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When Should Bitcoin be Subject to FBAR?

Submitted by: Arash Kiadeh, MST Student

Introduction

The IRS has not issued official guidance on whether or not bitcoin held in a foreign online account (known as a Bitcoin wallet)¹⁹ is to be reported on the Report of Foreign Bank and Financial Accounts (FBAR). The most recent statement from the IRS was during a webinar on June 4, 2014 in which Rod Lundquist, a Senior Program Analyst for the Small Business/Self-Employed Division stated, “At this time, FinCEN has said bitcoin is not reportable on the FBAR, at least for this filing season.”²⁰ This begs two questions: *should* bitcoin in a foreign online account be reportable on the FBAR and should bitcoin in a paper wallet or hard drive *located* in a foreign country be reported on the FBAR?

¹⁹ Coindesk. (2014, Dec. 22). How to Store Your Bitcoins. Retrieved from <http://www.coindesk.com/information/how-to-store-your-bitcoins/>

²⁰ Erb, K. (2014, June. 30). IRS Says Bitcoin Not Reportable on FBAR (For Now). Forbes. Retrieved from <http://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/>

History of the Tax Rule

By 1970, the Mafia was a hot topic and Congress was looking to provide tools to law enforcement to help take them down. Two key laws came into effect in 1970: 1) the Racketeer Influenced Corrupt Organization Act (RICO) which essentially made it illegal to be a part of a criminal organization and whereby mafia bosses could more easily be prosecuted for the crimes committed by their underlings²¹ and 2) the Bank Secrecy Act (BSA) which “requires businesses to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters.”²²

²¹ Schneider, S. (2015, May. 3). RICO Act. Encyclopedia Britannica. Retrieved from <http://www.britannica.com/topic/Racketeer-Influenced-and-Corrupt-Organizations-Act>

²² IRS Website. (n.d.). Bank Secrecy Act. Retrieved from <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Bank-Secrecy-Act>

The name “Bank Secrecy Act” stems from the fact that the law was intended to target those who used bank accounts in foreign secrecy havens to evade taxes and launder money.²³

The BSA requires individuals to report financial accounts maintained outside of the U.S. This is codified in 31 USC § 5314, which is titled Records and Reports on Foreign Financial Agency Transactions. The regulations are in 31 CFR § 1010.350 and state that all U.S. persons who maintain foreign financial account(s) that have a combined total of more than \$10,000 at any time during the year must file a Report of Foreign Bank and Financial Accounts (FBAR).

Since the FBAR laws were originally enacted a number of different financial instruments and products have been categorized as falling within the definition of financial account. Specifically, in addition to traditional bank accounts, accounts for the following are also considered financial accounts reportable on FBARs: securities, commodity futures,

insurance policies with cash value, and mutual funds.²⁴

Potential Precedent Setting Case

Reading into the initial intent of Congress in passing the Bank Secrecy Act (to stop foreign bank accounts from being used by criminals to evade tax and commit crime) suggests that the FBAR requirement would apply to bitcoin maintained in a foreign online account. Figuring out exactly where it fits into the law and regulations proves more challenging. A recent court case, *U.S. vs. John C. Hom* is a potential precedence setting case.²⁵

Hom played online poker at two different sites both located outside the U.S., PartyPoker and PokerStars.²⁶ Both sites allow users to deposit and withdraw real money and to maintain a balance.

The IRS brought suit against Hom because his poker accounts had a balance of more than \$10,000 in 2006 and 2007, which triggered the requirement to file an FBAR.²⁷ Per the regulations, “each United States person having

²³ American Banker’s Association. (n.d.). History of the Bank Secrecy Act. pg-1. Retrieved from <http://www.aba.com/Compliance/Documents/07cbe87f05f94aa8b84faa573c790ba5AppendixC.pdf>

²⁴ IRS Website. (2011, Feb. 24). IRS FBAR Reference Guide. Retrieved from http://www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf

²⁵ *U.S. vs. John C. Hom*, 45 F. Supp. 3d 175 (N.D. Cal. Jun. 4, 2014)

²⁶ *Id.*

²⁷ *U.S. vs. John C. Hom*, 45 F. Supp. 3d 175 (N.D. Cal. Jun. 4, 2014)

a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country shall report such relationship.”²⁸

The courts’ analysis found that the accounts maintained at the online poker services met the definition of a bank, and therefore, an FBAR was required. Specifically, the reasoning flowed as follows: under § 1010.350 (c)(3)(i) “other financial account” is defined as “an account with a person that is in the business of accepting deposits as a financial agency.” The Poker accounts were clearly accepting deposits, but did the service provided by PartyPoker and PokerStars make them a “financial agency”?

