Section of Taxation

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March 24, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Notice 2014-21.

Dear Commissioner Koskinen:

Enclosed please find comments in response to Notice 2014-21, which provided guidance on the tax consequences of transactions involving virtual currency ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
Erik Corwin, Deputy Chief Counsel – Technical, Internal Revenue Service
Andrew Keyso, Jr., Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
Hon. Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON NOTICE 2014-21

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Danshera Cords, Chair of the Section's Committee on Teaching Taxation (the "Committee"). Substantive contributions were made by Bryan Camp, Adam Chodorow, and Omri Y. Marian of the Committee; Kevin Johnson, Jennifer Breen, and Susan Berson of the Section's Committee on Administrative Practice; and Peter Hardy and Bryan Skarlatos of the Section's Committee on Civil and Criminal Tax Penalties. These Comments were reviewed by Adam Handler of the Section's Committee on Government Submissions, Keith Fogg, the Section's Council Director for the Committee, and Peter H. Blessing, the Section's Vice Chair (Government Relations).

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: March 24, 2015

EXECUTIVE SUMMARY

These Comments respond to Notice 2014-21[1] (the "Notice"), which provided guidance in FAQ format concerning certain issues raised by "convertible" virtual currencies. We commend the Internal Revenue Service (the "Service") for issuing guidance on this topic. Recognizing that guidance in this area may be an evolving process, these Comments identify a number of issues raised by the decision to treat virtual currency as property that the Notice does not address. In addition, these Comments identify questions about character, reporting, compliance and enforceability that may be important to address to ensure that the timing and characterization consequences of virtual currency transactions are consistent with cash and/or barter transactions.

While we have separated our Comments by FAQ number, we wish to emphasize certain underlying themes. First, future guidance should provide as much flexibility as possible to accommodate the changing uses to which virtual currencies will be put. Second, sensitivity will be required in future guidance to ensure that income and deductions are not mismatched and to prevent taxpayers from shifting the character of income between capital and ordinary. Third, the characterization of virtual currency as property as well as the anonymous nature of certain transactions poses vexing issues of compliance that require attention.

[1] Notice 2014-21, 2014-16 I.R.B. 938.

DISCUSSION

The following Comments respond to Notice 2014-21, in which the Internal Revenue Service (the "Service") requested comments "regarding other types of aspects of virtual currency transactions that should be addressed in future guidance." The Notice uses a Frequently Asked Questions (FAQ) format to address some of the key tax issues that arise with virtual currencies and the Comments are organized accordingly.

The Comments make an important assumption about the scope of the Notice. The Notice specifically addresses the tax treatment of "convertible" virtual currencies. We understand this term to refer to open-flow cryptography-based peer-to-peer currencies ("peer-to-peer currencies") (also known as cryptocurrencies, because of the encrypted algorithms used in their creation), and not to other forms of virtual currencies (for example, virtual currencies used in multiplayer online games), despite the fact that these other virtual currencies are, in some sense, "convertible." Should the Service intend to encompass other forms of virtual currencies, guidance should explicitly state the scope of the guidance's reach.

FAQ 1 states the basic rule that virtual currency is treated as property.

1. The Service should consider if and how this guidance might change in light of several possible future developments. First, a foreign country might adopt a virtual currency as legal tender; in such a circumstance, would such virtual currency be considered foreign currency subject to the rules under sections 985-89?[2] Second, businesses might create third-party exchanges. How would this affect how gains and losses are measured? For example, if third-party exchanges charged transaction fees for facilitating transactions, how would a merchant conducting business report such fees? Would they be treated as a cost of acquisition and therefore capitalized? If so, a mismatch might arise between the character and timing afforded the virtual currency sales vis a vis other merchant sales. If disposition of virtual currency is a transfer of property, then gains or losses would arise on the retransfer of the virtual currency and recovery of transaction fees incurred would be deferred until such retransfer of the currency. We are concerned that taxpayers may find it difficult to comply because of uncertainty in this area, especially in high volume transactions as a result of the absence of identifying information and recordkeeping. This may suggest an approach for these types of costs similar to those used for credit card fees, which are treated as ordinary business expenses.

2. Virtual currency can rapidly appreciate or depreciate. A merchant could receive $1 in virtual currency, have it appreciate in one minute to $1.20, and then use the virtual currency to purchase other goods or services. Under the Notice, it appears that the merchant would be required to report the $.20 gain.

[2] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

3. A de minimis exception, either with respect to value or holding period, may be appropriate. Without a de minimis exception, the cost of reporting may overwhelm taxpayers and require significant resources. Any such exception should be consistent with the FinCEN and IRS guidance related to foreign currencies. Creation of a de minimis exception should also include guidance on record-keeping. We recognize that may require statutory authorization, as such authorization existed for the de minimis exceptions to the general backup withholding and information reporting requirements found in sections 3046(b)(4) and 6041(a), respectively. However, the longstanding, de minimis rule in the capitalization versus expensing treatment permitted under appropriate circumstances appear to have been created under section 7805, and so the general section 7805 regulatory authority could be sufficient to create a de minimis exception to reduce record keeping and administrative burdens.

