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IRS notice may be obstacle for Bitcoin investors

Commentary by Marvin Kirsner

The use of Bitcoin has grown as a means of exchange in commerce, but a recent Internal Revenue Service notice could be an obstacle to its future role in the consumer economy.

Kirsner

This IRS notice will impose tax reporting obligations on both consumers who use Bitcoin to pay for merchandise and retailers who accept it as a method of payment. On the other hand, this IRS notice might benefit Bitcoin investors, at least in the short term.

The IRS released Notice 2014-21 in March stating that it will classify Bitcoin and other virtual currencies as property rather than treat it as a foreign currency.

An IRS notice stating it will classify Bitcoin and other virtual currencies as property rather than as a foreign currency may be good news for investors who hold Bitcoin for long-term investments, but the reporting burdens might reduce its use in consumer transactions.

On its face, the IRS notice is good news for investors who hold Bitcoin for long-term investment of more than one year because its classification as "property" rather than foreign currency will allow investors to pay tax at the favorable long-term capital gains rate when they sell their Bitcoin, rather that the higher tax rate for ordinary income. Gains from the sale of foreign currency, on the other hand, are taxed at the ordinary income rate, with a top rate of 39.6 percent. However, the burdens that this IRS notice will place on consumers who pay with Bitcoin might result in a slow-down of its use as a method of payment, which could affect its liquidity and reduce its long-term growth in value for investors.

CAPITAL GAIN

The problem the new IRS notice creates for consumers using Bitcoin to pay for everyday transactions is that it reminds them that each time Bitcoin is used in a retail transaction, the consumer will be treated as exchanging the Bitcoin for its fair market value, resulting in a taxable transaction, generating a capital gain or capital loss.

For example, assume a consumer purchased one Bitcoin for $500, and then uses it a month later to purchase a piece of jewelry that has a selling price of $700. This will generate a $200 profit to the consumer ($700 worth of goods purchased minus $500 paid for the Bitcoin).

This gain will have to be reported as a short-term capital gain on his federal income tax return. This will have to be done for every single transaction, no matter how small. All of the gains and losses on these exchanges over the course of the year will be netted, and tax will be due on the net gain.

Consumers who use Bitcoin to purchase merchandise will need to keep track of how much they paid for every Bitcoin they acquire, and then keep track of each time they use Bitcoin and tie the purchase of the merchandise to the price paid for the specific Bitcoin.

The bookkeeping requirements to keep track of the amount paid for the Bitcoin and the capital gain or loss triggered each time it is used as a method of payment might be cumbersome—at least until an app is developed that can track these transactions with the amount paid for each Bitcoin.

PAPER TRAIL

Retailers who accept Bitcoin also will have to keep track of their basis in the Bitcoin that they accept for payment, and report the gain or loss on the increase or decrease in its value from the time they accept it as payment, and the time they exchange if for currency.

It is not uncommon for Bitcoin prices to vary by 10 percent in a day, so unless the Bitcoin is simultaneously converted to cash as it is accepted as payment, this gain or loss calculation will need to be reported on the merchant's tax return each time a Bitcoin that was accepted for payment is converted into cash.

Small business owners who might have found the anonymity of Bitcoin enticing whether or not they intend not to report the sales paid in Bitcoin in order to evade taxes will also be affected by the IRS notice. The IRS says that third party settlement organizations who clear payments through credit cards, debit cards, gift cards and now Bitcoin transactions must file information returns telling the IRS the amount paid to retailers for Bitcoin transactions.

These new reporting requirements might result in fewer consumers and retailers using Bitcoin. If fewer consumers and retailers use Bitcoin, this might have a negative effect on its potential for appreciation as its popularity diminishes.

So, although the IRS notice may be good news for investors who hold Bitcoin for long-term investments, since the gains will be taxed at a more favorable tax rate, the reporting burdens on Bitcoin users might reduce its use in consumer transactions thus dimming its prospects for future appreciation.

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