Under 31 U.S. Code § 5312 (a)(1) a financial agency is a “person acting for a person” as a “financial institution” or a person who is “acting in a similar way related to money.”²⁹ Consequently, if the accounts and related services provided by the poker companies met the definition of financial institution, then they met the definition of financial agency. The definition of a “financial institution” in § 5312 (a)(2) lists 26 different types of entities that are considered financial institutions. An online

poker account was not one of them. However, the court cited *United States v. Dela Espriella*, 781 F.2d 1432, 1436 (9th Cir. 1986), which stated that “the term ‘financial institution’ is to be given a broad definition.”

Also, the court cited *Clines*, 958 F.2d at 582, which stated that “by holding funds for third parties and disbursing them at their direction, [the organization at issue] *functioned as a bank.*”

Online poker and Bitcoin accounts have many similarities. In both instances a person can deposit, withdraw, and maintain a balance. Some of the differences are that a bitcoin account is funded with bitcoins vs. a poker account must be funded with currency. Also, a bitcoin account can be used to purchase real goods and services from anyone that accepts bitcoin. Differences aside, based on the broad interpretation of the term financial institution, the analysis in the Hom case can be used to make a compelling argument that the services provided by foreign online

²⁸ 31 CFR 1010.350

²⁹ *Id.*

bitcoin account providers should be considered financial institutions subject to FBAR reporting.

What about Bitcoin Stored on Paper Wallets and Hard Drives Located in a Foreign Country?

The IRS does not require antiques, jewels, cars, art, foreign currency, and real property that is held outside the country *directly* to be reported on an FBAR.³⁰ For instance, \$20,000 worth of pesos held in a safe deposit box in Mexico is not reportable because a safe deposit box is not considered a financial account. Thirty-thousand dollars in gold bars sitting in a Canadian vacation home is also not reportable. Bitcoin has characteristics of currency and jewels (they are both “mined” and often held for investment.³¹ Neither foreign currency nor jewels are required to be reported on an FBAR if held directly, and therefore, bitcoin should not be either.

³⁰ IRS Website: Comparison of Form 8938 and FBAR Requirements (2/2/2015 ver.): <http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements>

³¹ See: <http://www.coindesk.com/information/how-bitcoin-mining-works/>

Principles of Good Tax Policy

Equity and Fairness

Requiring bitcoin held in a foreign online account to be reported on an FBAR increases horizontal equity. The IRS has stated that virtual currencies such as Bitcoin should be treated as property.³² However, bitcoin undeniably has characteristics of real currency (such as functioning as a medium of exchange), which is required to be reported on an FBAR if it meets the threshold and is kept in an offshore financial account. If two individuals both maintain foreign accounts with more than \$10,000 in currency (virtual or real), they should both be subject to FBAR reporting.

While horizontal equity is increased, vertical equity may be decreased if FBARs are required. Requiring FBARs will increase the cost of maintaining and transacting with bitcoin. Lower income taxpayers are likely to have smaller bitcoin account balances than higher income taxpayers. Therefore, in proportion to their account balances, lower income taxpayers would in theory bear a larger compliance burden. This theory is balanced against the fact that in many, if not most cases, the amount of bitcoin held by

³² IRS Notice 2014-21

lower income tax payers would not meet the filing threshold. Additionally, higher income taxpayers are more likely to already have offshore accounts that require an FBAR. Adding one additional account to their existing FBAR will not pose a significant increase in costs for these particular taxpayers.

Certainty

Providing an IRS Notice or amending the regulations to definitively require bitcoin held in a foreign online account to be reported on an FBAR would increase certainty for taxpayers. The most recent guidance from the IRS came on a June 4, 2014 webinar in which Rod Lundquist a Senior Program Analyst for the Small Business/Self-Employed Division, stated that virtual currencies are not required to be reported.³³ The guidance also stated that this may change. In the meantime, searching for Internet advice about Bitcoin and FBAR produces articles written by several tax experts stating that as an abundance of caution virtual currencies should be reported on an FBAR.³⁴ This uncertainty creates confusion

³³ Erb, K. (2014, June 30). IRS Says Bitcoin Not Reportable on FBAR (For Now). Forbes. Retrieved from <http://www.forbes.com/sites/kellyphillipserb/2014/06/30/irs-says-bitcoin-not-reportable-on-fbar-for-now/>

³⁴ Id., Also see Beyoud, L. (2014, June. 10). Bitcoin Exchange Accounts Should Be

for people who currently hold bitcoin and may be holding others back from purchasing bitcoin.

