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THE FACELESS COIN: ACHIEVING A MODERN TAX POLICY IN  
THE CHANGING LANDSCAPE OF CRYPTOCURRENCY

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*As technology continues to evolve at breakneck speed, the tax treatment of virtual currency has reached an inflection point. Now, given its shifting dynamics, how should we classify and tax virtual currency? This Note argues that the primary differentiator amongst the many different forms of virtual currency lies in its ability to be sold or exchanged for real world goods and services. The Internal Revenue Service (“IRS”) currently treats all transactions involving virtual currency as a realization event, requiring taxpayers to calculate their tax consequences even in situations where there is no receipt of a real-life benefit. This Note suggests that the IRS should adopt the proposed Cryptocurrency Tax Fairness Act along with the more sensible three-part definition of virtual currency as introduced by the U.S. Government Accountability Office. Taxpayers should not have to worry about whether or not their use of virtual currency solely in the virtual world will result in real-world taxable income.*

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## I. INTRODUCTION

The growth of modern technology has seen the development of alternative payment methods as a medium of exchange.<sup>1</sup> More recently, cryptocurrency, a form of virtual currency, has been developed as an alternative to government-issued currencies as a medium of exchange for real-world goods and services.<sup>2</sup> This innovation raises new questions concerning its tax requirements and whether the dynamics and increasing use of virtual currencies in an era of constant digital transformation presents significant challenges in relation to the Internal Revenue Service's ("IRS") tax compliance efforts.<sup>3</sup>

Since the IRS began assessing tax compliance risks for virtual currencies over the past decade, it has only developed a brief informal guidance document on the taxation of "convertible virtual currencies."<sup>4</sup> The short and undersized Notice 2014-21 provided that for tax-reporting purposes, the IRS considered virtual currency as property.<sup>5</sup> Tax consequences of virtual currency transactions vary depending on how it is characterized under the Internal Revenue Code ("Code").<sup>6</sup> While many practitioners praised the guidance, Notice 2014-21 brought along a heightened reporting regime that imposes a significant burden on users of virtual currencies.<sup>7</sup> Only after policymakers fully understand the characteristics and benefits of virtual currencies can they begin to develop a more effective tax structure that eases the reporting burden faced by users while simultaneously reducing the risk of noncompliance.

This Note recognizes the growing use of virtual currency as a legitimate method of payment and argues that it should be subject to more favorable tax reporting requirements. While it currently characterizes virtual currency as property, this Note argues that the IRS needs to modify its reporting requirements for virtual currencies and provide a *de minimis* exemption in certain cases. Accordingly, this Note recommends that Congress adopt the Cryptocurrency Tax Fairness Act ("CTFA"), subject to a few key modifications.<sup>8</sup> These modifications include narrowing the definition of what qualifies as a convertible virtual currency and reducing the amount that can be excluded from gross income.

Part II of this Note reviews the history of currency and the United States tax system. It further describes the tax basics behind calculating taxable income under the Code and introduces several key tax deferral provisions. Part II will then examine the characteristics and functions of cryptocurrency in practice, as

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1. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, VIRTUAL ECONOMICS AND CURRENCIES 1-3 (2013).

2. *Id.*

3. *Id.*

4. IRS Virtual Currency Guidance, I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (Apr. 14, 2014) [hereinafter I.R.S. Notice 2014-21].

5. *Id.* at 2.

6. *See generally* I.R.C. § 61 (2018).

7. I.R.S. Notice 2014-21, *supra* note 4.

8. H.R. 3708, 115th Cong. (1st Sess. 2017) [hereinafter H.R. Bill 3708].

well as its related tax requirements. Part III analyzes the concerns associated with the IRS's current overbroad classification of virtual currency and reviews a number of alternative tax treatment options for cryptocurrency. Part IV recommends adopting a modified version of the CTFA, which would help ease the burdensome reporting requirements that cryptocurrency users currently face.

## II. BACKGROUND

This Part reviews the conceptual foundations necessary to understand the tax implications of cryptocurrency under the Code. First, this Part will review the evolution from normal currency to cryptocurrency, as well as a brief overview of the U.S. tax system and the mechanics behind calculating taxable income resulting from the sale or disposition of property. This Part will then discuss the link between those tax results and certain provisions under the Code that allow taxable gain to be deferred until a later date. Finally, this Part will examine the characteristics of cryptocurrency and examine some of the challenges the IRS faces with its taxation.

### A. *Rise from Currency to Cryptocurrency*

Before money existed, people traded and bartered their goods and services with each other.<sup>9</sup> When people barter, everyone benefits because they receive the goods or services they want or need.<sup>10</sup> In a bartering transaction, trust is one of the key components, as the misrepresentation of goods and services often leaves the defrauded party with no recourse.<sup>11</sup> While a transaction between two individuals tends to be simple and straightforward, issues arise in an exchange when parties' wants or needs fail to coincide or when the transaction requires too many parties to provide separate services for a single product.<sup>12</sup>

The operation of bartering is best understood by way of example. Assume a simple society where *A*, *B*, *C*, and *D* live together. *A* is a doctor, *B* owns ore-producing land, *C* is a miner, and *D* is a blacksmith. If *A* wants a shield, that shield will require ore from *B*'s land, as well as labor from *C* and *D*. This transaction only works if *A* is able to offer medical services to *B*, *C*, and *D*. If just one of the three decides he or she does not want a medical exam from *A*, the exchange fails. In response, currencies were introduced as a new medium of exchange, and, in essence, acted as a type of economic buffer by allowing people to convert their services into something that maintains value.

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9. *The History of the Trade and Barter System*, SQUARE UP, <https://squareup.com/townsquare/a-history-of-the-trade-and-barter-system> (last visited Mar. 24, 2019).

10. *Id.*

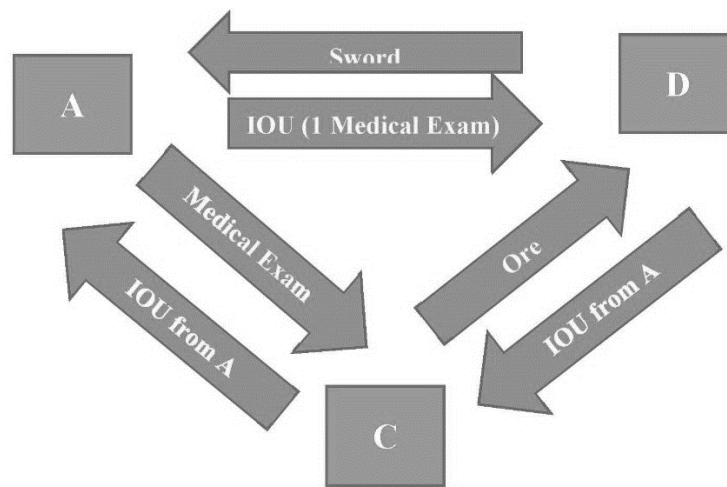
11. *Id.*

12. *Id.*

To illustrate, suppose that *A* wants a sword from *D*, but *D* is not interested in a check-up from *A*. *D* forges the sword and delivers it to *A*, but, in return, *A* instead gives *D* a slip of paper that states that the slip of paper is good for one medical exam. This piece of paper—effectively an “I owe you” (“IOU”)—now has value associated with it because it represents a medical exam from *A*. Now suppose that *D* knows that *C* is sick but has been unable to see *A* because *A* does not want anything that *C* is offering. If *C* is offering mined ore, which *D* values more than the medical exam, *D* can exchange the IOU for the ore.

Thus, in sum, the economic substance of the transaction was this: *A* gets the sword he wants from *D*, and *D* converted his efforts into an IOU from *A*, which he then traded to *C* for ore, who needed a medical exam from *A*.

FIGURE 1



Eventually, as more transactions were structured in the way portrayed by Figure 1, the practice of counterfeiting IOU’s became more widespread and began threatening the legitimacy of such exchanges.<sup>13</sup>

The practice of counterfeiting is rooted in an individual’s intent to take advantage of the superior value of an imitated product.<sup>14</sup> Suppose that it took *D* five hours to create a sword. In theory, an IOU from *D* represents an equivalent value equal to five hours of *D*’s work. If *C*, a counterfeiter, pays for a medical exam from *A* with a counterfeit IOU from *D*, *C* becomes unjustly enriched without having exchanged goods or services of equal value.

The preceding scenario raises the question of *how* to prevent counterfeit IOU’s. To address this, IOU’s have traditionally been backed with rare or finite

13. *The Progression of Counterfeiting Throughout U.S. History*, PMG (Feb. 24, 2015), <https://www.pmgnotes.com/news/article/4495/Counterfeiting-Paper-Money/>.

14. *Id.*

resources from the real world, like gold.<sup>15</sup> Gold is a scarce resource that naturally occurs in large quantities.<sup>16</sup> This means that if an individual possesses gold, he must have either retrieved it from nature or received it from someone, who, at some point, collected it from nature. Referring back to the example above, when *D* makes a sword, *A* has the ability to value that sword based on a set quantity of gold.<sup>17</sup> Thus, when *D* receives the gold, he can use it to pay for goods from other individuals who also value gold.<sup>18</sup> The end-recipient can easily test to see if the gold is a real, and not counterfeit, representation of value.

