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## Journal of Accounting Education

journal homepage: [www.elsevier.com/locate/jaccedu](http://www.elsevier.com/locate/jaccedu)

## The role of secondary sources on the taxation of digital currency (Bitcoin) before IRS guidance was issued

Andrew Gross, Jeff Hemker, Jamie Hoelscher\*, Brad Reed

School of Business, Southern Illinois University Edwardsville, Box 1104, Edwardsville, IL 62026, United States

## ARTICLE INFO

**Article history:**

Received 14 November 2016

Received in revised form 13 February 2017

Accepted 13 February 2017

Available online xxxx

**Keywords:**

Tax research

Primary sources

Secondary sources

Digital currency

## ABSTRACT

This case explores the tax issues related to transactions when substantial authoritative guidance is lacking. The case involves the Winklevoss twins' purchase of tickets on Virgin Galactic's SpaceshipTwo using the digital currency Bitcoins. At the time the purchase was made, there was no substantial tax guidance related to digital currency transactions. Since the Winklevoss twins anticipate future Bitcoin transactions, they have come to you to help them understand how their use of digital currency was previously reported and how the recent IRS guidance will affect those reporting decisions. You will be required to assume the role of the Winklevoss twins' professional tax advisor at the time of the original transaction, before the IRS provided guidance regarding Bitcoin transactions. You will need to determine if the appreciation in the Bitcoins should have been reported as taxable income. If so, you will need to determine whether the Bitcoins should be treated as currency or property potentially subject to the capital gain/loss rules. You will need to find secondary authorities available at the time, to provide professional guidance. You should compare the guidance provided by secondary sources to the guidance subsequently issued by the IRS. Finally, you should discuss whether or not an amended return is required, permissible or beneficial.

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### 1. Introduction

Digital currencies, including Bitcoins, are relatively new and involve a unique type of asset that could possibly be viewed as currency, an ordinary asset, or a capital asset for tax purposes. Each of these classifications may have differing tax ramifications. When the Winklevoss twins purchased \$250,000 of Virgin Galactic space shuttle tickets, using 375 Bitcoins (Bradbury, 2014), there was no guidance from the IRS or courts on the classification of digital currency.

You have been hired as a tax consultant to provide guidance to the Winklevoss twins. You are expected to perform research related to the tax issues that arose when the Winklevoss twins purchased the tickets using Bitcoins, and to make recommendations for how the Winklevoss brothers should plan on filing their tax returns.

\* Corresponding author.

E-mail addresses: [angross@siue.edu](mailto:angross@siue.edu) (A. Gross), [jehemke@siue.edu](mailto:jehemke@siue.edu) (J. Hemker), [jahoels@siue.edu](mailto:jahoels@siue.edu) (J. Hoelscher), [brreed@siue.edu](mailto:brreed@siue.edu) (B. Reed).

<http://dx.doi.org/10.1016/j.jaccedu.2017.02.001>

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Cameron and Tyler Winklevoss each bring new meaning to the term “Renaissance Man.” Growing up, the twins were no strangers to financial success. Their father, Howard Winklevoss, is a millionaire entrepreneur, author, actuary, and former professor at the University of Pennsylvania’s renowned Wharton School of Business. The twins are both Harvard graduates, they both received MBA’s from Oxford and they both competed in the 2008 Beijing Olympics (Ross, 2013).

The twins are most notably known for their legal battle with Facebook cofounder, Mark Zuckerberg, depicted in the movie, *The Social Network*. The twins, along with Divya Narendra, cofounded HarvardConnections, later known as ConnectU, a social networking platform that hired Mark Zuckerberg to assist in coding for the website. Soon after, Mark Zuckerberg allegedly used ConnectU as the basis for Facebook and was sued by the twins and Narendra, who later received a \$65 million settlement in the form of both cash and Facebook stock (Ionescu, 2011). The twins have since engaged in a multitude of venture-capitalism efforts in the digital currency domain and they have much of their own personal wealth tied to Bitcoin, reportedly owning 1% of all existing Bitcoins.

Most recently, the twins’ LLC registered Winklevoss Bitcoin Trust, an exchange-traded fund (ETF) that will provide investors the opportunity to purchase shares of Bitcoins on the NASDAQ (using the ticker COIN), thus allowing investors the opportunity to invest in Bitcoins without having to personally buy and secure Bitcoins (Cotillard, 2015). The twins also created Winkdex, a Bitcoin price tracker, which takes into account the current price of Bitcoin from the three largest exchanges. Winkdex helps provide the dollar exchange rate for the value of the COIN shares (Pagliery, 2014; Winkdex, 2016). The twins have also announced Gemini, a Bitcoin exchange based in New York (Chen, 2014; Cotillard, 2015; Winklevoss Capital, 2016).



<http://media.coindesk.com/2014/01/virgin-galactic.jpg>  
(photo credit)

Founded by Richard Branson, Virgin Galactic is proposed to be the world’s first commercial spaceline. Branson first announced in an interview with CNBC in November of 2013, that Bitcoin could be utilized to pay for the \$250,000 ticket to space, stating, “Why not? Virgin Galactic is a bold entrepreneurial technology and is driving revolution – Bitcoin is doing just the same.”

With a length of sixty feet, Virgin Galactic’s SpaceShipTwo seats six passengers. With seven hundred civilians currently in line to take flight, the maiden flight continues to be postponed following the October 31, 2014 fatal crash on the experimental spaceship (Boyle, 2015).

Bitcoins are a popular form of peer-to-peer digital currency with no formal governmental backing. Regulation of the cryptocurrency varies greatly from country to country, with some countries banning Bitcoin usage. Lacking physical substance, Bitcoins exist only as a string of alphabetical and numerical characters, stored digitally, leaving Bitcoins highly susceptible to hacking and theft.

Individuals can transact directly with other Bitcoin users to buy, sell, and transfer Bitcoins by scanning QR codes.<sup>1</sup> More recently, a variety of organizations and businesses, including Overstock.com, PayPal, iTunes, the Sacramento Kings, and even Subway franchises, are allowing consumers to pay in Bitcoins. In addition, Bitcoin ATM’s are popping up around the country and worldwide.

<sup>1</sup> QR code stands for Quick Response Code. The QR code is a machine-readable barcode that can be scanned by smart phones, computers, and other technological devices to read and transmit information. In this case, the scanning of QR codes allows individuals to buy, sell, or transfer Bitcoins from other consumers or businesses.

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