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An awkward moment as taxman eyes bitcoin

By Joshua Sebold
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Recent Internal Revenue Service guidance on bitcoin threatens headaches for those who use the digital currency for buying and selling goods. Now expected to claim bitcoins as property, not currency, users will be on the hook for reporting capital gains realized through the purchase and sale of bitcoins — even if a gain resulted from buying a $2-equivalent cup of coffee. But despite initial concerns about the new reporting requirements, attorneys say bitcoin remains surprisingly robust and will likely spawn even more legal work going forward.

Joshua Sebold / Daily Journal
Emily J. Kingston, left, and Steven M. Katz, tax partners at Sideman & Bancroft LLP, say they were surprised to see the IRS label the digital currency as property.

Under the guidance, bitcoin users will have to note the initial market value of the bitcoins they own and then report any capital gains at the point when those bitcoins are sold. The property designation will also mean new obligations for businesses that accept bitcoins as payment and the so-called "miners" of bitcoins, who generate them through the use of special computer programs.

Attorneys said the changes will likely affect how people use bitcoins going forward, and it will almost certainly inconvenience users who have completed numerous transactions with bitcoins. Making things especially difficult is that the shift — to a designation that some feel is an awkward fit — occurred just weeks before 2013 tax returns are due.

"I was surprised," said Emily J. Kingston, a tax litigation partner at Sideman & Bancroft LLP, "because it has all the trappings of currency and is treated as such by most of the people who use it."

Bitcoin enthusiasts have pitched the online tool as a possible replacement for credit cards and money transfer services — one that would offer anonymity and heightened security — but the obligation to record the value of each bitcoin a user or business receives could be too burdensome for average users to tolerate. So rather than spending them, more people might view bitcoins as investment vehicles.

"People already hoard bitcoins, but you might find people hoarding them even more because spending them is a pain in the butt," said Veronica K. McGregor, a Jones Day partner who studies digital currency.

Trading bitcoins likely won't be as simple as dealing with stocks and bonds, because the IRS didn't include the option of using an "average-cost" method of recording bitcoin gains, which would make tracking the value of multiple bitcoins much easier.

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Using that method, said Douglas W. Schwartz, a tax partner at Nossaman LLP, an asset holder can assign a single average price to a group of investments rather than recording the individual price of each item.

"Let's say I bought four shares in a mutual fund, two shares for $10 and two for $20," Schwartz said. Under the average-cost method, "I could divide my $30 among all four shares and average them out."

For heavy bitcoin users, Schwartz said he would ask the IRS for further clarification on that point. He'd advise clients against assuming the agency would simply accept the average-cost accounting method.

The new regulations will also complicate life for bitcoin miners, who use computing power to help the bitcoin system function earning some of the digital currency in return.

For bitcoin advocates, one of the currency's most alluring traits is its system allowing third parties to analyze transactions objectively and ensure they're above board. This advantage has become even more apparent in light of recent high-profile scams involving online transactions. In theory, it means you don't have to trust the person who's paying you.

To pull this off, Bitcoin miners perform elaborate calculations that check whether a given Bitcoin transaction is legitimate. If enough separate mining computers agree that a given transaction is genuine, the first miner that approved the transaction is rewarded with bitcoins, providing an incentive for users to use their equipment for the collaborative recordkeeping effort.

The new IRS guidance could diminish that incentive. The rules indicate that bitcoins gained through mining will be considered taxable income, and people who mine bitcoins as their primary form of business will have to pay self-employment taxes.

"They're going to have this enormous reporting obligation," Kingston said.

But despite the early outcry surrounding the new IRS guidelines, few expect them to significantly weaken bitcoin. McGregor said the government clarification actually makes the controversial financial tool seem more stable and legitimate.

"The technology geeks and the people who are sort of anarchy hobbyists paid attention at the early stages. Now it's gaining traction in the cultural consciousness," she said. "This is when investors start to say, 'OK, well, somebody will find a way to make this work. We just need to back the right horse.'"

Attorneys expect some will view the new rules as a business opportunity, perhaps by designing consumer apps that automatically track capital gains on bitcoin transactions. Simple changes, they say, could further ease Bitcoin's use as currency.

And while the new rules eliminate deniability for those who hoped to use Bitcoin's relative anonymity to avoid paying taxes, said Steven M. Katz, another Sideman & Bancroft tax partner, the odds of persuading the government with that argument were never very good to begin with.

"Even though there may be some users out there who were viewing them as somehow outside of the system and a means to escape taxation," he said, "that was never really the case."

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