IMPROVING BITCOIN TAX COMPLIANCE

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Bitcoin has captivated much attention and imagination since its emergence in 2009, but there are still several areas in need of consideration when it comes to the federal tax treatment of virtual currency. The right guidance on these issues would strengthen the legitimate use of virtual currency and increase tax compliance.

I. INTRODUCTION

The anonymity of bitcoin can facilitate tax evasion.[1] Even the most well-intentioned taxpayers, however, might have trouble complying with the current tax guidance on bitcoin given its complexity.[2]

Satoshi Nakamoto, a pseudonym for an unknown person or group, designed bitcoin and introduced it in a 2008 white paper titled "Bitcoin: A Peer-to-Peer Electronic Cash System."[3] At its essence, bitcoin is a cryptocurrency, which is a digital currency issued electronically by a computer program that has a predetermined cap of 21 million bitcoins.[4] To implement bitcoin, Nakamoto devised the first blockchain database to solve the double-spending problem for digital currency so that people cannot spend the same money twice.[5]

There are two methods of obtaining bitcoin—to buy it on an exchange such as Coinbase, or to earn it by processing bitcoin transactions, called "mining."[6]

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1. Sean Foley et al., *Sex, Drugs, and Bitcoin: How Much Illegal Activity is Financed Through Cryptocurrencies?*, REV. FIN. STUD. (forthcoming 2019) (manuscript at 34–35), https://ssrn.com/abstract=3102645 ("[A]pproximately one-quarter of bitcoin users and one-half of bitcoin transactions are associated with illegal activity. Around $72 billion of illegal activity per year involves bitcoin, which is close to the scale of the US and European markets for illegal drugs."). *Id.* at 1.
2. INFO. REPORTING ADVISORY COMM., 2018 GENERAL REPORT 72 (Oct. 24, 2018), https://www.irs.gov/pub/irs-pdf/p5315.pdf.
3. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System, Bitcoin* (2008), https://bitcoin.org/bitcoin.pdf.
4. David Groshoff, *Kickstarter My Heart: Extraordinary Popular Delusions and the Madness of Crowdfunding Constraints and Bitcoin Bubbles*, 5 WM. & MARY BUS. L. REV. 489, 512 (2014).
5. Scott J. Shackelford & Steve Myers, *Block-By-Block: Leveraging the Power of Blockchain Technology to Build Trust and Promote Cyber Peace*, 19 YALE J.L. & TECH. 334, 342 (2017).
6. Benjamin W. Akins, Jennifer L. Chapman, & Jason M. Gordon, *A Whole New World: Income Tax Considerations of the Bitcoin Economy*, 12 PITT. TAX REV. 25, 32 (2014).

Owners store their bitcoin in a "digital wallet," which exists either in the cloud or on a user's computer.[7]

As virtual currencies such as bitcoin have gained prevalence in the United States, they have drawn the attention of regulators. In fact, bitcoin has become sufficiently popular as a digital currency to pose tax compliance issues serious enough to receive attention from an advisory committee to the Internal Revenue Service ("IRS" or "the Service") in October 2018.[8]

Bitcoin transactions have also drawn scrutiny from the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Financial Crimes Enforcement Network ("FinCEN"), and the federal courts.[9] These agencies have differed in their treatments of virtual currency, and confusion continues over whether the law considers bitcoin and its related products to be securities, commodities, currency, or property.[10]

II. TAX TREATMENT

In 2014, the IRS issued the only guidance thus far on the income taxation of virtual currency in the form of IRS Notice 2014-21 (hereinafter "Notice").[11] In it, the IRS made clear that it treats virtual currency as property instead of currency.[12] The Notice describes how existing tax principles apply to virtual currency transactions and answers a variety of common questions relating to the income tax treatment of virtual currency gains or losses.[13]

7. Catherine Martin Christopher, *Whack-A-Mole: Why Prosecuting Digital Currency Exchanges Won't Stop Online Money Laundering*, 18 LEWIS & CLARK L. REV. 1, 14 (2014); *How to Store Your Bitcoin*, COINDESK (Jan. 20, 2018), https://www.coindesk.com/information/how-to-store-your-bitcoins/.

8. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, FINAL AUDIT REPORT-AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE (Sept. 21, 2016), https://www.treasury.gov/tigta/audit-reports/2016reports/201630083fr.pdf. "First there was gold, then paper, then plastic, and now bitcoin. Bitcoin is a new, widely-accepted virtual currency that is currently being used by businesses as a method of payment to minimize costs. But, no matter the form of currency a business or individual chooses to use, where there is money, there are taxes." Elizabeth E. Lambert, *The Internal Revenue Service and Bitcoin: A Taxing Relationship*, 35 VA. TAX REV. 88, 88 (2015).

9. Christopher Burks, *Bitcoin: Breaking Bad or Breaking Barriers?*, 18 N.C. J.L. & TECH. On. 244 (2017).

10. *Id.*

11. I.R.S. Notice 2014-21, 2014-16 I.R.B 938 (Apr. 14, 2014).

12. *Id.* Adam Chodorow, *Bitcoin and the Definition of Foreign Currency*, 19 FLA. TAX REV. 365, 365 (2016) (arguing that the IRS "should extend the basis rules applicable to foreign currency to virtual currencies to prevent taxpayers from using the basis rules to improperly reduce their tax obligations."). *See, e.g.*, Roland Weekley, *The Problematic Tax Treatment of Cryptocurrencies*, 17 FLA. ST. U. BUS. REV. 109, 111 (2018) (offering two alternatives to the tax treatment of virtual currencies as property to "make it easier for taxpayers to determine taxable gain, ensuring more accurate filings with the Service": 1) "the Service could tax only virtual currencies when a taxpayer converts the virtual currency to fiat currency for ease of administration, similar to frequent flier miles," and 2) "when a taxpayer exchanges virtual currency for tangible property, the value of the property would be the amount included in gross income."). *See also* Joseph Burleson, *Development Article, XI. Bitcoin: The Legal Implications of a Novel Currency*, 33 REV. BANKING & FIN. L. 99, 103 (2013) (summarizing Canada's, Australia's, and Germany's tax treatment of bitcoin).

13. I.R.S. Notice 2014-21, 2014-16 I.R.B 938 (Apr. 14, 2014).

As the Notice explains, virtual currency is subject to general tax principles applicable to property.[14] Buying bitcoin has no tax consequences, but selling it can yield capital gains or losses like other property investments.[15]

Those accepting bitcoin as payment for goods or services must include in their income its fair market value when received.[16] Fair market value is determined by reference to the value of the coin in U.S. dollars.[17] That value then becomes the recipient's basis in the coin.[18] If the value of the coin received is greater than the fair market value of the goods or services given in exchange, then the recipient of the coin has taxable gain.[19] If the value of the virtual currency received is less than the value of the goods or services given, then a loss results.[20] The character of this loss depends on the status of the bitcoin in the hands of the taxpayer. If bitcoin is a capital asset in the hands of the taxpayer, then that transaction will generate capital gains or losses.[21] Otherwise, a transaction will result in ordinary gains or losses.[22]

For bitcoin miners, the tax treatment is slightly more complex. Like wages, any coin received from mining is ordinary income to the miner in the amount of the value of the coin on the date it was mined.[23] Furthermore, if that taxpayer's mining activity constitutes a trade or business and is not undertaken as an employee, then that taxpayer will also be subject to self-employment tax.[24] If that miner then, at a later date, exchanges that coin for goods or services, then the miner may still be subject to tax (at capital gains rates) on that transaction under the general property transfer rules.[25] In other words, although the bitcoin constituted wages when it was received, it becomes a capital asset in the hands of the taxpayer afterwards, subject to the same gain and loss rules as bitcoin purchased by a casual user on an exchange.

While this tax treatment has been criticized, it is nonetheless clear that bitcoin transactions are subject to tax.[26] Yet, not all people are reporting their bitcoin transactions.[27]

14. *Id.* at A-1.
15. *Id.* at A-7.
16. *Id.* at A-3.
17. *Id.* at A-5.
18. *Id.* at A-4.
19. *Id*. at A-6.
20. *Id.*
21. *Id.* at A-7.
22. *Id.*
23. *Id.* at A-8.
24. *Id.* at A-9. Miners fitting this description may also deduct their mining expenses as ordinary and necessary business expenses. Id.
25. *Id.*
26. On potential improvements to the tax treatment of bitcoin, see ABA Section on Taxation, Comment Letter on Notice 2014-21 (Mar. 24, 2015), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032403comments.authcheckdam.pdf (recommending additional guidance on character, reporting, compliance and enforceability).
27. "Based upon an IRS search, only 800 to 900 persons electronically filed a Form 8949 that included a property description that is 'likely related to bitcoin' in each of the years 2013 through 2015." U.S. v. Coinbase,

