Virtual currencies are not currently accepted as the legal tender or “fiat” currency of any country. In the United States, the IRS has stated its view that convertible virtual currency is property, subject to the general tax rules that apply to property, and is not foreign currency. As such, virtual currency does not qualify for the special tax rules available to foreign currency transactions. This article explores the major consequences of this rule on taxpayers.

**IN DEPTH**

At the date of this article, no government (generally) treats any virtual currency as its legal tender or “fiat” currency, which means that virtual currency is not accepted as any country’s valid and legal currency (Financial Crimes Enforcement Network, FIN-2013-G001, “Guidance on the Application of FinCEN’s Regulations to Persons to Persons Administering, Exchanging, or Using Virtual Currencies,” March 18, 2013). Although virtual currency has a digital representation of value and can be used as an alternative to money in some circumstances, it is not issued by a central bank,

In Notice 2014-21, the IRS states its view that convertible virtual currency is property, subject to the general tax rules that apply to property transactions. The IRS explicitly says that virtual currency is not foreign currency (Notice 2014-21, Q&A-2), which means that virtual currency would not qualify for the special tax rules available to foreign currency transactions. (For additional discussion, see McDermott’s article, “The Legal Effect of IRS Pronouncements on Virtual Currency.”)

Taxing virtual currencies as property—not foreign currency—has four major consequences for taxpayers.

- First, the tax character (as capital or ordinary) of many foreign currency transactions does not turn on the taxpayer’s tax status. Instead, many foreign currency transactions generate ordinary income or loss without regard to the taxpayer’s tax status. Taxpayers who enter into virtual currency transactions, on the other hand, must determine their status as an investor, trader, dealer, hedger, miner, staker or personal user. For a discussion of the tax issues for miners, stakers and personal users, see the following McDermott articles:
  - “Taxation of Virtual Currency Mining Activities” – (to be published June 24)
  - “Taxation of Virtual Currency Staking Activities” (to be published June 24)
  - “Virtual Currency Losses Disallowed on Infrequent Activities”

As a result, ordinary income or loss is only available to virtual currency users that hold virtual currency as ordinary assets or that are eligible to make certain elections into ordinary tax treatment (I.R.C. § 988(a)(1); see I.R.C. § 475(f) and McDermott’s article, “Can Virtual Currency Traders Elect into Special Rules that Allow Current Deductions of Trading Losses?” (to be published June 24).

- Second, each unit of virtual currency has its own tax basis, which requires taxpayers to track the basis of each unit or position they hold by identifying each individual unit or position they dispose of. (For additional discussion of the tax basis rules that apply to virtual currencies, see McDermott’s article, “Specific Identification of Virtual Currency Positions.”) Taxpayers cannot rely on the average cost basis method for determining tax basis and calculating gains and losses as they can for their foreign currency transactions that they enter into for personal use (not for business or investment purposes) (I.R.C. § 988(e)).

- Third, individual taxpayers cannot rely on the personal use exemption that applies to foreign currency transactions. This means that taxpayers must report gain or loss every time they sell or spend virtual currency units, with their gain or loss based on the change in their units’ value between the time they were acquired and when they were disposed of.

- Fourth, the $200 de minimis gain exclusion available to individual taxpayers for their personal use of foreign currency is not available to taxpayers with respect
to virtual currency. As a result, all virtual currency gains are taxable and the *de minimis* gain exemption of $200 does not apply to taxpayers for personal use virtual currency (I.R.C. § 988(e)(2)).

* * * *

The tax distinctions between transactions in virtual currency, which is taxed as property, and foreign currency transactions can be very significant. Taxpayers should discuss their virtual currency holdings with their tax advisors to determine appropriate tax reporting for their transactions.

If a particular virtual currency subsequently becomes the legal fiat currency of a government or foreign country, gains and losses on that particular virtual currency generally would be taxed at ordinary rates under I.R.C. § 988, without regard to the tax status of the taxpayer. Treatment as a foreign currency could result for such a virtual currency without additional guidance from the Treasury or the IRS. Taxpayers should be aware of this possibility and monitor new developments.

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