However, the use of gold as a medium of exchange also presents a number of challenges. Gold is heavy, immobile, easy to lose, and its scalability is capped due to its limited quantity.<sup>19</sup> For these reasons, throughout the nineteenth and twentieth centuries, countries abandoned the gold standard in lieu of currencies underpinned by gold, often referred to as commodity money.<sup>20</sup> Soon after, as a means of addressing concerns regarding the stability of the value of gold, governments issued fiat currencies—currency that no longer operates as an IOU but instead becomes the resource itself, its value underpinned by the strength of the issuing sovereignty.<sup>21</sup>

The most significant aspect of any currency is the stability of its value, and comparatively, fiat currencies are more effective than commodity currencies at maintaining that value.<sup>22</sup> Fiat currencies afford sovereign governments more flexibility as it now controls the supply and demand of its currencies, which can help combat the impact of future financial crises.<sup>23</sup> For instance, in order to prevent the exacerbation of the 2008 economic recession, the U.S. government increased the amount of money put into circulation as a way to stimulate the U.S. economy by increasing commerce.<sup>24</sup>

Furthermore, fiat currency is considered a form of centralized currency, as it is legal tender backed by a central government who is solely responsible for money issuance and regulation.<sup>25</sup> For example, currency in the United States is

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15. See Michael D. Bordo, *Gold Standard*, LIBR. OF ECON & LIBERTY, <http://www.econlib.org/library/Enc/GoldStandard.html> (last visited Mar. 24, 2019).

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*; see also Kimberly Amadeo, *History of the Gold Standard*, BALANCE (Oct. 22, 2018), <https://www.thebalance.com/what-is-the-history-of-the-gold-standard-3306136>.

20. Amadeo, *supra* note 19; Bordo, *supra* note 15; Jason Hall, *Fiat Currency: What It Is and Why It's Better Than a Gold Standard*, MOTLEY FOOL (Jan. 4, 2017), <https://www.fool.com/investing/general/2015/12/06/fiat-currency-what-it-is-and-why-its-better-than-a.aspx>.

21. Amadeo, *supra* note 19; Bordo, *supra* note 15; Hall, *supra* note 20.

22. Hall, *supra* note 20.

23. *Id.*

24. *Id.*

25. Mary Hall, *Who Decides When to Print Money in the U.S.?*, INVESTOPEDIA (May 22, 2018, 3:59 PM), <https://www.investopedia.com/ask/answers/082515/who-decides-when-print-money-us.asp>.

centralized,<sup>26</sup> and the Treasury Department is responsible for printing and distributing U.S. currency.<sup>27</sup> Additionally, the Secret Service is tasked with reducing the amount of counterfeit money in circulation.<sup>28</sup> If you assume that *A* possesses a U.S. \$50 bill, that bill itself has a value of \$50 to anyone who has trust in the U.S. government. If *A* earns an hourly wage of \$50, that bill represents an hour of his time converted into a piece of paper that the U.S. government has made incredibly difficult to duplicate. In effect, the backing of the U.S. government is what gives U.S. currency its value and fungibility.<sup>29</sup>

In sharp contrast, cryptocurrency is a form of decentralized digital currency that allows individuals to make direct payments to anyone through the use of cryptography without the need of third-party intermediaries.<sup>30</sup> According to the U.S. Government Accountability Office (“GAO”), virtual currency is considered a “digital unit of exchange that is not backed by a government-issued legal tender.”<sup>31</sup> In other words, while cryptocurrency is legal and taxable in the US as investment property, it is not considered legal tender.<sup>32</sup>

At first, virtual currencies were solely used in the online gaming industry.<sup>33</sup> Recently, however, virtual currencies have been used in lieu of a government-issued currency to purchase goods and services in the real world.<sup>34</sup> At the time of this writing, there are 2,526 types of cryptocurrencies with an estimated active user base of somewhere between 13 million and 25 million.<sup>35</sup> In addition, cryptocurrency appears to be more prevalent among younger generations, with 17.21% of millennials claiming to own cryptocurrency, followed by Generation X at 8.75% and baby boomers at 2.24%.<sup>36</sup> Among all types, Bitcoin is the largest

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26. *Id.*

27. *Id.*

28. *The Progression of Counterfeiting Throughout U.S. History*, *supra* note 13.

29. Doug Eberhardt, *What Really Backs the U.S. Dollar?*, SEEKING ALPHA (June 28, 2009, 4:29 AM), <https://seekingalpha.com/article/145722-what-really-backs-the-u-s-dollar>.

30. *Cryptocurrency*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/cryptocurrency.asp> (last visited Mar. 24, 2019); *see e.g.*, Andy Greenberg, *Crypto Currency*, FORBES (Apr. 20, 2011, 6:00 PM), <https://www.forbes.com/forbes/2011/0509/technology-psilocybin-bitcoins-gavin-andresen-crypto-currency.html#263e94f6353e>.

31. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, 2016-30-083, AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOME MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE 1 (Sept. 21 2016), <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf>.

32. *Id.*

33. *Id.*

34. *Id.*

35. GARRICK HILEMAN & MICHAEL RACUHS, GLOBAL CRYPTOCURRENCY BENCHMARKING STUDY 10 (2017), [https://www.jbs.cam.ac.uk/fileadmin/user\\_upload/research/centres/alternative-finance/downloads/2017-global-cryptocurrency-benchmarking-study.pdf](https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017-global-cryptocurrency-benchmarking-study.pdf); *All Cryptocurrencies*, COINMARKETCAP, <https://coinmarketcap.com/all/views/all/> (last visited Mar. 24, 2019).

36. ICO Manager, *How Many People Own Cryptocurrency*, ICO MAKING (Jan. 14, 2019), <https://icomaking.com/how-many-people-own-cryptocurrency/>.

cryptocurrency by market capitalization with 52.05%, followed by Ethereum at 11.44%.<sup>37</sup>

Released in 2009 by a group known as Satoshi Nakamoto, Bitcoin is the world's first completely decentralized digital currency and introduced the use of blockchain technology.<sup>38</sup> The Bitcoin network allows for the storage of unique digital representations of value, Bitcoins, and facilitates the assignment of those Bitcoins through an Internet-based, peer-to-peer network.<sup>39</sup> In other words, instead of having a central government issue and regulate virtual transactions, a network of users carries out money issuance and transaction management.<sup>40</sup>

More precisely, Bitcoins are created and transactions are verified through a process known as "mining," which utilizes blockchain technology.<sup>41</sup> Blockchain technology is simply a way for multiple people to create a singular version of something on the web.<sup>42</sup> In the pre-blockchain world, because there was no way to get different people to create something singular, individuals turned to third-party intermediaries (*e.g.*, a bank) to create and maintain the singular versions of things we needed.<sup>43</sup>

For example, consider the steps of a normal banking transaction. If *A* sends money to *B*, *A* has to use her bank, who then sends it to *B*'s bank. *A*'s bank ledger will show the money being taken out whereas the ledger in *B*'s bank will show the money being deposited in his account. But without the banks, how does *A* send *B* money over the internet?

The value of blockchain comes in its ability to provide a system of distributed trust.<sup>44</sup> In the example above, banks are the entity in the middle that provides that trust. There are, however, valid concerns surrounding giving banks this much power, as they can easily manipulate transaction fees at the expense of customers.<sup>45</sup> Conversely, the blockchain itself, which is a public ledger of all transactions, provides that trust so value can be transferred autonomously.<sup>46</sup>

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37. JERRY BRITO & ANDREA CASTILLO, BITCOIN: A PRIMER FOR POLICYMAKERS 1 (2013); COINMARKETCAP, *supra* note 35; WORLDCOININDEX, <https://www.worldcoinindex.com> (last visited Mar. 24, 2019).

38. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION 1, *supra* note 31, at 1–2; *see also* Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN.ORG (Oct. 31, 2008), <https://bitcoin.org/bitcoin.pdf>.

39. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 31, at 1–2.

40. *Id.* at 2.

41. *Id.*

42. Sam Patterson, *What Are Decentralized Markets?*, COIN CENTER (Nov. 10, 2015), <https://coincenter.org/entry/what-are-decentralized-markets>; Peter Van Valkenburgh, *What Is Bitcoin Mining, and Why Is It Necessary?*, COIN CENTER (Dec. 15, 2014), <https://coincenter.org/entry/what-is-bitcoin-mining-and-why-is-it-necessary>.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

The role of mining comes into play with updating the public ledger.<sup>47</sup> Bitcoin miners download free software that they then use to solve complex mathematical equations.<sup>48</sup> This process allows Bitcoin miners to verify the validity of Bitcoin transactions by checking them against a public ledger and mathematically proving that the transactions are bona fide and do not involve the same single Bitcoin being spent more than once, often referred to as double spending.<sup>49</sup>

To illustrate the importance of preventing double spending, consider an example where *A*, a currency user, has a \$10 bill that he gives to *B*.<sup>50</sup> Can *B* be sure that the \$10 he received is real and not counterfeit? It depends. In the physical world, *B* would need ink, paper, and the technology capable of forging counterfeit bills.<sup>51</sup> Those material costs, coupled with the threat of prosecution by the U.S. government, are generally adequate safeguards against counterfeiting.<sup>52</sup> Meanwhile, in the digital world, an electronic file of a \$10 note, similar to a word document, can be easily replicated at little to no cost, and it would be virtually impossible to tell which file is the original.<sup>53</sup> In essence, Bitcoin miners themselves play the role of bank tellers—they process checks, ensure that account numbers are valid, inspect customer identification, and look for proof that the customer has sufficient funds for the transaction.<sup>54</sup>

When a group of miners solves an equation, the Bitcoin network accepts the block of transactions as bona fide and includes it in the public ledger that is used to verify future transactions.<sup>55</sup> In exchange for their work, successful miners are awarded portions of newly created Bitcoins.<sup>56</sup> Between May 2013 and April 2016, the number of Bitcoins in circulation increased from 11 million to 15 million, while the number of daily transactions quadrupled from 58,795 to 220,804.<sup>57</sup> As of now, there are 17.3 million Bitcoins in circulation.<sup>58</sup> In terms of dollar amounts, in February 2013, one Bitcoin was valued at \$22.09.<sup>59</sup> In December 2017, the value of one Bitcoin reached a high of \$19,086.64 but has since tumbled to \$3,780.99 as of February 2019.<sup>60</sup>

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47. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 31, at 2.