Convenience of Payment.

Requiring bitcoin to be reported on an FBAR will not impact the time or manner that the taxpayer will be required to pay tax on any income from bitcoin. This is because the FBAR is merely a foreign account reporting form and not an income tax form.

Economy in Collection

Requiring an FBAR will increase costs to taxpayers but may reduce overall costs to the government. Taxpayers will bear the cost of submitting an additional form and keeping track of account balances throughout the year. Currently, taxpayers must maintain records of purchases, sales and uses of bitcoin to be able to calculate taxable income.³⁵ If FBAR reporting were mandatory and taxpayers knew they faced steep FBAR penalties for incorrect calculations, their overall record keeping would likely improve. This improved record keeping would simplify the government's

Reported on FBARs, Analysts Say. Daily Tax Report. Retrieved from <http://www.bna.com/bitcoin-exchange-accounts-n17179891170/>

³⁵ IRS Notice 2014-21

ability to audit a taxpayer and collect the correct amount of tax. However, this analysis is pure speculation, and the actual impact would be difficult if not impossible to measure since offshore bitcoin accounts are easily hidden.

FBAR is difficult for the average taxpayer. Couple this difficulty with the fact that a taxpayer must read laws and regulations and search for the most recent IRS guidance before deciding if an FBAR is required.

Neutrality

Under current IRS guidance, the principal of neutrality is not met. A foreign online bitcoin account has many characteristics of securities and currency held in a foreign account, both of which require the filing of an FBAR. Decisions whether to purchase bitcoin or a security will be skewed toward Bitcoin for individuals who do not want the additional cost of filing an FBAR. Mandating FBARs for Bitcoin would allow taxpayers to make their decisions without having to weigh the cost of compliance.

Economic Growth and Efficiency.

The effect mandating FBARs for Bitcoin will have on economic growth and efficiency has strong arguments on both sides of the coin (pun intended). Bitcoin has at least three

Simplicity

The regulations should be amended to provide a definite answer to a taxpayer's question of "does my virtual currency need to be reported on an FBAR?" As it is, complying with an characteristics which give it the power to potentially revolutionize the world economy. Those characteristics and how they interact with growth and efficiency are as follows.

- 1) Transaction costs are lower than other payment methods (think credit cards, Paypal and wire transfers) which increases purchasing power. This is particularly important for lower income individuals. Requiring FBARs will raise transaction costs, negatively impacting growth for lower income individuals.
- 2) Intermediaries such as banks are not required to conduct a transaction with bitcoin. Therefore, Bitcoin gives the unbanked population the ability to purchase items online just like others. This characteristic of Bitcoin will not be changed by reinterpreting the regulation.
- 3) Bitcoin is a global currency, not tied to any particular country. This feature has the potential to provide a currency with stability. Although no single country has the ability to control Bitcoin, each country can make their

own rules. Whether certain countries choose to ban Bitcoin or accept it has a yet to be determined impact.

On one hand, requiring FBARs may enhance the legitimacy of Bitcoin, which will lead to greater acceptance and increased opportunity for the poor and unbanked to benefit from it. On the other hand, the additional costs and time required to file an FBAR may drive people away from Bitcoin.

Transparency and Visibility.

The proposal will substantially enhance this principle. Currently, there exists a world of confusion about whether or not to file FBARs for bitcoin. Internet searches reveal a slew of analysis and opinions by CPAs and law firms, but no concrete guidance.

Minimum Tax Gap.

Requiring FBARs will undoubtedly minimize the tax gap. The first Voluntary Offshore Initiative was launched in 2003.³⁶ Taxpayers were given the option to come forward, declare their offshore accounts, and pay the

³⁶ IRS Website. (1/14/2003) IR-2003-5, IRS Unveils Offshore Voluntary Compliance Initiative; Chance for ‘Credit-Card Abusers’ to Clear Up Their Tax Liabilities: <http://www.irs.gov/uac/IRS-Unveils-Offshore-Voluntary-Compliance-Initiative;-Chance-for-‘Credit-Card-Abusers’-to-Clear-Up-Their-Tax-Liabilities>

back taxes they owed. In return, the IRS would not criminally prosecute these taxpayers or assess them the stiff FBAR penalties. In conjunction with this initiative, the IRS ramped up enforcement and outreach about the need to file FBARs. As a result of these efforts, the number of FBARs filed in 2004 more than doubled by 2009, going from 217,699 to 534,043, respectively.³⁷ IRS news release 2012-5, released January 9, 2012, stated that the IRS had collected a total of \$4.4 Billion from its 2009 and 2011 offshore voluntary disclosure programs.

