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High Net Worth Family TAX REPORT

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Congressman Camp Camp Releases His Long-Awaited Tax Reform Plan

On February 26, 2014, David Camp (R-Mich.), Chairman of the House Ways and Means Committee, released his long-awaited plan to reform and simplify the Internal Revenue Code. The Tax Reform Act of 2014 would reduce the marginal tax rates on individuals and pay for the rate reduction by eliminating or further restricting a variety of popular deductions. Although Camp has vowed to push hard for tax reform before retiring at the end of this year, the political division of the current Congress makes passage unlikely. Accordingly, we will mention only some significant highlights and keep you informed of future significant developments.

For most taxpayers, Camp would fix the top marginal rate at 25 percent. For individuals with modified adjusted gross income in excess of $400,000 ($450,000 for married individuals filing a joint return), the highest marginal rate would be 35 percent. The current 20 percent income tax rate on long-term capital gain income would be replaced by a deduction of 40 percent of the gain amount with the balance of 60 percent being taxed at the regular rates. For taxpayers in the 35 percent bracket, this would increase the capital gain tax rate to 21 percent. The 3.8 percent Medicare tax would continue to apply on top of that. Qualified dividends, also currently taxed at a 20 percent rate, would be taxed in the same manner.

The significant tax deductions and other benefits that would be eliminated or curtailed include the following:

- The deduction for state and local income taxes, sales taxes and taxes on real property would be eliminated.
- The maximum home mortgage on which the interest can be deducted would be reduced from $1,000,000 to $500,000 for debt incurred after 2014. Existing debt can be refinanced at the same principal amount prior to 2018, and interest will remain deductible on the current ceiling of $1,000,000. The deduction for interest on home equity loans of up to $100,000 would be eliminated.

- The ability to exchange like-kind property tax-free under IRC Section 1031 would be eliminated.
- The deduction for personal exemptions would be eliminated; however, the standard deduction would be increased, so even fewer taxpayers will need to itemize their deductions.
- The deduction for medical expenses would be eliminated.
- The deduction for personal casualty losses would be eliminated.
- Employees receiving Form W-2 salary income would no longer be permitted to deduct any business expenses they incur in connection with their jobs.
- The cost of having your income tax returns prepared would no longer be deductible.

A bit of good news is that the alternative minimum tax would be repealed, as would the current 2 percent floor on adjusted gross income for deducting miscellaneous itemized deductions, as well as the itemized deduction phaseout.

The above good news, however, is offset for many high-income taxpayers by another provision that would impose an adjusted gross income floor of 2 percent on charitable contributions. In other words, a taxpayer would receive a charitable contribution deduction only to the extent that his contributions exceed 2 percent of his adjusted gross income.

For many taxpayers, the loss of the above deductions would add more to their tax bill than the rate reductions would save them. We will keep you apprised of significant developments.

Tax Court Addresses Valuation Issues Related to Tax on Built-In Corporate Gain

In *Estate of Richmond* (February 2014), the Tax Court again addressed how a future liability for income taxes on built-in asset gain should be taken into account in determining the value of the stock of a closely held corporation for estate or gift tax purposes. In this case, a family holding company that was a C corporation owned a portfolio of publicly traded stocks. Most of the positions had been held for years, and the unrealized appreciation represented about 87 percent of the total value of the portfolio, so significant income tax would be payable by the corporation if it sold the portfolio.

There has been a lot of litigation over the past ten or more years on how a future tax liability should be taken into account for valuation purposes. There are differing views among the Tax Court and the Courts of Appeal that have considered the issue. The Fifth and Eleventh Circuits have allowed a discount for 100 percent of the future tax liability on built-in asset gain when valuing the shares of a company that owns the built-in gain assets. The Second and Sixth Circuits, along with the Tax Court, have taken the view that future recognition of the gain is not certain and there may be things that can be done to mitigate the future tax liability. These courts have allowed a discount of something less than the full amount of the future tax.

In the *Richmond* case, the Tax Court followed the IRS expert witness's opinion that the correct discount was 43 percent of the future tax liability. The expert had based his opinion on the discount for future taxes reflected in the price of shares of closed-end mutual funds.

The case also presented other interesting issues. The estate's expert had valued the holding company shares before applying any discounts by capitalizing the dividend stream that the portfolio produced. The court said that discounting future cash flow was not an appropriate valuation method for assets that have daily published trading prices such as the stock portfolio in this case.