48. *Id.*

49. *Id.*

50. Van Valkenburgh, *supra* note 42.

51. *Id.*

52. *Id.*

53. *Id.*

54. TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 31, at 2.

55. *Id.*

56. *Id.*

57. *Number of Bitcoins in Circulation Worldwide from 1st Quarter 2011 to 3rd Quarter 2018 (in Millions)*, STATISTA, <https://www.statista.com/statistics/247280/number-of-bitcoins-in-circulation/> (last visited Mar. 24, 2019).

58. *Id.*

59. *Bitcoin (USD) Price*, COINDESK, <https://www.coindesk.com/price/> (last visited Mar. 24, 2019).

60. *Id.*



In theory, cryptocurrencies are intended to act as legitimate currencies. Yet, despite similarities in basic functionalities, its decentralized character and volatility has raised a number of challenges for sovereign powers relating to its taxability.

*B. The Mechanics of Exchanged or Disposed Property Under the Code*

In the United States, the individual income tax system is progressive, meaning that the percentage of income an individual, or household, pays in taxes tends to increase with increasing income.<sup>61</sup> Not only will those with higher incomes pay more in taxes, they will pay a higher tax rate.<sup>62</sup> To understand the progressive tax system, consider the 2018 federal tax bracket table for unmarried, single individuals below.<sup>63</sup>

FIGURE 2

Tax Rate	Taxable Income Over	Tax Amount
10%	\$0	10% of taxable income
12%	\$9,525	\$952.50 plus 12% of the excess over \$9,525
22%	\$38,700	\$4,453.50 plus 22% of the excess over \$38,700
24%	\$82,500	\$14,089.50 plus 24% of the excess over \$82,500
32%	\$157,500	\$32,089.50 plus 32% of the excess over \$157,500
35%	\$200,000	\$45,689.50 plus 35% of the excess over \$200,000
37%	\$500,000	\$150,689.50 plus 37% of the excess over \$500,000

For instance, suppose at the end of a fiscal year, *A* has taxable income of \$8,000. *A* has taxable income of under \$9,325, so his tax rate is 10%. As such, *A* will have to pay \$800 worth of tax as a result of this income. Alternatively, assume that *B* has taxable income of \$75,000, putting him in the 22% tax bracket. A progressive tax system does not impose a flat tax rate of 22% on all of *B*'s income; instead, *B* is required to pay the tax rate at every respective tax bracket before he reaches the 22% tax bracket. In this situation, *B* will be taxed 10% on the first \$9,325, 12% on the income between \$9,325 and \$38,700, and then any remaining income in excess of \$38,700 will be subject to the 22% tax. In sum, *B*'s total tax liability will be \$12,439.50—the sum of \$952.50 (10% tax bracket), \$3,501 (12% tax rate), and \$7,986 (22% tax rate).

61. Amir El-Sibaie, *2018 Tax Brackets*, TAX FOUNDATION (Jan. 2, 2018), <https://taxfoundation.org/2018-tax-brackets>.

62. *Id.*

63. *Id.*; *2017-2018 Tax Brackets*, BANKRATE (Jan. 12, 2018), <https://www.bankrate.com/finance/taxes/tax-brackets.aspx>.

Turning to transactions dealing with property, how does the U.S. government determine the amount that is included in taxable income? The Code and IRS Rulings are two important sources that help clarify this issue.

Section 61 of the Code broadly states that gross income is “all income from whatever source derived, including (but not limited to) . . . (3) gains derived from dealing in property.”<sup>64</sup> But the amount an individual owes in taxes is not based solely off his gross income.<sup>65</sup> Once gross income is calculated, taxpayers are allowed to deduct some nontaxable expenses in order to arrive at their adjusted gross income.<sup>66</sup> Section 62 defines adjusted gross income (“AGI”) as “gross income minus the following deductions . . . (3) losses from the sale or exchange of property.”<sup>67</sup> Accordingly, after calculating his AGI, a taxpayer may be entitled to take additional allowances for personal exemptions and itemized deductions that aim to lower his total taxable income.<sup>68</sup>

When calculating taxable income resulting from the sale or disposition of property, a taxpayer needs to determine the gain or loss resulting from the transaction.<sup>69</sup> Section 1001(a) provides that gain is determined as the “excess of the amount realized . . . over the adjusted basis.”<sup>70</sup> Conversely, loss is held to be “the excess of the adjusted basis . . . over the amount realized.”<sup>71</sup> Next, Section 1001(b) defines the amount realized as the “sum of any money received plus the fair market value of the property.”<sup>72</sup> Finally, Section 1012(a) states that the basis is calculated as an asset’s purchase price, plus commissions, transaction fees or improvement costs, minus depreciation deductions—put more simply, one’s after-tax investment in the property.<sup>73</sup>

From a taxability standpoint, gains become taxable in the year that they are realized.<sup>74</sup> Realization occurs when one sells or exchanges property for any type

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64. 26 U.S.C. § 61(a) (2018).

65. *What Is Adjusted Gross Income (AGI)?*, TURBO TAX, <https://turbotax.intuit.com/tax-tips/irs-tax-return/what-is-adjusted-gross-income-agi/L2C6rCEit> (last visited Mar. 24, 2019).

66. Brian Roach, *Taxes in the United States: History, Fairness, and Current Political Issues*, GLOBAL DEV. & ENVIR. INST. 4 (2010), [http://www.ase.tufts.edu/gdae/education\\_materials/modules/Taxes\\_in\\_the\\_United\\_States.pdf](http://www.ase.tufts.edu/gdae/education_materials/modules/Taxes_in_the_United_States.pdf).

67. 26 U.S.C. § 62(a) (2018).

68. *Id.*; *What Is Adjusted Gross Income (AGI)?*, *supra* note 65.

69. *Publication 544: Sales and Other Dispositions of Assets*, IRS, <https://www.irs.gov/pub/irs-pdf/p544.pdf> (last visited Mar. 24, 2019).

70. 26 U.S.C. § 1001(a) (2018).

71. *Id.*

72. *Id.* § 1001(b).

73. *Id.* § 1012(a).

74. *See Taxable Gain*, INVESTOPEDIA, <https://www.investopedia.com/terms/t/taxablegain.asp> (last visited Mar. 24, 2019).

of other property, such as cash, goods, or services.<sup>75</sup> Stated otherwise, any transaction involving the sale or disposition of property is a realized event that will trigger taxable gain.<sup>76</sup>

To understand these terms in context, consider a scenario where *A* purchases one Bitcoin from *B* and electronically wires him \$500. As a result of this exchange, *A* has a basis of \$500 in his new Bitcoin. Now, if we assume the transaction was subject to a 1% broker's commission fee and a \$5 wire transfer fee, *A* will have an adjusted cost basis of \$510. This number represents *A*'s total after-tax investment in the property, which includes the sum of the purchase price (\$500), broker's commission fee (\$5), and wire transfer fee (\$5). Therefore, if *A* later sells his Bitcoin to *C* for \$1,000, *A* would realize a gain of \$490, which is \$1,000 less \$510.

Depending on how the property is characterized, gain or loss from the transaction can result in two distinct tax consequences.<sup>77</sup> If property is characterized as ordinary, it will be included in gross income and taxed at ordinary rates portrayed by Figure 2.<sup>78</sup> But if the property is characterized as capital, it may be subject to more favorable capital gain tax rates.<sup>79</sup>

Section 1221 of the Code states that a capital asset is "property held by the taxpayer (whether or not connected with his trade or business)."<sup>80</sup> In other words, almost everything you own or use for personal or investment purposes qualifies as a capital asset. For example, capital assets may include a home owned and occupied by the taxpayer, personal household furnishings, or stocks and bonds held for investment. The definition of a capital asset, however, does not include, among others:

- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
- (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business.<sup>81</sup>

Generally, when a capital asset is sold, the taxpayer may realize taxable income determined as the difference between the amount realized from the sale

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75. Elizabeth R. Carter, *Taxation of Virtual Currency*, BLOOMBERG (Jan. 16, 2017), <https://www.bna.com/taxation-virtual-currency-n73014449855>.

76. *Id.*

77. *Capital Gains Tax*, INVESTOPEDIA, [https://www.investopedia.com/terms/c/capital\\_gains\\_tax.asp](https://www.investopedia.com/terms/c/capital_gains_tax.asp) (last visited Mar. 24, 2019); *Ordinary Income*, INVESTOPEDIA, <https://www.investopedia.com/terms/o/ordinaryincome.asp> (last visited Mar. 24, 2019).