4. In the alternative, the Service may also consider whether third parties who clear cryptocurrencies transactions should submit information to cryptocurrencies consumers who use clearing services.

FAQs 3 & 4 require taxpayers who receive virtual currency as payment for goods or services to use the rules of section 1001 to calculate gain, and to measure fair market value in U.S. Dollars.

1. We welcome guidance on how this rule applies to exchanges that do not value virtual currency in U.S. dollars. It would be helpful to know what documentation the Service will accept to establish cost of acquisition, holding period, and related measures of value.

2. We welcome guidance on how taxpayers should measure the basis of currency received as payment for goods or services, and, therefore, gain or loss in instances where the taxpayer has acquired virtual currencies in several transactions at different times. One potential difficultly with the valuation on receipt rule is the fungibility of virtual currencies. Would cost averaging, LIFO, and FIFO all be reasonable accounting approaches, or will one convention be mandatory? The use of pooling or cost averaging might be an accurate measure, especially in the context of merchants conducting many transactions each day.

FAQ-5 concerns how to determine the fair market value of virtual currency.

1. We suggest replacing the word "real" with "legal tender currency." Users may consider virtual currency to be every bit as "real" as a U.S. dollar. Such a word change could eliminate time and resource consuming philosophical arguments at the outset. Guidance regarding what the Service views as a "reasonable" and "consistent" manner for measuring the fair market value of currencies with multiple markets would be helpful.

2. We welcome guidance on timing and other tax accounting issues. When is virtual currency received? For example, some taxpayers receive virtual currency as a result of their computer's actions, called "mining." Others receive it in exchange for goods or services. Is virtual currency always "received" when the currency is transferred to a

virtual wallet or account, or should there be different rules for receipt depending on how the virtual currency is acquired? Will the miner recognize income when all acts entitling the miner to virtual currency are complete (for example, when mining through a mining pool creates an entitlement for cryptocurrency, but such cryptocurrency has not been received yet)?

FAQ 6 concerns how taxpayers compute gains or losses upon an exchange of virtual currency for other property.

1. We welcome guidance on how this rule applies to exchanges of one virtual currency for another. The FMV of property received in exchange for virtual currency is used to determine the taxpayer's basis in the virtual currency paid.[3] The operating presumption in property exchanges is that they have equal fair market values.[4] Will this FAQ and the related basis rules apply to the exchange of one virtual currency for another? Or will virtual currencies be viewed as cash equivalents, particularly in instances where only one exchange exists or there is an established market that sets the value of the virtual currency?

2. We welcome guidance on the application of section 1031. If exchanges of virtual currencies are property swaps, how may such exchanges qualify for non-recognition under section 1031?

FAQ 8 states: "when a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income."

1. We welcome guidance on the treatment of mining costs. Miners may incur costs in the process of "mining" virtual currency. How and when may such costs be deducted for purposes of determining a miner's basis in virtual currency?[5]

2. We welcome guidance on the tax consequences of pooled mining. Given the computing capacities required to mine virtual currencies, most miners pool their computing resources through "mining pools." Such pools might constitute partnerships for tax purposes. If so, guidance on the possibility of making an election under section 761(a), as well as on timing and character of income included from the mining pool would be useful.

3. How is interest to be treated by a lender and borrower in a peer-to-peer lending platform wherein borrowers submit loan requests and the lenders make loans of virtual currency in such a manner that interest is assessed on the virtual currency, including for purposes of the FATCA, FBAR and other financial reporting regulations?

[3] *Philadelphia Park Amusement Co. v. United States*, 126 F.Supp. 184 (Ct.Cl. 1954).
[4] *Id.*
[5] See also comment to FAQ 9.

FAQ 9 concerns whether mining is an activity subject to self-employment tax.

1. We welcome guidance on the circumstances that would indicate whether mining activity is a trade or business, or is an investment activity.

2. We also welcome guidance on the character of income generated by mining. One characteristic of mining virtual currency about which we are concerned is that, depending on the resources available and dedicated to mining, which varies dramatically, some miners are "awarded" more bitcoins than others. Miners acquire bitcoins by using computer resources to solve complex problems in maintaining the public bitcoin ledger. By doing so, miners verify ownership transfers. Specifically, each problem requires multiple steps of analysis and only the miner whose computer takes the last necessary step is rewarded with a Bitcoin. It is thus arguable that miners are rewarded for "service" similar to bookkeeping. It is also arguable that mining resembles pull tab gambling. Based on the time and dedication to the enterprise the courts have recognized gambling as a trade or business.[6] In the alternative, can bitcoins acquired by solving the algorithm be treated as a capital gain where a miner has invested in the activity, but has not been actively involved in the enterprise? We welcome guidance regarding whether mined bitcoins acquired for the mining activity should be treated as prize income, earned income, or even in some instances capital assets.