Significantly, the court also agreed with the IRS that the valuation understatement penalty should be imposed. The court pointed out that the initial appraisal for the estate was done by a CPA, rather than by a certified appraiser. The court also noted that at the time the estate tax return was filed, the taxpayer had received only an unsigned draft of the appraisal report and said a taxpayer could not rely on an unsigned draft for purposes of filing the return.

Shareholder of S Corporation Required to Include Income Even Though Shut Out from Management

The recent case of *Kumar v. Commissioner* (August 2013) highlights a very important consideration for anyone who becomes a minority shareholder of an S corporation. In general, an S corporation does not pay Federal income tax on its taxable income. Instead, each shareholder reports his proportionate share of the income on his individual tax return and pays any resulting income tax, similar to what occurs with a partnership or limited liability company.

In *Kumar*, the taxpayer owned 40 percent of a professional medical corporation that was an S corporation for income tax purposes. Following a dispute among the shareholders, he was frozen out of management and received no salary or distribution from the corporation. He did receive a Schedule K-1 that reported his share of the corporation's taxable income.

He argued that he was not the beneficial owner of his shares because he had been frozen out of the corporation's management. The Tax Court did not accept this argument and held that as long as he owned the shares, he had to pay tax on his share of the corporation's income whether or not he received it or had any say in the management of the corporation.

The lesson here is that you should never become the owner of shares of an S corporation in a non-controlling situation unless the corporation has in place a Shareholders' Agreement that provides that the corporation must make distributions each year in an amount sufficient to enable the shareholders to pay their income taxes on their share of the corporation's income. Many S corporations do not have Shareholders' Agreements in place, but many of them should. A Shareholders' Agreement is also very useful in preventing shareholders from transferring their shares to a person, trust or entity that is not permitted to be a shareholder of an S corporation.

The same issue can arise in a partnership or limited liability company. The partner or member must pay tax on his share of the net income whether or not he receives any distributions from the entity. In the case of these entities, however, it is now common practice to include a provision in their governing agreement that requires tax distributions to be made to the partners or members. If you are acquiring an interest in a partnership or limited liability company, you should be sure that the applicable agreement contains such a provision.

Tax Court Rules That a Trust Can Materially Participate and Be Actively Engaged in Real Property Businesses under the Passive Activity Loss Rules

On March 27, 2014, the Tax Court released its much-anticipated decision in the *Frank Aragona Trust* case. At issue in the case was how material participation of a trust is determined under the passive activity loss rules and whether a trust can qualify for the exception to the passive activity loss rules for taxpayers who are engaged in a real estate business on a substantially full-time basis.

In general, losses from a business activity conducted by an individual as a proprietor or through an entity or trust are treated as passive losses unless the taxpayer "materially participates" in the activity. Passive losses can be deducted only against other passive activity income. The principal way that a taxpayer can materially participate is by spending more than 500 hours during the year on the activity.

In the case of rental activities, including real estate, the activity is always passive, even if the taxpayer does materially participate. There is an exception to this rule, however, in IRC Section 469(c)(7) for people who work substantially full-time in a real estate business. If the taxpayer materially participates and also spends more than half of his working time and more than 750 hours in real estate trades or businesses, then his real estate rental activity is not a passive activity.

The concept of passive activity has recently taken on expanded importance beyond just limiting the deduction of losses. If a taxpayer does not materially participate in a business activity in which he has an ownership interest, then his income from that activity is also subject to the new 3.8 percent Medicare tax imposed on net investment income.

The IRS has consistently taken a very narrow view of how a trust can materially participate in a business activity. Its position has been that only participation by actual trustees may be considered and then only to the extent they participate in their capacity as a trustee. If they are also employed by a business owned by the trust, the IRS has said that their participation as an employee of the business cannot be counted. The IRS took an even narrower view of the full-time real estate exception and said that a trust simply cannot qualify for that exception.

These positions of the IRS came before the Tax Court in the *Frank Aragona Trust* case. The court took a very long time to reach its decision after the trial was completed and the parties' briefs had been filed. People who follow the passive activity area have been eagerly awaiting the result, which was a significant taxpayer victory.

The court first determined that there is nothing in IRC Section 469(c)(7) or its legislative history that would lead to a conclusion that the exception was not intended to apply to trusts. Having dispensed with that issue, the court turned to how the level of participation by the trust was determined. The court determined that all activities of the trustees, whether in their trustee capacity or in their capacity as an employee of the business owned by the trust, should be counted. In this case, three of the trustees worked full-time in the trust's real estate business, so all of the participation requirements were easily satisfied.