78. *Ordinary Income*, *supra* note 77.

79. See I.R.S. Notice 2014-21, *supra* note 4.

80. 26 U.S.C. § 1221(a) (2018).

81. *Id.* § 1221(a)(1)–(2).

and the asset's adjusted basis.<sup>82</sup> The taxpayer realizes a capital gain if he sells the property for more than its adjusted basis.<sup>83</sup> Conversely, a transaction results in a capital loss if the property is sold for less than its adjusted basis.<sup>84</sup>

In addition, capital gain or loss must be classified as long-term or short-term.<sup>85</sup> Long-term capital gain or loss means any gain or loss “from the sale or exchange of a capital asset held for more than 1 year.”<sup>86</sup> On the other hand, short-term capital gain or loss is defined as any gain or loss resulting from the “sale or exchange of a capital asset held for not more than [one] year.”<sup>87</sup>

If a taxpayer sells a number of capital assets in any given taxable year, the end result could be a mix of long- and short-term capital gains and losses.<sup>88</sup> In this scenario, the IRS provides steps as to how gains and losses are to be netted against each other—first, net short-term gains against short-term losses and second, net long-term gains against long-term losses.<sup>89</sup> After determining the net amount from both holding periods, if the results are different—one results in a gain and the other in a loss—the taxpayer will then need to net them against each other.<sup>90</sup> This will result in a final amount that is characterized as either a net capital gain, meaning “the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year,”<sup>91</sup> or a net capital loss, defined as “the excess of the losses from the sale or exchange of capital assets over the sum allowed under section 1211.”<sup>92</sup>

In the event there is a net capital gain, a lower tax rate may apply to the gain than the tax rate that applies to the taxpayer's ordinary income.<sup>93</sup> Where there is a net capital loss, however, the taxpayer is only permitted to deduct a maximum of \$3,000 annually against his ordinary income in any one year.<sup>94</sup> In comparison, where there is an ordinary net loss from the disposition of noncapital assets, the entire amount is fully deductible and not subject to the \$3,000 limitation.<sup>95</sup>

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82. *Capital Gains Tax*, *supra* note 77.

83. *Id.*

84. *Capital Loss*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/capitalloss.asp> (last visited Mar. 24, 2019).

85. 26 U.S.C. § 1222 (2018); *Netting Capital Gains and Losses and Wash Sales*, INVESTOPEDIA, <https://www.investopedia.com/exam-guide/series-65/taxation/netting-capital-gains-losses-wash-sales.asp> (last visited Mar. 24, 2019).

86. 26 U.S.C. § 1222.

87. *Id.*

88. *Netting Capital Gains and Losses and Wash Sales*, INVESTOPEDIA, *supra* note 85.

89. *Id.*

90. *Id.*

91. 26 U.S.C. § 1222.

92. *Id.*

93. *Topic Number 409- Capital Gains and Losses*, IRS, <https://www.irs.gov/taxtopics/tc409> (last updated Mar. 29, 2018).

94. *Id.*

95. *Ordinary Loss*, INVESTOPEDIA, <https://www.investopedia.com/terms/o/ordinary-loss.asp> (last visited Mar. 24, 2019).

The differing tax rates for a single taxpayer relating to his ordinary and capital assets is summarized in Figure 3.<sup>96</sup>

FIGURE 3

Taxpayer Income	Tax Bracket	Short-term CG Rate	Long-term CG Rate
Up to \$9,525	10%	10%	0%
\$9,326 to \$38,600	12%	12%	0%
\$38,601 to 38,700	12%	12%	15%
\$38,701 to \$82,500	22%	22%	15%
\$82,501 to \$157,500	24%	24%	15%
\$157,501 to \$200,000	32%	32%	15%
\$200,000 to \$425,800	35%	35%	15%
\$425,801 to \$500,000	35%	35%	20%
\$500,001 and over	37%	37%	20%

### C. Tax Benefits Under the Code

Now, suppose that instead of selling, *B* wants to exchange his one Bitcoin for five of *A*'s Litecoin. Since Litecoin is one of the 2,526 types of cryptocurrencies in circulation, would this exchange constitute a taxable event?<sup>97</sup>

Section 1031 of the Code provides that gain or loss can be deferred in certain circumstances where property is exchanged for like-kind property.<sup>98</sup> Under the previous version of this provision, no gain or loss “shall be recognized on the exchange of property held for productive use in a trade or business or for the investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”<sup>99</sup>

Historically, the IRS has construed the definition of like-kind narrowly for personal property.<sup>100</sup> For example, gold and silver are not considered like-kind,

96. Tina Orem, *2018 Capital Gains Tax Rates—and How to Avoid a Big Bill*, NERDWALLET (Nov. 2, 2018), <https://www.nerdwallet.com/blog/taxes/capital-gains-tax-rates/>; *Topic Number 409—Capital Gains and Losses*, *supra* note 93.

97. COINMARKETCAP, *supra* note 35; *What Is Litecoin?*, LITECOIN, <https://litecoin.org/> (last visited Mar. 24, 2019).

98. 26 U.S.C. § 1031 (2018).

99. *Id.* § 1031 (2006).

100. David Floyd, *How the New Tax Law Impacts Cryptocurrencies*, INVESTOPEDIA (Jan. 8, 2018, 3:25 PM), <https://www.investopedia.com/news/how-new-tax-law-impacts-cryptocurrencies-trump/>.

nor are livestock of different sexes.<sup>101</sup> With respect to real property however, the IRS had adopted an expansive interpretation: it considers almost all exchanges of real property as like-kind, finding that land relates only to the grade or quality of the property, not a kind or class.<sup>102</sup>

However, in 2017, President Trump's new tax reform plan, the *Tax Cuts and Jobs Act*, effectively eliminated any interpretation concerns.<sup>103</sup> Under the revised version of Section 1031, the scope of like-kind exchanges is now limited to only transactions involving real property.<sup>104</sup> Accordingly, when dealing with the exchange of personal property, individuals are now forced to calculate their tax liability on every single transaction, no matter how small.

In addition to Section 1031 tax deferrals, the Code imposes tax benefits for certain transactions that qualify as de minimis.<sup>105</sup> Section 132(a) of the Code states that:

Gross income shall not include any fringe benefit which qualifies as a –

- (1) no-additional-cost service,
- (2) qualified employee discount,
- (3) working condition fringe,
- (4) de minimis fringe,
- (5) qualified transportation fringe,
- (6) qualified moving expense reimbursement,
- (7) qualified retirement planning services,
- (8) qualified military base realignment and closure fringe.<sup>106</sup>

Specifically, Section 132(a)(4) states that “gross income does not include any fringe benefit that qualifies as a de minimis fringe benefit.”<sup>107</sup> The Code then defines a de minimis fringe as “any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.”<sup>108</sup>

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101. See 26 U.S.C. § 1031.

102. *Id.*

103. David Floyd, *Trump's Tax Reform Plan Explained*, INVESTOPEDIA (Oct. 30, 2018, 10:15 AM), <https://www.investopedia.com/taxes/trumps-tax-reform-plan-explained/>.

104. 26 U.S.C. § 1031.

105. *De Minimis Fringe Benefits*, IRS, <https://www.irs.gov/government-entities/federal-state-local-governments/de-minimis-fringe-benefits> (last updated May 25, 2018).

106. 26 U.S.C. § 132(a) (2018).

107. *Id.* § 132(a)(4).

108. *Id.* § 132(e)(1); *De Minimis Fringe Benefits*, *supra* note 105; Jean Murray, *What Does De Minimis Mean for Business Taxes?*, BALANCE, <https://www.thebalance.com/what-does-de-minimis-mean-for-business-taxes-398218> (last updated Sept. 10, 2018).

In practice, de minimis tax benefits are commonly seen in employee benefits. De minimis employee benefits are benefits that an employer provides to an employee that is not taxable to the employee as income.<sup>109</sup> For example, the IRS has stated that traditional holiday gifts with a low fair market value, or occasional theater or sporting event tickets are excluded from taxes for employees.<sup>110</sup> In contrast, the use of an employer's boat or season tickets to sporting or theatrical events is not excludable from the employee's gross income and is taxable to the employee.<sup>111</sup> It is important to note that the employee benefits listed in subsection (a)(1) and (2) are subject to the nondiscrimination rule.<sup>112</sup> The nondiscrimination rule holds that the exclusions in subsection (a)(1) and (2) will only apply provided that such fringe benefit is "available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees."<sup>113</sup> Thus, when employee fringe benefits qualify for exclusion, employees are not subject to any reporting requirements.<sup>114</sup>

Furthermore, the IRS established a de minimis rule that governs the treatment of market discount bonds—bonds that are being sold for less than its maturity value because market conditions, such as rising rates, have caused the price of the bond to drop.<sup>115</sup> Under this rule, if a bond is purchased with a small amount of market discount, the market discount is considered to be zero.<sup>116</sup> The market discount amount must be less than 0.25% of the face value of the bond times the number of complete years between the bond's acquisition and its maturity date.<sup>117</sup> If the market discount is less than the de minimis amount, the discount on the bond is treated as a capital gain upon disposition, as opposed to ordinary income.<sup>118</sup>

To illustrate, assume *A* purchases a bond maturing in five years. Now, by multiplying 0.25% by five, the number of years to maturity from the purchase date, the percentage is 1.25%. Subtracting this value from par, or 100, gives us a sum of 98.75. Accordingly, \$98.75 is the lowest minimum allowable purchase price for the bond in order for the IRS to treat the discount as zero and not taxable income to *A*. Therefore, in situations where the bond is purchased at an amount

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109. Murray, *supra* note 108.

