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Craig Smalley • Dec. 18, 2017

The Classification of Bitcoin and Cryptocurrency by the IRS

By Craig W. Smalley, EA, MST

In 2014, after many years of speculation, the Internal Revenue Service (IRS) issued guidance in Notice 2014-21 that classified cryptocurrency as property[1], not currency, for federal income tax purposes. But according to the requirements of the Foreign Account Tax Compliance Act (FATCA), which requires foreign financial institutions to provide the IRS with information about accounts held by U.S. taxpayers or foreign entities controlled by U.S. taxpayers, cryptocurrency exchanges, in the ordinary course of doing business, are considered financial institutions.

On Nov. 30, 2016, a federal judge in the Northern District of California granted an IRS application to serve a "John Doe" summons[2] on Coinbase Inc., which operates a cryptocurrency wallet and exchange business. The summons asked Coinbase to identify all U.S. customers who transferred convertible cryptocurrency from 2013 to 2015. Why? Because the IRS is trying to get cryptocurrency owners to report the value of their wallets to the federal government.

So, an argument could be made that the IRS is treating cryptocurrency as both property and currency.

Reeling from this dichotomy, the American Institute of Certified Public Accountants recommended in a June 2016 letter[3] to the IRS that cryptocurrency accounts be reported in the summary information section of Form 8938, *Statement of Specified*

Foreign Financial Assets, which breaks with the IRS's 2014 guidance that

In the case of cryptocurrency, we have a dichotomy where the IRS is treating the currency as property for income taxes, and then asking that the property be reported as a foreign bank account.

Property is divided into certain sections within the Internal Revenue Code (IRC) that determine everything from how the property is treated at sale, to how the property is depreciated, to the nature and character of the gain on sale of the asset. For instance, IRC §1231 property (real or depreciable business property held for more than one year) is treated as capital in nature when sold for a profit[4], but is treated as ordinary when the property is sold for a loss[5].

IRC §1245 property, on the other hand, is treated as ordinary in nature[6]. §1245 property encompasses most types of property. IRC §1250 property covers everything else. IRC §1250 states that a gain from selling real property that has been depreciated should be taxed as ordinary income, to the extent that the accumulated depreciation exceeds the depreciation calculated using the straight-line method, which is the most basic depreciation method used on an income statement. § 1250 bases the amount of tax due on the type of property, such as residential or nonresidential property, and on how many months the property was owned.[7]

IRS guidance is silent on which section of the tax code cryptocurrency falls into. For instance, IRC §1031 allows for the like-kind exchange of certain property. §1031 exchanges typically are done with real estate or business assets. However, with the classification of cryptocurrency as property by the IRS, many tax professionals will argue that cryptocurrency can be exchanged using IRC §1031.

IRC §1031 Exchange

IRC §1031 is a deferral mechanism that allows a taxpayer who exchanges investment property with like-kind investment property to defer any gain until such property is exchanged for property that is not of a like kind, such as cash. Instead of being

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