III. TAX COMPLIANCE

Tax compliance can always be improved, but compliance issues are particularly abounding in the anonymous world of bitcoin, which is devoid of connections to governments and mortar banks. Compliance is so much an issue that bitcoin risks creating the new offshore banking system.[28]

Already, several countries including the United States have collaborated to increase enforcement collaboration.[29] Multiple IRS divisions are now working to address guidance and policies on virtual currencies.[30] Guidance from the Service in addition to its five-year-old Notice could improve reporting of virtual currency gains, thereby increasing tax revenues overall.[31] When it comes to the taxation of bitcoin, there are several different ways to increase compliance.[32]

A. De Minimis Exception

A de minimis exception for bitcoin transactions would be perhaps the most favorable measure for which bitcoin enthusiasts could hope. Exempting gain on a transaction below a certain threshold would dispose of a huge segment of virtual currency transactions, eliminating the tax compliance issue for many people since smaller transactions would not be subject to taxation. Casual bitcoin users could therefore buy a certain amount of goods or services with virtual currency without the fear of tax consequences, but the primary limitation would be the potential volatility of the value of bitcoin that might wildly fluctuate below and above the de minimis exception.[33]

Inc., No. 17-cv-01431-JSC, 2017 WL 5890052 (N.D. Cal. 2017). Yet, "Coinbase offers buy/sell trading functionality in 33 countries, with (according to its website) 5.9 million customers served and $6 billion exchanged in bitcoin." *Id.* There might be more incentive to self-report when there are losses instead of gains.

28. *See* Eric Biber, *The Importance of Resource Allocation in Administrative Law*, 60 ADMIN. L. REV. 1, 17 (2008) ("[N]o agency has limitless resources, and perfect enforcement of any statute is impossible."). *See also* Omri Marian, *Are Cryptocurrencies 'Super' Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38 (2013).

29. IRS, Joint Chiefs of Global Tax Enforcement (July 2, 2018), https://www.irs.gov/compliance/joint-chiefs-of-global-tax-enforcement.

30. 2018 General Report, *supra* note 2, at 73.

31. "Although the IRS requested comments to Notice 2014-21 from the public, no actions were taken to address the comments received. TIGTA reviewed all the comments and found several examples of information requested by the public that would be helpful in understanding how to comply with the tax reporting requirements when using or receiving virtual currencies." Press Release, Treasury Inspector General for Tax Administration, Rising Use of Virtual Currencies Requires IRS to Take Additional Actions to Ensure Taxpayer Compliance (Nov. 8, 2016), https://www.treasury.gov/tigta/press/press_tigta-2016-34.htm. *See also* U.S. Gov't Accountability Off., GAO-13-516, Virtual Economies and Currencies: Additional IRS Guidance Could Reduce Tax Compliance Risks 3–5 (2013), available at https:// www.gao.gov/assets/660/654620.pdf ("GAO recommends that IRS find relatively low-cost ways to provide information to taxpayers, such as on its website, on the basic tax reporting requirements for virtual currencies. In commenting on a draft of this report, IRS agreed with our recommendation.").

32. *See, e.g.*, Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 675 (2006) (suggesting that structural safeguards, such as the withholding of employee taxes by employers, help achieve a high rate of tax compliance).

33. In 2018 alone, the value of bitcoin fluctuated between $3,178 and $14,577. *Bitcoin Price*, MARKETS INSIDER, https://markets.businessinsider.com/currencies/btc-usd (last visited Apr. 10, 2019).

Nonetheless, the threshold should be high enough to dispose of a large number of routine consumer transactions. Consider, for example, the oft-envisioned future of bitcoin, where users pay for daily small purchases, such as a cup of coffee, directly from their virtual wallets. Without a de minimis exception, purchasing a cup of coffee would be a taxable event, requiring taxpayers to calculate their gain or loss on the transaction. A de minimis exception would eliminate this result. Overall, taxpayers would benefit from the simplified process and the IRS would still capture revenue from larger virtual currency transactions.