110. *De Minimis Fringe Benefits*, *supra* note 105.

111. *Id.*

112. See 26 U.S.C. § 132(j)(1).

113. *Id.* § 136(j)(2) (2018).

114. *De Minimis Fringe Benefits*, *supra* note 105.

115. INTERNAL REVENUE SERV., CAT. NO. 15093R, INVESTMENT INCOME AND EXPENSES 13, <https://www.irs.gov/pub/irs-pdf/p550.pdf> (last visited Mar. 24, 2019) [hereinafter INVESTMENT INCOME AND EXPENSES]; Joshua Hudson, *Muni Investors: Beware of the De Minimis Tax Rule*, SEEKING ALPHA (Jan. 1, 2017, 7:09 AM), <https://seekingalpha.com/article/4033619-muni-investors-beware-de-minimis-tax-rule>.

116. INVESTMENT INCOME AND EXPENSES, *supra* note 115; Hudson, *supra* note 115.

117. Hudson, *supra* note 115.

118. *Id.*

below \$98.75, then the entire difference between par and the purchase price would be treated as income and taxed at the ordinary income tax rate.

In sum, given the preferential tax treatment imposed on the disposition of certain capital assets, as well as the applicability of tax deferral provisions or de minimis rules, this begs the question: how should the U.S. government classify and tax cryptocurrency?

#### *D. Taxability of Cryptocurrency Under the Code*

In its Notice 2014-21, *Virtual Currency Guidance*, the IRS set the existing general tax principles that apply to virtual currency transactions.<sup>119</sup> This incredibly short Notice provides:

##### SECTION 1: PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

##### SECTION 2: BACKGROUND

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency—i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance—but it does not have legal tender status in any jurisdiction. Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

##### SECTION 3: SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term “virtual currency” as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

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119. See I.R.S. Notice 2014-21, *supra* note 4.



## SECTION 4: FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.<sup>120</sup>

Most importantly, this brief Notice states that virtual currencies are classified as property for tax purposes.<sup>121</sup> Additionally, if a taxpayer sells or trades virtual currency, its fair market value must be included when computing taxable income.<sup>122</sup> Since the IRS considers cryptocurrency as property, should it also subject to lower capital gains tax rates?

Looking at the list of excluded properties under Section 1221(a) of the Code, cryptocurrency is not expressly excluded by name, nor does it seem to fall within any of the excluded categories.<sup>123</sup> Although uncommon, if cryptocurrency is held as inventory for a trade or business—such as a taxpayer mining Bitcoins—it could not be considered a capital asset.<sup>124</sup> But in the hands of most taxpayers, cryptocurrency qualifies as a capital asset that may be subject to preferential capital rates.

By treating virtual currency as property, the IRS prematurely closed the door on the possibility of classifying virtual currency as foreign currency. If instead cryptocurrency was treated as foreign currency, it could not be characterized as a capital asset and would not receive preferential capital gains tax treatment.<sup>125</sup> Stated otherwise, foreign currency gains are taxable at the taxpayer's ordinary income rates, regardless of how long they were held.<sup>126</sup>

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120. *Id.* at 1–2.

121. *Id.* at 2.

122. *Id.*

123. 26 U.S.C. § 1221(a) (2018).

124. *See id.*

125. *See id.* § 988(a)(1).

126. *Id.*

While at first this may seem unappealing, the Code allows for a personal transactions exception for foreign currency gains.<sup>127</sup> Section 988(e) specifically addresses the exclusion for personal transactions:

(e) APPLICATIONS TO INDIVIDUALS:

(2) EXCLUSION FOR CERTAIN PERSONAL TRANSACTIONS—

(A) nonfunctional currency is disposed of by an individual in any transaction, and

(B) such transaction is a personal transaction; no gain shall be recognized for purposes of this subtitle by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition. The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds \$200.

(3) PERSONAL TRANSACTIONS: For purposes of this subsection, the term “personal transaction” means any transaction entered into by an individual, except that such term shall not include any transaction to the extent that expenses properly allocable to such transaction meet the requirements of—

(A) section 162 (other than traveling expenses described in subsection (a)(2) thereof), or

(B) section 212 (other than that part of section 212 dealing with expenses incurred in connection with taxes).<sup>128</sup>

Put simply, gains on foreign currency of less than \$200 are tax-free as long as the foreign currency is not held for investment or used for business purposes.<sup>129</sup> Absent this exception, any amount of gain resulting from the disposition of foreign currency would be treated as ordinary income. In turn, because cryptocurrency is not subject to this exclusion, the tedious reporting requirements create a significant burden on the use of cryptocurrency for day-to-day consumer purchases. Thus, having a minimal exclusion amount as noted above would change the future of cryptocurrency.

As it stands, current U.S. tax laws relating to digital currency transactions has led to serious friction between consumers and merchants.<sup>130</sup> Indeed, many consumers believe that the laws discourage the use of cryptocurrency as an everyday payment method.<sup>131</sup> Among one of the most well-known cryptocurrency

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127. *Id.* § 988(e)(2)(B).

128. *Id.* § 988(e).

129. *See id.*

130. Press Release, Congressman David Schweikert, Creating Tax Parity for Cryptocurrencies (Sept. 7, 2017), <https://schweikert.house.gov/media-center/press-releases/creating-tax-parity-cryptocurrencies> [hereinafter Creating Tax Parity for Cryptocurrencies].

131. *Id.*

cases illustrating this belief involved Coinbase, a digital currency exchange, against the IRS.<sup>132</sup>

In *United States v. Coinbase*, the IRS noticed a large discrepancy between the number of tax returns claiming gains on virtual currency in relation to the expanding popularity of digital currencies as an investment vehicle.<sup>133</sup> It estimated that only 800 to 900 taxpayers reported gains relating to cryptocurrency each year, even though Coinbase has a user base of more than 500,000 active customers.<sup>134</sup> As part of its investigation, the IRS issued a “John Doe” administrative summons seeking information pertaining to “any United States persons who, at any time during the period January 1, 2013, through December 23, 2015, conducted transactions in a convertible virtual currency.”<sup>135</sup>

In a partial victory, Coinbase was able to vastly narrow the scope of the IRS summons.<sup>136</sup> The court ruled that Coinbase must hand over identifying information regarding approximately 14,000 users who engaged in transactions totaling more than \$20,000 worth of annual transactions on its platform between 2013 and 2015.<sup>137</sup> In effect, this ruling preserved more than 480,000 customers’ records from disclosure—a 97% reduction rate.<sup>138</sup> While some consider this a small victory, this dispute is likely to be the beginning of a prolonged effort by the U.S. government to stifle the growth of cryptocurrency.<sup>139</sup>

To help combat this divide, Representatives Jared Polis and David Schweikert introduced a bipartisan bill, the Cryptocurrency Tax Fairness Act, to Congress on September 7, 2017.<sup>140</sup> The proposed bill seeks to exclude from gross income *de minimis* gains resulting from the sale or exchange of virtual currency,<sup>141</sup> and is currently referred to the House Ways and Means Committee.<sup>142</sup> The Amendment offers to insert the following proposed section:

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132. *United States v. Coinbase, Inc.*, No. 17-cv-01431-JSC, 2017 WL 3035164 (N.D. Cal. July 18, 2017).

133. *Id.* at \*5.

134. Taylor Hatmaker, *Coinbase Ordered to Give the IRS Data on Users Trading More than \$20,000*, TECHCRUNCH (Nov. 29, 2017), <https://techcrunch.com/2017/11/29/coinbase-internal-revenue-service-taxation/>; see also David Farmer, *Coinbase Obtains Partial Victory Over IRS*, COINBASE BLOG (Nov. 29, 2017), <https://blog.coinbase.com/coinbase-obtains-partial-victory-over-irs-dac041db59a3>.

135. *Coinbase*, 2017 WL 3035164, at \*1.

136. Farmer, *supra* note 134; Hatmaker, *supra* note 134.

137. Farmer, *supra* note 134; Hatmaker, *supra* note 134.

138. Farmer, *supra* note 134.

139. Jeff John Roberts, *IRS Wins Bitcoin Fight, Gets Access to 14,000 Coinbase Account*, FORTUNE (Nov. 30, 2017), <http://fortune.com/2017/11/29/irs-coinbase/>.

140. H.R. Bill 3708, *supra* note 8.

141. *Id.*

142. *Id.*

## SEC. 139G: Gain from Sale or Exchange of Virtual Currency

(A) IN GENERAL: Gross income shall not include gain from the sale or exchange of virtual currency for other than cash or cash equivalents.

(B) Limitation:

(1) IN GENERAL

The amount of gain excluded from gross income under subsection (a) with respect to a sale or exchange shall not exceed \$600.

(2) AGGREGATION RULE

For purposes of this subsection, all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

(C) Virtual currency:

For purposes of this section, the term *virtual currency* means a digital representation of value that is used as a medium of exchange and is not otherwise currency under section 988.