The court did not have to decide, and so left for another day, the question of whether the activities of employees of the trust or its business who are not also trustees can be counted. Again, the IRS does not think so. Thus far, one District Court in Texas, in the *Mattie Carter* case, has held that the activities of any employees can be counted. That issue may eventually reach the Tax Court as well. The government may also appeal the *Aragona* case to the Court of Appeals.

New York Court Clarifies Statutory Residence Test

A resident individual for New York State income tax purposes generally is an individual who (1) is domiciled in New York State or (2) maintains a permanent place of abode in New York State and spends more than 183 days of the taxable year in the state (a "statutory resident"). The New York Court of Appeals, the highest court in New York, in *Gaied v. New York State Tax Appeals*, ruled that to qualify as a statutory resident, there must be some basis to conclude that the permanent place of abode was used as the taxpayer's residence.

In *Gaied*, the taxpayer was domiciled in New Jersey but worked in and owned a multifamily apartment building in New York State for investment purposes and, in part, as a residence for his parents. While the taxpayer insisted that he never lived or maintained any personal effects at his parents' apartment, he paid the bills and maintained a telephone number for the apartment. The taxpayer had keys to the apartment but contended he never had unfettered access to it. He stayed at the apartment at his parents' occasional request to assist with their medical needs and slept on the couch. The New York State Department of Taxation and Finance argued that to qualify as a statutory resident, a taxpayer does not have to actually dwell in the permanent place of abode, only maintain it. The New York Court of Appeals determined that the taxpayer must himself have a residential interest in the property to have maintained a permanent place of abode to be a New York statutory resident. The court remanded the case to the lower court to resolve whether the taxpayer used the apartment as a residence.

IRS Clarifies Substantial Risk of Forfeiture in New Section 83 Regulations

Code Section 83 generally requires an employee to include in ordinary income the value of property which is transferred in connection with the performance of services when the property is no longer "subject to a substantial risk of forfeiture." If the transferred property is determined to be subject to a substantial risk of forfeiture, the employee will not be required to take the value of the property into income for income tax purposes until the risk of forfeiture lapses. An employee may, however, elect under Code Section 83(b) to take the value of the property into income at the time of the transfer to avoid tax on a potentially higher value when the restrictions lapse.

The Section 83 Treasury regulations generally provide that whether a risk of forfeiture is "substantial" depends on the particular facts and circumstances. Recently issued final Treasury regulations effective January 1, 2013, clarify that (1) a "substantial risk of forfeiture" may be established only if rights in the property transferred are subject to a "service condition" (*i.e.*, future performance of services or refraining from performance of services) or a "condition related to the purpose of the transfer" (*i.e.*, a performance condition); (2) in determining whether a "substantial risk of forfeiture" exists, both the likelihood that a forfeiture event will occur and the likelihood that the forfeiture will be enforced must be considered; and (3) transfer restrictions applicable to stock or securities (such as rights of first refusal, call rights, lock-up provisions, blackout periods and insider trading compliance programs) generally will not create a substantial risk of forfeiture, even if a violation may result in penalties or disgorgement of some or all of the property.

Both the final Treasury regulations and the *Austin* case (discussed below) indicate that the existence of a "substantial risk of forfeiture" for purposes of delaying the timing of income taxation will turn on the facts and circumstances of each case and whether the likelihood that forfeiture may occur is truly substantial, in some cases without regard to how forfeiture provisions are labeled.

Tax Court Clarifies Cause Definition in Section 83 Regulations

In *Austin v. Commissioner*, the taxpayers formed an S corporation into which they transferred their ownership interests in certain entities in exchange for S corporation shares. The taxpayers, employees of the S corporation, executed related Restricted Stock Agreements and Employment Agreements requiring them to perform future services in order to secure full rights in their S corporation stock. The Employment Agreement provided that taxpayers would forfeit a substantial amount of the value of their stock upon a termination for cause prior to a certain date, which included the taxpayers' refusal to perform their customary duties of employment.

The Treasury regulations under Code Section 83 provide that a requirement that stock be forfeited "if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture." The taxpayers argued that their S corporation stock was subject to a substantial risk of forfeiture, and therefore, absent a Section 83(b) election, there is no income until the stock vests (*i.e.*, ceases to be subject to the substantial risk of forfeiture).

