O'MALLEY & BERBERICH CPAs P.C.

Virtual Currency Overview

How Does the IRS Treat Virtual Currency?

The IRS treats virtual Currency as property for federal tax purposes. This means that, depending on your circumstances, Bitcoin can be classified as business property, investment property, or personal property. For example, if you mine Bitcoin as part of a trade or business, it will be considered business property. Because virtual currency is property (as opposed to currency) in the eyes of the IRS, you must recognize gain or loss every time bitcoin is exchanged for goods or services.

What If I Receive Virtual Currency as Payment for Goods or Services?

If you receive virtual currency as payment for goods or services, you must include in income the fair market value (measured in U.S. dollars) of the currency as of the date it was received. In most situations, virtual currency is listed on an exchange. For example, Bitcoin is listed on the Coinbase exchange (www.coinbase.com), among others. To calculate fair market value, you simply convert the virtual currency into U.S. dollars using the listed exchange rate.

If the virtual currency is later exchanged for other property, gain or loss will be recognized. You will report gain if the fair market value of the property received exceeds your basis in the virtual currency (generally, its fair market value on the date you received it). You will recognize loss if the fair market value of the property received is less than your basis in the virtual currency. If the virtual currency was held for investment purposes for more than one year, any gain will be subject to preferential long-term capital gain rates.

For example, say you digitally accept 10 Bitcoins as payment for services. On the date of receipt, Bitcoins are worth $1,000 each, as listed by Coinbase. Therefore, you recognize $10,000 ($1,000 x 10) of business income. A month later, when Bitcoins are trading for $1,500 on the Coinbase exchange, you use two Bitcoins to purchase supplies for your business. At that time, you will recognize $3,000 ($1,500 x 2) in business expense and $1,000 [($1,500 - $1,000) x 2] of gain due to the Bitcoin exchange. Since you are not in the trade or business of selling Bitcoins, the $1,000 gain is capital in nature.

What Happens If I "Mine" Virtual Currency?

During the *mining* process, complex math problems are solved to produce Bitcoins. In addition, Bitcoin transactions are verified and added to a public ledger. If you successfully mine virtual currency, you must include in income its fair market value as of the date of receipt. Also, if the mining activity is a trade or business (and you are not considered an employee of the business), your *net earnings*

What If I Use Virtual Currency to Pay Independent Contractors and/or Employees?

If an independent contractor receives virtual currency for performing services, the fair market value of the currency will be subject to self-employment tax. Also, the payment is subject to information reporting to the same extent as any other payment made in property. So, you are required to report a virtual currency payment with affair market value of $600 or more to the IRS and the independent contractor on form 1099-MISC.

If you use virtual currency to pay employee wages, the fair market value of the currency will be subject to federal income tax withholding, FICA and FUTA taxes, and must be reported on Form W-2 (Wage and Tax Statement).

Do I Have to Disclose Virtual Currency on My Foreign Bank Account Report?

If you have an interest of more than $10,000 in foreign financial accounts at any time during the year, you must file FinCEN Report 112 [Report of Foreign Bank and Financial Accounts (FBAR)]. It is not entirely clear if virtual currency must be disclosed on an FBAR. The IRS has informally stated (a Senior Program Analyst in the IRS's Small Business/Self-Employed division, during an IRS webinar) that taxpayers are not required to report Bitcoin on an FBAR. However, taxpayers may soon have to report virtual currency accounts held in foreign exchanges as the agency's focus on foreign assets sharpens. We will monitor this issue and let you know if anything changes.

What Are Some Best Practices on Handling Virtual Currency?

By far, the most important thing you can do is maintain detailed records on your virtual currency. The records should summarize (1) when the currency was received, (2) the current's fair market value on the date of receipt (check the applicable exchange), and (3) for what purpose you are holding the currency (investment, inventory, etc.). An effective way to track multiple batches of virtual currency is to store each purchase in a separate online wallet. Also, appropriate records should be maintained to show when each wallet was established.

Finally, always let us know when you engage in a virtual currency transaction. The IRS has been on the prowl for those using virtual currencies to evade taxes. Keeping us informed will allow us to properly report your virtual currency transactions.

As you can see, the tax treatment of virtual currency can be complex, but we are available to help. Please contact us if you have any questions or want more information.