(D) Inflation adjustment:

In the case of any taxable year beginning in a calendar year after 2018, the dollar amount in subsection (b) shall be increased by an amount equal to—

(1) such dollar amount, multiplied by

(2) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting calendar year 2017 for calendar year 1992 in subparagraph (B) thereof.

Any increase determined under the preceding sentence shall be rounded to the nearest multiple of \$50.<sup>143</sup>

The main function of this bill creates a de minimis exemption of \$600 when cryptocurrency is used to purchase consumer goods or services.<sup>144</sup> In effect, any transaction under \$600 would be completely exempt, meaning a taxpayer no longer has to worry about keeping track of his gains on small consumer purchases, nor will the taxpayer owe taxes upon the disposition of those cryptocurrencies below that threshold.<sup>145</sup> This proposal mirrors the current exemption allowed for foreign currency and acts as a way to encourage the everyday use of cryptocurrency.<sup>146</sup>

143. *Id.*

144. *Id.*

145. Tyler Durden, *Bipartisan 'Cryptocurrency Fairness Act' Moves to Congress*, ZERO HEDGE (Dec. 11, 2017, 3:30 PM), <https://www.zerohedge.com/news/2017-12-11/bipartisan-cryptocurrency-fairness-act-moves-through-congress>.

146. *Id.*

Since its proposal, there have been mixed reactions within the community. Proponents of the bill argue that it would encourage, not stifle, the use of cryptocurrency.<sup>147</sup> In a press release, Representative Polis explained that “[c]ryptocurrencies can be used for anything from buying a cup of coffee to paying for a car . . . and more and more consumers are choosing to use this type of payment.”<sup>148</sup> In order to keep up with modern technology, the United States must “remove outdated restrictions on cryptocurrencies . . . [and] by eliminating onerous reporting requirements, it will allow cryptocurrencies to further benefit consumers and help create good jobs.”<sup>149</sup> In the same release, Representative Schweikert asserted that “[i]ndividuals all over the world are starting to use cryptocurrencies for small every day transactions,”<sup>150</sup> and “[w]ith this simple legislative change, anyone can make digital payments to buy a newspaper or a bike without worrying about tax code challenges.”<sup>151</sup>

Within the cryptocurrency world, the proposed bill continues to garner positive praise.<sup>152</sup> Jerry Brito, the executive director of the cryptocurrency think tank, Coin Center, stated that the CTFA “will create a level playing for digit currencies [and] it will also help unleash innovation on applications like micro-payments, which can consist of dozens of transactions per minute and thus are difficult to square with the current law.”<sup>153</sup>

In response, opponents of the bill claim that the IRS’s Notice 2014-21 offers more than sufficient guidance on transactions involving digital currencies.<sup>154</sup> Senator Tom Carper stated that the Notice acts “as a crucial step in making sure taxpayers are compliant and that we are limiting the potential tax vulnerabilities that digital currency may present.”<sup>155</sup>

Many cryptocurrency advocates, however, continue to feel that the Notice itself is insufficient and that it may actually hamper cryptocurrency from getting off the ground.<sup>156</sup> Pamir Gelenbe, a CoinSummit Conference co-founder, believes that instead of encouraging its use, the Notice may tempt people to “hoard rather than spend, because as soon as they spend they would be liable to incur capital gains taxes.”<sup>157</sup>

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147. Creating Tax Parity for Cryptocurrencies, *supra* note 130.

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. Press Release, *Chairman Carper Reacts to Internal Revenue Service’s New Guidance on Transactions Involving Digital Currencies* (Mar. 25, 2014), <https://www.carper.senate.gov/public/index.cfm/2014/3/chairman-carper-reacts-to-internal-revenue-service-s-new-guidance-on-transactions-involving-digital-currencies>.

155. *Id.*

156. Rachel Abrams, *I.R.S. Takes a Position on Bitcoin: It’s Property*, N.Y. TIMES (Mar. 25, 2014), <https://dealbook.nytimes.com/2014/03/25/i-r-s-says-bitcoin-should-be-considered-property-not-currency>.

157. *Id.*

While the CTFA continues to await a vote in the Committee on Ways and Means, House Representatives Warren Davidson and Darren Soto introduced a separate bill, the Token Taxonomy Act (“TTA”), on December 20, 2018.<sup>158</sup> The new TTA, referred to both the House Committee on Financial Services and the Committee on Ways and Means, attempts to modify both securities and tax laws with respect to the issuance and trading of cryptocurrency.<sup>159</sup> Most importantly, with respect to the portion of this proposed bill involving tax modifications, the TTA recommends treating the sale or exchange of virtual currencies in the same manner as that proposed in the CTFA above.<sup>160</sup>

Today, absent the CTFA, the taxpayer is solely responsible for tracking and accurately reporting every single penny of gain realized in a cryptocurrency transaction.<sup>161</sup> In contrast, if a taxpayer owned stock, his stockbroker is required to provide him and the IRS with a Form 1099-B that accounts for all of his gains and losses.<sup>162</sup> Even the Department of Justice itself noted, in response to Coinbase’s amicus brief, that if “Congress had subjected bitcoin exchanges like Coinbase to similar reporting requirements as those imposed on an online stock broker or a barter exchange, no John Doe summons to Coinbase would likely have been necessary . . . .”<sup>163</sup> Thus, passing the CTFA would help alleviate some of the tax reporting burdens faced by the IRS while encouraging the development and use of cryptocurrency.<sup>164</sup>

This Note argues that the treatment of cryptocurrencies by IRS Notice 2014-21 is burdensome and flawed. In order to properly address these concerns, the proposed version of the CTFA should be passed, subject to a few modifications, in order to allow the United States to remain current with the rapidly changing landscape of cryptocurrency.<sup>165</sup>

### III. ANALYSIS

Given the great variety of virtual currencies, developing a single standard that fairly accounts for tax liability for each and every type of virtual currency has proven to be a daunting task. This Part will begin with a comprehensive analysis of the concerns surrounding the IRS’s flawed treatment of all convertible virtual currencies as property in Notice 2014-21.<sup>166</sup> This Part will conclude by

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158. H.R. 7356, 115th Congress (2nd Sess. 2018) [hereinafter H.R. Bill 7356]

159. *Id.*

160. *Id.*

161. Durden, *supra* note 145.

162. *Id.*

163. *Id.*

164. Jerry Brito, *Bitcoin Taxation Is Broken. Here’s How to Fix It.*, COIN CENTER (Apr. 12, 2017), <https://coincenter.org/entry/bitcoin-taxation-is-broken-here-s-how-to-fix-it>.

165. H.R. Bill 3708, *supra* note 8.

166. I.R.S. Notice 2014-21, *supra* note 4.

providing an analysis of commonly suggested reforms to tax treatment options for virtual currency.

*A. Concerns Surrounding IRS Notice 2014-21*

With Notice 2014-21, the IRS attempted to develop a single tax standard by treating all convertible virtual currencies as property.<sup>167</sup> This, however, led to more questions than answers.

First, the IRS limited the scope of the Notice to convertible virtual currencies. It broadly defined a convertible virtual currency as a unit of exchange that “has an equivalent value in real currency, or that acts as a substitute for real currency.”<sup>168</sup> Yet this definition directly conflicts with the IRS’s belief that virtual currency does not possess all the attributes of real currency and does not accurately reflect the different characteristics of the 2,526 types of cryptocurrencies available on the market as of February 2019.<sup>169</sup>

Second, the IRS chose to treat virtual currencies as property, as opposed to foreign currency. This classification seemingly stems from a general distrust of cryptocurrencies, as it is not issued by a foreign sovereignty and lacks the status of legal tender of traditional currencies.<sup>170</sup> Specifically, the IRS’s concern is that the value of cryptocurrency is purely speculative, and it is not backed up by a real commodity or by the power of any sovereign government.<sup>171</sup> As the use of digital currency becomes more widespread, however, there seems to be a huge divide between how different countries choose to recognize and regulate cryptocurrency.

In Japan, for example, a law was passed early last year that recognized Bitcoin as legal tender.<sup>172</sup> More recently, Japan’s Financial Services Agency “officially recognized [eleven] companies as registered cryptocurrency exchange operators.”<sup>173</sup> This registration is intended to protect cryptocurrency investors from fraud by requiring companies to check the identity of users, as well as promote financial technological innovation by requiring the use of faster and more powerful computers.<sup>174</sup>

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167. Nika Antonikova, *Real Taxes on Virtual Currencies: What Does the I.R.S. Say?*, 34 VA. TAX REV. 433, 438 (2015).

168. I.R.S. Notice 2014-21, *supra* note 4.

169. *All Cryptocurrencies*, INVESTING.COM, <https://www.investing.com/crypto/currencies> (last visited Mar. 24, 2019).

170. Antonikova, *supra* note 167, at 446–47.

171. *Id.* at 447.

172. Luke Graham, *As China Cracks Down, Japan Is Fast Becoming the Powerhouse of the Bitcoin Market*, CNBC (Sept. 29, 2017, 8:43 AM), <https://www.cnbc.com/2017/09/29/bitcoin-exchanges-officially-recognized-by-japan.html>.