The Tax Court noted that prior proposed Section 83 Treasury regulations provided that a substantial risk of forfeiture would not have occurred if the employee were required to forfeit stock because the employee committed a crime. The phrase "discharged for cause" was added to the final Section 83 Treasury regulations and is not defined by statute, regulation or legislative history. The Tax Court determined that "discharged for cause" does not necessarily have the same scope or meaning that parties to a particular contract may have given to it in their negotiations. Discharged for cause, the Tax Court stated, refers to a termination for serious misconduct that is roughly comparable – in its severity and in the unlikelihood of its occurrence – to criminal misconduct. Further, the ability of the S corporation to terminate the taxpayers for unsatisfactory job performance is not a remote event that is unlikely to occur.

The Tax Court ultimately determined that the taxpayers' potential to forfeit a substantial amount of the value of their stock upon a termination of employment for failure to perform their customary duties of employment prior to a certain date essentially amounted to an earn-out restriction that gave rise to a substantial risk of forfeiture. Even though the taxpayers' failures to perform their customary duties of employment were grounds for termination for cause, the Court determined that such activity is outside the scope of the meaning of discharged for cause or for committing a crime under the Section 83 Treasury regulations. As a result, the taxpayer was immediately taxable on the receipt of the stock.

In sum, although forfeiture of property received for services on termination for cause or for commission of a crime generally is not considered to be substantial, the facts in this case indicated that any voluntary termination of employment by the employee would necessarily come under the definition of termination for cause as defined in the applicable agreement (which included the employee's failure or refusal to perform customary duties of employment) such that the risk of forfeiture in that case was determined by the Court to be substantial.

Change to California 541 Schedule J Regarding Trust Allocation of an Accumulation Distribution

This article is included for the benefit of tax return preparers. The California taxation of trust accumulation distributions is complex and not something that is important for most clients to understand. The rules are generally designed to tax a beneficiary who receives a distribution of income that a trust accumulated in prior tax years as though the beneficiary received the income in the same year the trust received it.

Under the California Revenue and Taxation Code provisions, no exception to the California throwback taxes exists for accumulations in a trust during a period when a California resident beneficiary was under the age of 21 (even though there was such a rule under the repealed federal throwback tax statute). However, in the past, the instructions to the California fiduciary income tax return (Form 541) have stated something different. Specifically, the instructions for years prior have stated that a beneficiary may exclude amounts accumulated before the beneficiary becomes age 21.

The instructions have changed on the 2013 California Schedule J (Form 541). They state that "California R&TC Section 17779 specifically excludes from conformity IRC Section 665. Therefore, California law does not conform to federal law to exempt from taxation those accumulations occurring prior to a beneficiary turning 21." We also note that the current instructions reiterate that the trustee must report the total amount of all accumulations, regardless of the beneficiary's age at the time of accumulation.

New Jersey Voluntary Disclosure Initiatives

New Jersey recently announced two limited voluntary disclosure initiatives that run from March 15, 2014, through May 15, 2014. During such period, all penalties will be waived and there will be a limited "look back" period with respect to:

- Partnerships with New Jersey-sourced income that have not filed the applicable New Jersey forms or remitted the respective tax and fees to New Jersey ("Partnership Initiative"); and
- Companies that derived income from intangible assets used in New Jersey that have not reported such income to New Jersey ("Intangible Initiative").

Both initiatives require taxpayers to file all required returns and pay any tax liability reported within 45 days of executing a voluntary disclosure agreement and remit any interest within 30 days of assessment. The returns remain subject to audit with respect to issues not covered under the terms of the voluntary disclosure agreement with New Jersey. The Partnership Initiative limits the look back to periods beginning on or after January 1, 2010, and also applies to individual partners that have not satisfied their New Jersey filing and tax remittance requirements. The Intangible Initiative limits the look back to the later of periods beginning after July 1, 2010, or the date the business commenced and allows companies that have paid and added back royalties to their New Jersey entire net income to amend returns for open periods to claim an exception to the add back.

To participate, a taxpayer (1) cannot have had any previous contact by the New Jersey Division of Taxation or any of its agents; (2) cannot be registered for the taxes the taxpayer wishes to come forward and report; and (3) cannot currently be under any criminal investigation.

Taxpayer Falls into Ordinary Income Trap under Section 1239

The recent case of *Fish v. Commissioner* (November 2013), points out a very subtle trap into which this taxpayer stumbled. The taxpayer owned a business through an S corporation called "Fish Security." As part of a plan to bring in outside financing, he formed a new corporation to serve as a holding company ("Fish Holding") and also elected to treat the new holding company as an S corporation. The taxpayer contributed the stock of Fish Security to Fish Holding to create a parent-subsidiary structure. Since an S corporation cannot have a corporation as its shareholder, it was necessary to make a Qualified Subchapter S Subsidiary ("QSUB") election for Fish Security. This resulted in Fish Security being deemed liquidated into Fish Holding under IRC Section 332.