As the aforementioned research shows, the stiff penalties, outreach, and various offshore compliance initiatives have brought in over \$4 billion dollars and increased FBAR compliance. Mandating FBARs for foreign online bitcoin accounts will have a similar effect of increased compliance with the tax laws.

Appropriate Government Revenues.

Prior research on the number of unfiled FBARs found that it was nearly impossible to determine exactly how many people were not

³⁷ 9/29/2010 TIGTA Report at: <http://www.treasury.gov/tigta/auditreports/2010reports/201030125fr.html>

compliant.³⁸ They did arrive at some broad estimates.³⁹ This will very likely be the case here. However, a few years after FBARs are mandated for bitcoin, the government will have new information to draw upon to analyze and assess the amount of Bitcoin related tax revenue it can expect.

Conclusion

FBARs should be required for bitcoin held in a foreign online account. Implementing this requirement will not need an amendment to the laws or regulations. Existing laws and regulations are broad enough that they can be interpreted as already requiring FBARs for bitcoin. Hence, to implement the new requirement, the IRS only need issue a Notice explaining their position. This will undoubtedly be challenged and make its way to court. In court, the IRS will be able to leverage off of the analysis in the *Hom* decision.

Bitcoin accounts should be reportable because they meet the definition of “other financial accounts” under the current regulations. Here

is why. In *Hom*, the court reached the conclusion that poker accounts were reportable because the way they were being used fell within the definition of financial institution, which was within the definition of financial agency, which made them subject to reporting. To expand on that analysis, an online bitcoin account will fit in at least two places within the 26 different definitions of financial institution.

31 USC § 5312(a)(2)(H) defines a financial institution as a “broker or dealer in securities or commodities.” One definition of broker is as follows: An individual or firm employed by others to plan and organize sales or negotiate contracts for a commission.⁴⁰ Bitcoin exchanges that provide online bitcoin accounts function like brokers by charging a commission to organize sales of bitcoin. Dictionary.com defines commodity as “something of use, advantage or value.”⁴¹ Bitcoin can be *used* to purchase goods and services, and it also has a readily available *value*. Based on these definitions, we can substitute exchange for broker and Bitcoin for commodity, and we arrive at the conclusion

³⁸ Sheppard, H. (2006). Evolution of the FBAR: Where We Were, Where We Are, and Why it Matters. Houston Business and Tax Journal. Retrieved from <https://americansabroad.org/files/5413/6913/9189/sheppard2.pdf>

³⁹ Id.

⁴⁰ The Free Dictionary.com. (n.d.). Retrieved from <http://legal-dictionary.thefreedictionary.com/broker>

⁴¹ Dictionary.com. (n.d.). Retrieved from <http://dictionary.reference.com/browse/commodity>

that a Bitcoin exchange meets the definition of financial institution.

31 USC § 5312(a)(2)(R) defines financial institution as “... any other person who engages as a business in the transmission of funds, including any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system.” Because the IRS has characterized bitcoin as property not currency, the definition of “funds” must be interpreted broadly. An online dictionary defined funds as “A sum of money or other resources set aside for a specific purpose.”⁴² Bitcoin can definitely be classified as other resources. Additionally, the second half of the definition suggests that the spirit of the law was to capture informal value transfer systems, not just “informal money transfer systems.”

To maintain simplicity, bitcoin accounts should be reported on the existing FBAR form. Most if not all of what is required on the existing form (maximum account balance, type of account, financial institution name,

and account number) is relevant to reporting an online bitcoin account. Minor adjustments to the FBAR instructions will be required such as what type of account to select for bitcoin: “Bank” or “other.”

Regardless of where and how Bitcoin fits into the regulation, the IRS should take the time to finalize its research on Bitcoin and other virtual currencies and issue official guidance. Mandating FBARs will enhance the majority of the 10 guiding principles of good tax policy, increase tax revenue, and produce records that will assist law enforcement, which is what the BSA originally intended.

⁴² Thefreedictionary.com. (n.d.). Retrieved from <http://www.thefreedictionary.com/funds>