173. *Id.*

174. *Id.*

On the opposite end of the spectrum, China continues to clamp down on the use of cryptocurrency.<sup>175</sup> Last September, the People's Bank of China announced a ban on digital token fundraisers, referred to as initial coin offerings.<sup>176</sup> As a result, several major digital exchanges announced they would end trading of cryptocurrency.<sup>177</sup> In one of its largest regulatory actions, Chinese regulators are planning on heavily restricting Bitcoin trading, and many believe that they will eventually shut down Bitcoin mining operations.<sup>178</sup>

While Japan and China present opposing views, both governments have offered clear guidelines on compliance involving the use of virtual currency. In contrast, the IRS has only stipulated that it considers virtual currency to be a form of property.<sup>179</sup> Without more detailed guidelines, the IRS is unable to properly educate taxpayers to ensure that virtual currency exchanges are compliant with tax reporting laws.

Third, Notice 2014-21 unnecessarily burdens owners of cryptocurrency by imposing the same information reporting requirements as ordinary property. The IRS requires that when a taxpayer disposes of cryptocurrency worth more than \$600, the taxpayer is required to file a Form 1099.<sup>180</sup> In addition, after *Coinbase*, the IRS now requires third-party corporations that handle virtual currency transactions to file information reports when a user has more than 200 transactions and the annual gross amount of those transactions exceeds \$20,000.<sup>181</sup>

These reporting requirements can be reasonable when cryptocurrency is held as an investment, however, they can quickly become burdensome when the primary use of the cryptocurrency becomes a means of payment for consumer products and services.<sup>182</sup> Based on this general guidance, when cryptocurrency is used to make a consumer purchase, taxpayers will have to treat the transaction as property and determine their tax basis on the day of the purchase.<sup>183</sup>

Consider Bitcoin, which is divisible up to eight decimal places, meaning it can be divided up into 100 million separate pieces.<sup>184</sup> Suppose *A* uses Bitcoin to buy a sandwich every day for a month. *A* will have to calculate what portion of the Bitcoin was used to make the purchase based on a daily exchange rate, convert that amount into U.S. dollars, and keep a log of each transaction so that he

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175. Evelyn Cheng, *China's Bitcoin Clampdown Is Likely Here to Stay, Analysts Say*, CNBC (Sept. 19, 2017, 5:30 PM), <https://www.cnbc.com/2017/09/19/chinas-bitcoin-clampdown-is-likely-here-to-stay-analysts-say.html>.

176. *Id.*

177. *Id.*

178. *Id.*

179. I.R.S. Notice 2014-21, *supra* note 4.

180. Antonikova, *supra* note 167, at 444.

181. *United States v. Coinbase, Inc.*, No. 17-CV-01431-JSC, 2017 WL 3035164, at \*3 (N.D. Cal. July 18, 2017); Antonikova, *supra* note 167, at 444.

182. Antonikova, *supra* note 167, at 448.

183. I.R.S. Notice 2014-21, *supra* note 4.

184. *Help:FAQ*, BITCOIN WIKI, [https://en.bitcoin.it/wiki/Help:FAQ#How\\_divisible\\_are\\_bitcoins.3F](https://en.bitcoin.it/wiki/Help:FAQ#How_divisible_are_bitcoins.3F) (last visited Mar. 24, 2019).



can accurately report his cryptocurrency gains or losses at the end of the taxable year.<sup>185</sup>

This approach not only raises administration challenges for the IRS, but it leads to heavy compliance costs for the individual taxpayer.<sup>186</sup> Notice 2014-21 fails to provide taxpayers with sufficient guidance on what records should be kept and how the records should be maintained.<sup>187</sup> Thus, a simple consumer transaction involving virtual currencies can quickly turn into a complex reporting mess for both the taxpayer and IRS auditors.

Additionally, these reporting requirements fail to consider the distinction between centralized and decentralized currencies.<sup>188</sup> In a centralized system, where there is a single issuer of the currency, it is more reasonable to impose a reporting duty on the issuer.<sup>189</sup> Conversely, in a decentralized system, where cryptocurrency is generally issued anonymously from multiple sources and settled by a host of miners, it would be challenging to attempt to impose a reporting duty at either the issuance or approval stages.<sup>190</sup> The IRS simply does not have the manpower or resources to attempt to discern the identity of all issuers or of the group of miners that verified certain cryptocurrency transactions.<sup>191</sup> The more practical and efficient solution would be for the IRS to impose reporting requirements on the user when he chooses to sell his virtual currency, as that would be the stage where it would be easiest to accurately determine his identity.<sup>192</sup>

Furthermore, as noted above, the IRS requires a cash method taxpayer who receives cryptocurrency in exchange for goods or services to include its fair market value when computing taxable gross income.<sup>193</sup> For this purpose, the IRS provides that the best time to determine fair market value is on the date of payment or receipt.<sup>194</sup> In essence, the IRS argues that cryptocurrency qualifies as constructively received income because it can be readily converted into money and acts as “more like a check that has already been delivered to a person[,] but not yet deposited into his bank account.”<sup>195</sup>

This reasoning, however, fails to consider the volatility of cryptocurrency and the tedious steps surrounding the conversion of some cryptocurrency into fiat currency.<sup>196</sup> Due to the inherent volatility of cryptocurrency, its fair market

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185. I.R.S. Notice 2014-21, *supra* note 4.

186. Antonikova, *supra* note 167, at 445.

187. *See* I.R.S. Notice 2014-21, *supra* note 4.

188. Antonikova, *supra* note 167, at 445.

189. *Id.*

190. *Id.*

191. *See id.*

192. *Id.*

193. *See* I.R.S. Notice 2014-21, *supra* note 4.

194. Antonikova, *supra* note 167, at 441–42.

195. *Id.* at 443.

196. *Id.*

value can fluctuate drastically, even within the same day.<sup>197</sup> For instance, if *A* received one Bitcoin on December 27, 2017 at 12:04 AM, its value would have dropped 7.4% from \$16,311.90 to \$15,114.30 by 7:09 AM.<sup>198</sup> As such, in computing gross income, using the fair market value as of the date of receipt may result in tax avoidance if taxpayers are instead reporting the lowest market price available for that day.

In addition, the IRS treatment of cryptocurrency as constructively received income is based on the assumption that all types of cryptocurrencies are easily convertible into fiat currency.<sup>199</sup> When dealing with more popular virtual currencies such as Bitcoin, this argument of constructive receipt holds water.<sup>200</sup> When transactions involve less developed currencies, however, this argument lacks merit as third-party exchanges generally are not willing to accept such currencies until there is an established market supply and demand.<sup>201</sup> This delay, in turn, limits the ability of the taxpayer to convert less popular forms of cryptocurrency into fiat currency in a manner that minimizes price volatility.<sup>202</sup>

Finally, the IRS attempted to use these burdensome tax-reporting requirements as a means to prevent illegal transactions.<sup>203</sup> The Notice failed to provide any guidelines relating to criminal liability for individuals who are engaged in criminal activities through the use of virtual currencies.<sup>204</sup> For example, consider the similarities between one Bitcoin and a U.S. one dollar bill: both allow users to pay directly to one another without the use of a third-party intermediary, such as a bank.<sup>205</sup> Ironically, the use of cash allows for a “higher degree of anonymity than Bitcoin because there is no public log to track monetary transactions,” whereas, every single Bitcoin transaction is recorded in a public ledger and verified by miners.<sup>206</sup> Given that the IRS does not prosecute or deter the use of cash, it makes little sense why the mere potential for abuse of virtual currency is sufficient to impose costly tax compliance procedures on cryptocurrency users.<sup>207</sup>

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197. Jill Treanor, *Bitcoin Loses a Quarter of Its Value in One Day's Trading*, GUARDIAN (Dec. 22, 2017), <https://www.theguardian.com/technology/2017/dec/22/bitcoin-price-plunges-2000-12-hours-year-end-rally-fizzes-out>.

198. Bitcoin (USD) Price, COINDESK, <https://www.coindesk.com/price/> (select Dec. 27, 2017 in starting date field) (last visited Mar. 24, 2019).

199. Antonikova, *supra* note 167, at 441–44.

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. *See id.*

205. *Id.* at 447.

206. *Id.*

207. *Id.* at 447–48.

### B. *Suggested Tax Treatments for Cryptocurrency*

While the IRS established that it treats cryptocurrency as property, there are other, more favorable tax treatment options.<sup>208</sup> Among those options, Congress has the ability to narrow the definition of virtual currencies, treat cryptocurrency as a foreign currency, and create a de minimis exemption for cryptocurrency.

#### 1. *Categories of Virtual Currency*

First, the current expansive definition of virtual currencies can be subdivided into three categories.<sup>209</sup> In 2013, the GAO issued a report on virtual economies and currencies, in which it proposed a more sensible classification of virtual currency systems into three forms: closed-flow, hybrid, and open-flow.<sup>210</sup>

In a closed-flow virtual currency system, virtual currency can only be used to purchase in-game virtual goods or services.<sup>211</sup> For example, users can purchase new clothing for their virtual characters to use within the game. Players also have the ability to trade their virtual goods for other in-game assets.<sup>212</sup> More importantly, these virtual goods do not have value outside of the game.<sup>213</sup>

Suppose that *A* plays an online game through which she is issued virtual currency that can be used to purchase items within the game. Even though these items have no value outside the game and *A* cannot exchange her virtual currency for real dollars, *A*'s receipt of such virtual currency may result in taxable income. Thus, since virtual currency in a closed-flow system cannot be exchanged for government-issued tender, nor can it be used to purchase goods and services, these transactions should not be taxable.