The deemed liquidation was tax-free, so no problems had resulted yet. Following the QSUB election, Fish Security no longer existed for income tax purposes, and all of its assets were treated as owned by Fish Holding. For state corporate law purposes, however, Fish Security did exist and was a wholly owned subsidiary of Fish Holding. The concept of an entity that is disregarded for income tax purposes but still exists under state law is a very useful one for tax planning but can be extremely confusing.

To bring in outside financing for the business, Fish Security issued preferred stock to investors. This terminated the QSUB election for Fish Security because a QSUB must meet all of the same requirements as an S corporation and an S corporation is permitted to have only one class of stock. Part of the proceeds received for the preferred stock were distributed by Fish Security to Fish Holding and then out to its shareholder, the taxpayer in this case.

It fell upon the Tax Court to work through the income tax consequences of these steps. This is something that the taxpayer obviously did not do in a careful manner. When Fish Security issued the preferred stock, its status as a QSUB terminated. When the QSUB status terminated, its shareholder, Fish Holding, was deemed to have contributed all of Fish Security's assets to Fish Security in a Section 351 transaction. This would have been a tax-free transaction but for the cash from the investors that was distributed by Fish Security to Fish Holding as part of the same transaction. The cash was considered "boot" and caused Fish Holding to recognize taxable gain on the asset transfer under IRC Section 351(b). The gain flowed out to the individual shareholder of Fish Holding because Fish Holding was still an S corporation.

Next, the court had to determine the character of the gain, and this is where the subtle trap came into play. The tax gain arose from the transfer of assets from Fish Holding to Fish Security that was deemed to occur when the QSUB election terminated and Fish Security simultaneously distributed cash to Fish Holding and then to the shareholder. Because Fish Holding owned 100 percent of Fish Security, they were “related parties” for purposes of IRC Section 1239. Section 1239 provides that if depreciable property is sold to a related party, the seller recognizes ordinary income rather than capital gain. The principal asset sold was the goodwill of the business, which is considered a depreciable asset because it is subject to amortization under IRC Section 197.

The Section 1239 trap arises most often in transactions that are not structured as sales but end up being treated as sales, such as what happened here. The taxpayer probably intended to have a Section 351 tax-free incorporation of Fish Security; however, the contemporaneous cash distribution of boot turned part of the transaction into a sale to which Section 1239 applied.

Property Equalization Payment Was Not Deductible as Alimony

In *McNealy v. Commissioner* (February 2014), another taxpayer tried but failed to obtain an alimony deduction for a payment made to his ex-spouse. Upon their divorce, the taxpayer and his wife each waived spousal support from the other. They agreed to divide their assets equitably as reflected on a schedule they prepared. Part of the equitable division included a cash payment from the taxpayer to his wife in the amount of $40,000, which he deducted as alimony under IRC Section 215.

The Tax Court held that the payment was not deductible because it was a part of the property division and settlement and was not paid for spousal support. In order to be a deductible alimony payment the payment must be made pursuant to a written agreement or court order and the instrument must not designate the payment as not being includible in income by the recipient and not being deductible by the payor. The payment(s) must also cease upon the death of the recipient.

While the agreement did not explicitly say that the payment was not included in the wife’s income, the court inferred that it was not because the payment was identified as part of the property settlement and property settlement transfers are not taxed due to IRC Section 1041. In any event, the payment was also disqualified from being deductible because nothing in the agreement said it did not have to be paid if the wife died before receiving the payment. This is a requirement of deductible alimony that is frequently overlooked.

In another recent alimony case, *Wignall v. Commissioner* (January 2014), the taxpayer got a better result. While his agreement with his spouse did not provide that the spousal support payments terminated at the spouse’s death, the Tax Court determined that under the applicable Oregon law, support payments do terminate upon the death of the recipient. The best practice is always to put a clear provision in the parties’ agreement providing that support terminates at the recipient’s death. You should not rely on state law to bail you out.