FAQs 12 and 13 say that virtual currency transactions are subject to information reporting to the same extent as any other payment made in property.

1. We welcome guidance on how taxpayers must account for virtual currencies held by third party providers located outside the United States. Many users hold their virtual currencies with third party providers, or use such providers to facilitate transactions in virtual currencies. Providers such as virtual currency exchanges, mining pool operators, virtual currency payment clearing services and others can plausibly be treated as financial institutions for FATCA purposes. Is FATCA reporting required for virtual currency? If so, how should taxpayers comply?

2. We welcome guidance on whether virtual currencies are subject to FBAR reporting? If so, guidance regarding the contours of the reporting requirements would be helpful. The technology for possessing virtual currency can vary; the issues presented are whether a particular holding of virtual currency represents a "foreign" "financial account" subject to reporting. Would different rules apply to different storage mechanisms, such as different types of virtual wallets?

3. We welcome guidance on how taxpayers may obtain cooperation from third parties to satisfy reporting requirements. Without some cooperation, compliance with, or enforcement of, any given reporting requirement will be difficult because of the difficulty associated with decrypting private keys. Can this difficulty be overcome without cooperation from a virtual currency holder, issuer, buyer, seller, or miner?

[6] *Comm. v. Groetzinger*, 480 US 23 (1987), *aff'g* 771 F2d 269 (7th Cir. 1985), *aff'g* 82 T.C. 793 (1984).

4. We welcome guidance on recordkeeping practices that would comply with the section 6041 reporting requirements. The nature of virtual currencies and their relative anonymity raises concerns about the record keeping that would be required of an owner, user, recipient, or miner of virtual currency. Guidance regarding the recordkeeping practices and compliance would be especially useful to taxpayers who accept or use virtual currency in exchange for goods or services. How is a purchaser of goods or service that must provide information reporting to make such a report when the seller is entirely unknown and unknowable to the seller and vice versa?

5. Third party virtual currency exchanges also face this problem. A virtual currency exchange operates similarly to a financial institution or to a barter exchange, which section 6045(c)(3) defines as "any organization of member providing property or services who jointly contract to trade or barter such property or services." Both financial institutions and virtual currency exchanges would benefit from clear guidance regarding their information reporting obligations. To what extent are virtual currency exchanges required to issue Forms 1099 to people who participate? Challenges in devising reporting requirements in this area include compliance issues may be unduly exaggerated by possible penalization in the marketplace for compliant businesses. We hope that guidance can be crafted that would allow this fledgling endeavor to mature and grow. In addition, we caution against underestimating the extent to which the Service will be required to devote resources to this issue. On the other hand, we recognize the implications for the tax system posed by the anticipated behavioral response if a segment of otherwise reportable transactions were exempted from reporting.

6. We welcome guidance addressing the recordkeeping requirements for persons who are under a duty to submit information returns. One of the chief characteristics of cryptocurrencies is the relatively high level of anonymity and difficulty associated with identifying a counter party in a transaction. What steps must a U.S. person take to ensure proper withholding on foreign payments and Form 1099-MISC reporting to other U.S. persons? Will a U.S. person be required to keep specific transactional documentation? Will the use of tax calculators (certain tools that may be used to measure the difference between acquisition value and disposition value of the virtual currency) be evidence that a buyer or seller has demonstrated reasonable and consistent treatment of virtual currency transactions?

FAQ 14 and 15 concern back-up withholding and collection measures

1. We welcome guidance about what steps taxpayers must take to comply given that transactions may be anonymous. Both withholding and determination of counterparties may be difficult in light of the encryption of transactions using both public and private keys. Our comments above concerning recordkeeping also are relevant here.

2. We welcome guidance on other collection issues. Will levies on virtual currency exchanges be subject to section 6332(c) (which allows a 21 days stay after service of levy on a bank before it must surrender "deposits")?

FAQ 16 concerns penalties.

We welcome guidance about penalties. It would be helpful to have guidance explaining the circumstances under which a taxpayer has made a sufficiently good faith effort to comply to avoid the assertion or imposition of a penalty. Because of the relative anonymity of those involved in the transaction, it may be difficult for a purchaser or seller to provide valid taxpayer information about the seller or purchaser. Unduly high due diligence burdens could burden either or both to such an extent that the transaction, often of relatively small amounts, will not occur. That business will then be consummated between two non-U.S. buyers and/or sellers. Another area of useful guidance would be standards regarding what a taxpayer would be required to show to have penalties waived. Would consistent use of a tax calculator be adequate?

Conclusion

Cryptocurrencies, and their exchange platforms, are in an early stage of development. We commend the Service for issuing Notice 2014-21. We recommend that the Service issue further guidance in FAQ or a similar format, which can be easily modified as the Service develops its understanding and expertise of virtual currencies. This will allow the continued evolution while still addressing the variety of current and anticipated tax issues. We would be happy to discuss these issues at your convenience.