies may place themselves at an economic advantage if bitcoin use continues to grow.

The Service’s lackluster response to bitcoin is not new or surprising to the bitcoin community. While not alone in its reluctant acceptance of bitcoin, the United States is putting itself at a disadvantage by not creating comprehensive and viable procedures to tax bitcoin transactions. The Service’s decision to treat bitcoin as property undermines the currency and creates such extensive record keeping problems that taxpayers may ultimately refuse to use bitcoins or may simply choose not to report bitcoin transactions. The Service appears to want to tax bitcoin as a “convertible” virtual currency without having the ability to accurately value a bitcoin at any given time. This shortcoming will create more problems for the Service unless more straightforward procedures are introduced or unless congressional legislation is passed to regulate the trading of bitcoins.

Still, the Service might be best suited to refrain from taxing bitcoin transactions until the Service can create a comprehensive solution, or to tax bitcoin transactions like foreign currency transactions. Any of these options would encourage the public to use of bitcoin, and each
alternative has the potential to generate tax revenue because bitcoin transactions would be more easily reported and valued. Essentially, the Service must be willing to set up a better system to observe and regulate bitcoins before the United States can benefit from the taxation of bitcoins.