The Cryptocurrency Tax Fairness Act, proposed in September 2017, contained such a de minimis exception.[34] Under this failed bill, any transaction resulting in $600 or less of gain would be excluded from taxation.[35] The United Kingdom has already adopted a de minimis exception, although its threshold is much higher (approximately £11,700 of gain in cryptocurrency transactions is tax-free under certain conditions).[36]

B. Enhanced 1099-K Reporting

Third-party reporting functions to improve compliance.[37] Coinbase, the largest bitcoin platform, currently issues Form 1099-Ks to a select group of users—those with at least 200 annual transactions totaling at least $20,000 who use Coinbase for business purposes.[38] This is generally in line with reporting by credit card companies settling payments for merchants.[39] In order to provide the Service with a better picture of the true scope of bitcoin transactions, all virtual currency platforms can be required to report user activity on Form 1099-K, not just large-volume business users. Any activity over a potential de minimis threshold can be exempt from such reporting.

C. Express Summons Authority

The Service has already made progress in establishing its authority to summon records from a virtual currency platform through a "John Doe" anonymous summons. In *U.S. v. Coinbase, Inc.*, the IRS served a summons on Coinbase seeking information on essentially all of its users.[40] The Service ultimately limited its request to seeking information for users with the equivalent of $20,000

34. H. R. 3708, 115th Cong. (2017).

35. *Id.*

36. *Crypto Tax and ICO Regulations in the United Kingdom*, CRYPTO DAILY (Aug. 31, 2018), https://cryptodaily.co.uk/2018/08/crypto-tax-and-ico-regulations-in-the-united-kingdom.

37. Michael Hatfield, *Taxation and Surveillance: An Agenda*, 17 YALE J. L. & TECH. 319, 330 (2015).

38. 1099-K Tax Forms FAQ for Coinbase Pro, Prime, Merchant, Coinbase, https://support.coinbase.com/customer/en/portal/articles/2721660-1099-k-tax-forms (last visited Apr. 10, 2019). Sean McLeod, Note, *Bitcoin: The Utopia or Nightmare of Regulation*, 9 ELON L. REV. 553, 568 (2017) ("Coinbase was opened in January 2014 and allows for legal trading of digital currencies. It was heralded as the first regulated Bitcoin exchange.").

39. Form 1099 K Reporting Requirements for Payment Settlement Entities, IRS (Mar. 2, 2019), https://www.irs.gov/businesses/new-1099-k-reporting-requirements-for-payment-settlement-entities.

40. U.S. v. Coinbase, Inc., No. 17-cv-01431-JSC, 2017 WL 5890052 (N.D. Cal. 2017).

in one transaction—around 10,000 users.[41] The District Court enforced, in part, the narrowed summons, ordering Coinbase to produce records revealing the name, taxpayer identification number, birth date, address, transactions logs, and account statements of certain users.[42] While the scope of the summons was significantly narrowed, it still represented a victory for the Service. The Service's ability to gather records necessary to examining a taxpayer's virtual currency transactions helps increase the frequency and accuracy of voluntary reporting of gains and losses.

D. A Tax Levy on Wallets

If an audit reveals that a taxpayer owes a debt, then the IRS can potentially be empowered to collect that debt (subject to all collection due process principles) directly from a taxpayer's virtual currency holdings. The IRS Advisory Panel already has recommended that the IRS establish a structure through which to accept virtual currency as payment for taxes.[43] Perhaps there could be additional guidance on when and how the Service may put a levy on such a virtual wallet when not prevented by anonymity.

E. Noncompliance Penalties

Although the above methods, taken together, should be sufficient to encourage tax compliance and to remedy many deficiencies, a penalty for noncompliance could further encourage accurate voluntary reporting. This could supplement current accuracy-related penalties and be based on a percentage of the amount of the coin transferred.[44]

IV. CONCLUSION

Virtual currencies are a potential source of highly secure, private, and fluid transactions. By providing better guidance that supports the legitimate purpose of virtual currencies, the IRS can empower users to take advantage of the benefits that virtual currencies offer. Perhaps more importantly to the Service, proper guidance could improve reporting of virtual currency gains, thereby increasing tax revenue.

Nonetheless, bitcoin has shortcomings that might slow its growth, including the length of time to process transactions, high fees, and volatility. Perhaps new products will replace bitcoin—with the success of bitcoin, a slew of other virtual currencies, such as etherium, ripple, and litecoin have appeared. The future is unclear about what new products will be coming next, but lessons from

41. *Id.* at *2.
42. *Id.* at *8–9.
43. 2018 General Report, *supra* note 2, at 75.
44. *See* I.R.C. § 6662 (2018).

bitcoin apply to other cryptocurrencies and similar ventures. Even when products are new, tax compliance issues are old and should be addressed in order to maximize tax compliance.