PERSPECTIVE

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Can You Pay Your Lawyer in Bitcoins?

By Robert W. Wood

If you're like me, you only started hearing about Bitcoin within the last year, but it seems to be taking the tech world by storm. It is the best-known virtual currency, and recently surged from a relatively stable $135 throughout September to a mid-October value of around $210. The emerging popularity of Bitcoin raises tax questions, and the Internal Revenue Service is sure to want a piece of the action.

Some lawyers have started accepting Bitcoin for services. For many, there's still a counter-culture thrill about the currency. Millions in bitcoins were seized by the federal government when Ross Ulbricht, aka Dread Pirate Roberts, was arrested and his Silk Road website was seized. Techies debate how anonymous Bitcoin really is, though it also may go mainstream. The Winklevoss twins of Facebook fame launched an investment fund in the Bitcoin.

Still, some people want to use the upstart digital currency for tax evasion. Bitcoin exchanges occur on a peer-to-peer level, so there's no central bank or government. That makes it difficult for third parties to track transactions. What's more, Bitcoin "mining," or the acquisition of bitcoins through the use of computer processing power, can be done by anyone with the proper computer equipment and know-how.

But can the IRS tax Bitcoin transactions or Bitcoin mining, and what would that look like? Some believe the anonymity of the system and the fact that anyone with processing horsepower can mine Bitcoin makes it easy to evade taxes on Bitcoin transactions. They better think again.

The IRS started watching such issues in 2007. In 2009, the IRS posted information on its website on the tax consequences of virtual transactions. However, IRS has not provided taxpayers with information *specific* to virtual currencies. Does that mean IRS doesn't care?

Nope, but a Government Accountability Office (GAO) report released earlier this year says the lack of formal guidance can cause some people to *assume* tax doesn't apply. See Virtual Economics and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks, GAO Report 13-516, May 2013. The GAO report urges the IRS to do a better job telling people they have to pay tax on Bitcoin transactions. The report gives a few simple examples:

1. Bill is a Bitcoin miner. He successfully mines 25 bitcoins. Bill may have earned taxable income from his mining activities.

2. Carol makes T-shirts and sells them on the Internet. She sells a T-shirt to Bill, who pays her with bitcoins. Carol may have earned taxable income from the sale of the T-shirt.

In short, people trading in bitcoins may *think* they are avoiding taxes. But they are not, at least not always. The IRS has already agreed with the GAO's suggestions, and is watching virtual currencies closely.

But the question remains — how would the IRS go about taxing Bitcoin? There is confusion whether transactions in Bitcoin should be treated as property, barter, foreign currency, or a financial instrument. How you see it can determine the tax treatment. Barter transactions may seem like the most logical treatment, but not everyone agrees.

In a recent ruling in U.S. district court, a federal judge in Texas ruled Bitcoin should be treated as currency. *SEC v. Shavers,* No. 4:13-CV-416 (E.D. Tex. filed Aug. 6, 2013) involves a man who tricked investors into a Bitcoin Ponzi scheme, making more than $4,500,000 worth of Bitcoin. When the SEC tried to prosecute Shavers for fraud, he argued that the scheme involved only Bitcoin and, as Bitcoin is not currency, he could not be charged for fraud.

The court responded that Bitcoin can "clearly be used as money." It can be used to purchase goods or services, and the only limitation of its use is the number of places willing to accept it. That meant Bitcoin should be treated as currency, and a Bitcoin Ponzi scheme is fraud.

Bitcoin classification issues are in their infancy and other courts might see them differently. If Bitcoin is a commodity, one could deduct capital gains or losses on Bitcoin transactions. Alternatively, treating Bitcoin as barter might trigger the IRS's Bartering Tax Center. Soon, the IRS may have a Bitcoin Center, too.

For some, the allure of avoiding taxes with Bitcoin is like a siren song. In his paper "Are Cryptocurrencies "Super" Tax Havens?" Law Professor Omri Y. Marian notes the pressure facing financial institutions to hand over account holders and withhold and remit taxes. The fight against offshore evasion is raging. And although the Foreign Account Tax Compliance Act was enacted in 2010, the dreaded law is just now coming into its own.

The timing is a perfect storm for Bitcoin. In addition to the relative anonymity of Bitcoin, it is not dependent on the existence of financial intermediaries. But more government regulation is coming. The Treasury unit called FinCEN, the Financial Crimes Enforcement Network, already has rules about Bitcoin. See *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, FinCEN, FIN-2013-G001, March 18, 2013.

The IRS is likely to follow. For example, IRS Forms 1099 for Bitcoin payments can't be too far off. If you pay a consultant with a new car or in bitcoins you may have to issue a Form 1099 for that value. But in California's high-tech environment, what about paying employees?

If you are paying wages with Bitcoin, you can hardly withhold some of the Bitcoin and send it to the IRS. If you exchange bitcoins for cash, whether you have gain may depend on whether Bitcoin is really currency or commodity. If the latter turns out to be true, you have gain to the extent of the appreciation in your Bitcoin.

FinCEN says Bitcoin exchanges and Bitcoin miners should register as Money Services Businesses and comply with anti-money laundering regulations. So far, ordinary Bitcoin users don't have to register just to purchase goods and services. The IRS treats it as pay in kind, just as if you paid in groceries or anything else of value. You must value what's provided, withhold income and employment taxes in cash and send the money to the IRS. If you pay employees, the employer must issue a Form W-2.

With no banking or government involvement, Bitcoin may be anonymous. It may even be ideal for someone who intentionally tries not to pay tax. Indeed, the intricacies of "mining" and the difficulty of tracking transactions in a peer-to-peer system make Bitcoin tax evasion schemes likely.

Yet even many cash transactions are the subject of IRS tax forms, and I'll bet some Bitcoin pay ends up on a Form 1099 or W-2. If I'm right and Bitcoin transaction reporting spreads, the IRS may have to specifically address it. Until then, digital pioneers accepting and paying in Bitcoin are tax pioneers, too.

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