Tax Court Changes Its Position on Assumption of Potential Estate Tax Related to a Net Gift

In *Steinberg v. Commissioner* (September 2013), the Tax Court changed a position it had maintained since 2003 in connection with “net gifts." In a net gift transfer, the donee agrees to pay the donor’s gift tax that results from the gift. It is well established that this assumption by the donee reduces the amount of the gift being made and therefore also reduces the amount of the gift tax.

In some net gift transfers, the donee also assumes the obligation to pay any estate tax that may become due under IRC Section 2035(b) as a result of the gift. Section 2035(b) provides that if someone makes a gift and then dies within three years of making the gift, any gift tax that was paid by the decedent or his estate in connection with the gift is brought back into the donor’s estate for Federal estate tax purposes. The courts have held that gift tax paid by the donee is deemed to have been paid by the donor for this purpose.

In the *McCord* case in 2003, the Tax Court held that the amount of the gift could not be reduced by the actuarial value of the estate tax that would be payable if the decedent dies within three years of making the gift. Since it was not known whether the taxpayer would die within three years and whether any additional estate tax would even be payable, the court did not believe it was appropriate to reduce the gift amount by some amount of hypothetical estate tax that may never be paid.

The Tax Court's position in the *McCord* case was reversed, however, by the Fifth Circuit on appeal. In the *Steinberg* case, the Tax Court decided that the Fifth Circuit was correct and that the liability for the contingent tax could be valued using recognized actuarial methods and mortality tables.

Taxpayer Has Capital Loss Rather Than Ordinary Loss upon Abandoning Stock

In *Pilgrim's Pride Corporation v. Commissioner* (December 2013), the taxpayer owned stock in another company for which it had paid $98.6 million. The company did not do well and offered to buy back the stock for $20 million. The taxpayer determined that if it abandoned the stock rather than selling it, it could claim an ordinary tax loss rather than a capital loss and the ordinary loss would result in tax saving to it in an amount greater than the $20 million the company had offered for the shares. Consequently, the taxpayer abandoned the shares and transferred them back to the company for no consideration.

The basis for deducting an ordinary loss from what is clearly a capital asset derives from the sale or exchange rule. In order for a capital asset to give rise to a capital gain or loss, it must be transferred in a transaction that is treated as sale or exchange. Where an asset is abandoned for no consideration, courts have held that there is no sale or exchange. The tax regulations also recognize this concept, and Treas. Reg. Section 1.165-2 allows an ordinary loss where property is abandoned under certain circumstances. The regulation does not apply, however, where the loss is incurred on a sale or exchange of the property.

While it appeared that this taxpayer should get an ordinary loss since an abandonment is generally not treated as a sale or exchange, the Tax Court thought otherwise. The Tax Court on its own initiative asked the parties to consider whether IRC Section 1234A might supply a "deemed" sale or exchange where an abandonment occurs. Section 1234A provides that gain or loss from the cancellation, lapse, expiration or other termination of rights to property which is or would be upon acquisition a capital asset in the hands of the taxpayer is a capital gain or loss. In effect, Section 1234A provides a statutory sale or exchange for certain transactions that are not otherwise considered a sale or exchange.

The court's holding represents a significant extension of the scope of IRC Section 1234A, which most people thought was intended to prevent taxpayers from recognizing ordinary loss when options lapsed. If this decision stands up on appeal, assuming it is appealed, the concept of being able to get an ordinary loss by abandoning a capital asset will be virtually eliminated.

IRS Addresses Tax Consequences of Acquiring and Spending Bitcoin

On March 25, 2014, the IRS issued Notice 2014-21 addressing the United States Federal income tax consequences of transactions involving Bitcoin and other virtual currencies. The IRS determined that Bitcoin is treated as property for income tax purposes. This means that it has a tax basis and can lead to the realization of taxable gain or loss when used in a transaction.

If you receive Bitcoin in payment for services, your taxable income is an amount equal to the then fair market value of the Bitcoin on the date you receive it, stated in dollars. This in turn becomes your income tax basis in that Bitcoin. You can also recognize tax gain or loss when you spend the Bitcoin. Suppose you receive a payment in Bitcoin for performing services that were worth $200 when you received the Bitcoin. You would have to report $200 as income on your income tax return for that year. Later, when the value of Bitcoin has increased, you spend that Bitcoin to purchase a new golf club. The price of the new club would be $300 if paid in dollars. You would recognize a gain of $100 on the transaction because your Bitcoin had a tax basis of $200 and you used that to obtain goods worth $300. The IRS did acknowledge that the Bitcoin can be a capital asset in your hands giving rise to a capital gain, provided you are not a dealer in Bitcoin.

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