tax treatment for virtual currencies like Bitcoin (IRS Notice 2014-21). In brief, taxpayers have been advised to treat Bitcoin as property for U.S. tax purposes. But accountants, particularly those with small business clients, are still struggling to get a better handle on how this will work in real-life situations.

Ken Berry, JD • May. 13, 2014

After several years of head-scratching, the IRS has finally offered guidance on the tax treatment for virtual currencies like Bitcoin (IRS Notice 2014-21). In brief, taxpayers have been advised to treat Bitcoin as property for U.S. tax purposes. But accountants, particularly those with small business clients, are still struggling to get a better handle on how this will work in real-life situations.

Virtual currency generally operates like "real" currency, such as coins or paper money of the U.S. or a foreign country, if it designated as legal tender, is put in circulation and is customarily used and accepted as a medium of exchange. Bitcoin is the world's most popular virtual currency. But no virtual or digitally-based currency, even Bitcoin, is considered legal tender in any jurisdiction.

Under the new Notice, the IRS says that virtual currency is to be treated as property under the U.S. tax laws. Although there's a belief in some quarters that the IRS will retract this stance, for now the general tax principles that apply to regular property transactions will also apply to transactions using virtual currency like Bitcoin. For example:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.
- Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply.

Normally, payers must issue Form 1099.

all the FAQs at http://www.irs.gov/pub/irs-drop/n-14-21.pdf?utm_source=3.31.2014+Tax+Alert&utm_campaign=3.31.14+Tax+Alert&utm_medium=

So what happens if you walk into a Starbucks in Manhattan and pay $5 in Bitcoin for a grand latte (Starbucks recently announced it will be accepting Bitcoin.) If you acquired the Bitcoin for $4, you'll owe a capital gains tax on your $1 profit. On the other hand, Starbucks would have to recognize the full $5 in gross income. (These prices are hypothetical.) Theoretically, you would have to report the tax ramifications for each time you engaged in one of these relatively trivial activities.

This puts a burden on both the consumer, who has to think very carefully about buying and selling decisions involving Bitcoin, and the businesses that must account for the transactions. And it could lead to a recordkeeping nightmare for those who aren't prepared.

Third-party vendors are already staking out the turf. Washington-based Avalara, a leading developer of online sales and use tax automation software, has launched a system for supporting Bitcoin other virtual online currencies. In a telephone conversation with CPA Practice Advisor, Webb Stevens, Head of Product at Avalara, noted the widespread impact of the use of Bitcoin on a transactional basis. "If you use Bitcoin, third-party integration will be needed for transactions," said Stevens. "It is important for keeping track of accounting and sales taxes across 12,000 tax jurisdictions."

For the time being, Bitcoin transactions have been relegated to cutting-edge corporations like online retailer Overstock.com and a small cadre of forward-thinking bricks-and-mortar businesses scattered throughout the country. But its use is expected to grow in leaps and bounds as consumers and businesses increasingly embrace this new technology. Most CPAs are standing by, awaiting further guidance from the IRS.