BITCOIN

What is Bitcoin? It is a “digital currency,” a “peer-to-peer” payment system, and also a “crypto-currency.” Got that? Try throwing those words out at your next dinner party.

Bitcoin may be considered a digital currency because it is electronically created and stored. It is not the only digital currency, but certainly the most widely used and discussed. It serves as a peer-to-peer payment system because you exchange your Bitcoins directly with someone else, without going through a financial institution. Finally, as a crypto-currency it uses cryptography to control the creation and transfer of money.

The Bitcoin system was introduced in 2008 by Satoshi Nakamoto, and no one really seems to know who that person really is. Bitcoins can be “mined” by solving increasingly complex algorithms with increasingly powerful computers. They can also be obtained by purchasing them on various exchanges, such as CoinBase.com and CoinCafe.com.

Bitcoins were embraced by computer nerds who loved the technical elegance of its creation. They also attracted the attention of libertarians and anti-government and conspiracy enthusiasts enthralled with the idea of a currency not held hostage by any government anywhere. Privacy advocates and shadowy underworld types reveled in the anonymity of dealing in Bitcoin and the lack of a paper trail. Practical business people saw the potential for Bitcoin to be a cheaper way of doing business, avoiding the high fees banks charge to process credit card transactions.

But is Bitcoin really a currency and will it survive and become something that is actually used beyond its current loyal band of followers? The jury is still out on that question.

What is a currency anyway? From the days of barter, we moved to gold and then to paper currencies. Any currency has to possess certain attributes. It has to be accepted by everyone as a medium of exchange. It must scarce – if anyone could just print dollar bills, then our dollars would be worthless. It must be portable, indestructible, and divisible into smaller quantities. Finally, currency must also have relative stability. You don’t want to accept a dollar one day only to find out that its value has been cut in half a few days later.

Bitcoin, by design, is scarce, with a limited amount of Bitcoins that apparently can be created. Of course, with the abilities of computer hackers and of potential new rival digital currencies emerging, who knows if the supply of Bitcoin or any virtual currency is really limited?

A huge obstacle to Bitcoin is stability. Since its inception, its price has gone from just pennies to over $1,000 for a single Bitcoin a few months ago, and then plunged to just half that amount shortly thereafter. As of this writing, it is hovering just below $600 per Bitcoin.

While some people have, no doubt made – or lost – substantial money by investing in Bitcoin, I do not view it, or any other currency, as something to actually invest it. A currency is a medium of exchange, not something to hold as an investment itself. For anyone interested in Bitcoin, I would suggest using in a transaction, but then to convert those Bitcoins back to dollars as soon as you can.

Where can you find places that accept Bitcoins? Check out https://spendbitcoins.com/places/ .

A hot area of debate is whether Bitcoin is "property" or a "currency."Certainly, it functions as a currency, but the IRS recently ruled that Bitcoin and other virtual currencies will be treated, for tax purposes, as property, not currency. What's the difference? If Bitcoin was treated as currency, then if you bought $1,000 in Bitcoins and used them in a transaction when their value had increased to $1,500, the $500 profit would be subject to a complex tax calculation in which 60% of the profits would be taxed as long-term capital gains and 40% as short-term capital gains. So, with the IRS ruling that Bitcoin will be treated as property instead of currency, does this makes for less of a tax headache? Unfortunately, but not surprisingly, the answer is no.

With Bitcoin profits now being taxed as property, it means that if you bought $1,000 of Bitcoins *and* when its value had increased to $1,500*and* you use those Bitcoins to pay a $1,500 invoice, you have a $500 taxable gain. It doesn't matter whether you convert your Bitcoins back to dollars or not. Bitcoin is now treated just like buying or selling a stock – you have to know and keep track of your Bitcoin "cost basis."

Why should you care about Bitcoin?Well, you don't have to, at least right now. We are still in the first generation of virtual currencies. There will, no doubt, be many changes as we move to a second or third generation. These are still the Wild West days for Bitcoins and all virtual currencies. Much like the early days of computers, the idea will survive, grow and gain acceptance, but there will be many casualties along the way. However, before virtual currencies such as Bitcoin can earn the confidence of most of us, it may require the government stepping in, providing controls and regulations – the very thing Bitcoin fans hoped to avoid when they first embraced the idea.

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