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Bitcoins

There's a new phenomenon emerging in the digital world; it's called "bitcoin." Bitcoin is a digital payment system that uses a peer-to-peer network to facilitate payments made in units called bitcoins. Members of the network can use an open-source cryptographic protocol to verify payments in return for transaction fees and new bitcoins in a process called "mining."

Commercial acceptance of bitcoins as payment has been slow; most of the bitcoin action has been in speculation. The value of one bitcoin was $15 in January 2013, and it rose to a peak of $1,100 in December of that year. At press time, one bitcoin was worth about $600.

Last spring a bitcoin project was announced at MIT. Two students raised enough money from donors to permit them to give $100 worth of bitcoin to every undergraduate student next fall. The goal is to develop a "bitcoin ecosystem" in which the use of bitcoin in purchases becomes routine. The group has been working through the summer on bringing local business on board.

The project has the support of ten faculty members. Professor Alex Pentland commented: "While the specific properties of bitcoin have some real problems, getting everyone at MIT to start playing with bitcoin … will prompt the MIT community to begin thinking seriously about how we can live in an all-digital future."

The IRS weighs in

In March the IRS delivered its views on the emergence of digital currencies. The most important observation was that a digital currency such as bitcoin is property, not currency. As such, it has a tax basis. Using bitcoin in making payments will generate taxable events, a major defect in using it for routine transactions.

For example, assume an individual used a bitcoin acquired for $15 in January 2013 to buy something today worth $600. Seems like quite a bargain. But the use of the bitcoin in this situation generates a taxable gain of $585, the difference between the $15 basis and the $600 value of the transaction. That amount will be subject to income tax. The tax may be at capital gain rates if the bitcoin is a capital asset in the hands of the owner. On the flip side, if a coin acquired for $1,100 is used for that $600 purchase, a loss may be incurred. The loss may or may not be deductible.

The Service clarified that bitcoins won't be an avenue for avoiding other tax rules. For example, bitcoins received by an independent contractor for performing services will be considered self-employment income, subject to self-employment tax as well as income taxes. If wages are paid in bitcoins, they are still subject to employment taxes. Payments made in bitcoin are subject to the same information-reporting requirements as payments made in dollars. Payments made in virtual currencies are subject to backup withholding in a manner similar to payments in dollars.

Finally, the IRS warns that tax penalties will apply, including accuracy-related penalties and penalties for failure to file information returns when required. Limited relief may be available for transactions before March 21, 2014, the date of the announcement.

Some observers believe that the effect of the IRS announcement will be to seriously impair the utility of bitcoin as a virtual currency. However, that hasn't dampened the enthusiasm at MIT, where the project is still expected to go forward in the fall.

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