Next, in a hybrid currency system, virtual currency can be used to purchase virtual goods as well as real goods and services.<sup>214</sup> For instance, players can earn virtual currency by purchasing it with real dollars or by completing virtual tasks, and players are then able to use that virtual currency to purchase real or virtual goods and services.<sup>215</sup> The most common hybrid systems are referred to as massive multiplayer online role-playing games (“MMORPG”), where a large number of players interact with one another within a virtual world.<sup>216</sup> MMORPG’s allow players to create online avatars that only exist within the virtual world, in which they assume the role of the character and control that character’s actions.

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208. I.R.S. Notice 2014-21, *supra* note 4.

209. U.S. GOV’T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 3–7.

210. *Id.*

211. *Id.* at 4.

212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.*

For example, players can use their avatars to interact with other players throughout the game.<sup>217</sup> Some MMORPG's, like World of Warcraft, however, use unaffiliated third-party exchanges that allow users to exchange virtual goods for real money.<sup>218</sup>

Now consider a situation where *B* plays World of Warcraft and collects a large quantity of virtual tools that are necessary to complete certain in-game objectives. World of Warcraft does not allow its users to directly exchange their virtual tools for U.S. dollars.<sup>219</sup> Instead, *B* can use an unaffiliated third-party exchange to coordinate the transfer of her virtual tools to another player in exchange for U.S. dollars. Not only is the transfer conducted by the third-party exchange, but the payment is mediated by a third-party payment network. Here, *B* may have earned taxable income as a result of her virtual tools. Thus, in situations involving a third-party exchange, players may realize taxable income as a result of the sale of their virtual goods.

Finally, virtual currency in an open-flow system “can be used to purchase both real and virtual goods and services, as well as be exchanged for real government-issued currency.”<sup>220</sup> For instance, consider Second Life, the online virtual game developed by Linden Lab, which has its own economy and a virtual currency referred to as “Linden dollars.”<sup>221</sup> Within the Second Life economy, players have the ability to earn Linden dollars by selling virtual services and goods to other players, just like in real life.<sup>222</sup> Players can sell virtual assets or even operate virtual businesses, such as retail stores that sell clothes or jewelry to other players.<sup>223</sup>

Assume *C*, a player in Second Life, rents virtual property to *D*, another player who pays him monthly rent of \$100 Linden dollars. At the end of the year, *C* has accrued \$1,200 worth of Linden dollars, which he exchanges for U.S. dollars on an exchange.<sup>224</sup> In doing so, *C* realizes a profit and may have earned taxable income from his activities in Second Life. This hypothetical portrays the key distinguishing feature present in an open-flow system: players are able to sell their Linden dollars for real money.<sup>225</sup> Therefore, players like *C* who cash out their virtual currencies may have earned taxable income from their virtual activities.

Another more prominent example of open-flow currency is Bitcoin. Bitcoin acts as a form of real-world currency in that users are able to use it to pay for real

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217. *Id.*

218. *Id.* at 5–6.

219. *Id.* at 5–6.

220. *Id.* at 5.

221. *Id.*

222. *Id.*

223. *Id.*

224. As of this writing, the exchange rate is roughly 261.20 Linden dollars for 1 U.S. dollar. *1 USD US Dollar to LD Linden Dollar*, CURRENCYRATE, <https://usd.currencyrate.today/ld> (last visited Apr. 18, 2019).

225. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 5.

goods and services, as well as exchange it for other forms of real currency.<sup>226</sup> According to Bitcoin program's design, there will be a maximum of 21 million Bitcoins in circulation once all Bitcoins have been mined, which is projected to be in the year 2140.<sup>227</sup> Because Bitcoin has spiked in popularity since its introduction, more and more users are beginning to use it as a form of payment for consumer products.<sup>228</sup> As of May 2013, Bitcoin's peer-to-peer, network-generated statistics claim that there is approximately a range of 8,000 to 70,000 Bitcoin transactions per day.<sup>229</sup> Third-party exchanges, like Coinbase, allow users to sell back Bitcoins in return for government-issued tender.<sup>230</sup>

In another example, suppose *A* makes high-quality leather belts and sells them over the Internet. He sells a belt to *B*, who pays him with Bitcoin. As a result, *A* may have earned taxable income from the sale of the belt. Therefore, in an open-flow system, the exchange of virtual goods for real property is a realizing event that may produce taxable income.<sup>231</sup>

These three types of virtual currency systems describe clear differences in how each form of virtual currency functions.<sup>232</sup> As such, the over-expansive definition of virtual currencies in Notice 2014-21 fails to reflect key differences in a virtual currency's characteristics and use.<sup>233</sup> Since most virtual currency systems are anonymous, the most reliable method for the IRS to track receipt of income is when a taxpayer cashes out.<sup>234</sup> By selectively focusing its time and resources on hybrid and open-flow virtual currency systems—systems that can be used in transactions with real currency and goods, the IRS can better identify users who may have incurred taxable income.

To date, the IRS has not issued any specific guidelines addressing the potential tax consequences associated with virtual economies and currencies.<sup>235</sup> It is more likely that many users lack sufficient knowledge of tax requirements and as a result, fail to properly identify income earned through virtual economies as taxable income.<sup>236</sup> If a taxpayer turns to the Internet for guidance regarding the taxation of Bitcoin transactions, there are a number of sources that offer differing opinions on the tax treatment of Bitcoin, which may lead him to believe that any form of virtual currency transaction relieves him of the responsibility to report and pay taxes.<sup>237</sup>

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226. *Id.*

227. *Id.* at 6.

228. *See id.* at 5.

229. *Id.* at 8.

230. *Id.* at 5.

231. *Id.* at 8.

232. Antonikova, *supra* note 167, at 455–65.

233. *Id.*

234. *Id.* at 459–62.

235. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 9–10.

236. *Id.* at 12–14.

237. *Id.* at 13.

Even if taxpayers are aware of such tax liability, they may be unsure as to how to properly characterize income or how to calculate their basis for gains. For instance, some online games afford players a weekly allowance of virtual currency.<sup>238</sup> If a player then exchanges that virtual currency for real money, the unsophisticated taxpayer may face a number of challenges associated with calculating the basis for any taxable gain.

Furthermore, there are clear challenges associated with third-party reporting. Currently, third-party information reporting requirements do not apply to specific virtual currency transactions.<sup>239</sup> In other words, the only time third-party information reporting is required occurs when transactions involve the use of a third-party payment network to mediate the transaction. For example, in *World of Warcraft*, exchanges of virtual currency for real currency through the use of an unaffiliated third-party exchange will trigger third-party reporting requirements.<sup>240</sup> But, largely due to its anonymous nature, virtual transactions are inherently difficult to track as it requires identifying the true identities of the parties to the transaction.

Thus, in failing to issue additional guidelines specific to virtual currencies, the IRS is losing out on a key opportunity to educate taxpayers on potential tax implications while minimizing the potential for future noncompliance.<sup>241</sup>

## 2. *Treatment of Virtual Currency as Foreign Currency*

Section 988 of the Code details a separate taxation module for foreign currency transactions.<sup>242</sup> Before the Tax Reform Act of 1986, “judicial and administrative decisions required treating foreign currency as personal property.”<sup>243</sup> This treatment of foreign currency was extremely time-consuming and challenging as taxpayers attempted to accurately keep track of the basis and dollar values for every single foreign currency transaction.<sup>244</sup> The inconsistent reporting made auditing tax returns by the IRS an administrative nightmare.<sup>245</sup>

To address these concerns, Congress enacted Subpart A, Section 988 of the Code.<sup>246</sup> Pursuant to Section 988, depending on the character of the income, gains from foreign currency transactions are subject to either a capital or ordinary tax rates.<sup>247</sup> If the receipt of foreign currency is the result of the sale of a capital

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238. *Id.*

239. *Id.* at 14.

240. *Id.* at 5.

241. *Id.* at 16.

242. 26 U.S.C. § 988(a)(1)(A) (2018).

243. Antonikova, *supra* note 167, at 449–50.

244. *Id.*

245. *Id.* at 463 n. 153.

246. 26 U.S.C. § 988(a)(1)(A).

247. Antonikova, *supra* note 167, at 449.

asset, any gain will be subject to the tax rate portrayed by Figure 3.<sup>248</sup> Meanwhile, if the receipt of foreign currency was for compensation for services, that income will be taxed at the taxpayer's ordinary tax rate.<sup>249</sup>

Furthermore, Section 988 provides for an exception regarding personal transactions made using foreign currency.<sup>250</sup> For instance, if *A* goes on vacation to Taiwan and buys a souvenir with foreign currency, that transaction does not require recognition of gains or losses. Moreover, when *A* returns back to the U.S. and converts foreign currency into U.S. dollars, gains from that conversion will only be recognized if they exceed the \$200 exemption limitation. Allowing similar treatment of cryptocurrency is not only appropriate but modernizes the Code to better address the expanding use of cryptocurrency.<sup>251</sup> In theory, a taxpayer should be able to go to a grocery store and buy yogurt using Bitcoin in the same seamless manner as another taxpayer using a debit card.

Taking into account the fact that the Internet was not fully commercialized until November 1989, it is understandable why Congress could not have foreseen the concept of cryptocurrency when proposing the Tax Reform Act three years prior.<sup>252</sup> However, the underlying reasons that led Congress to adopt Section 988 parallels the current economic situation surrounding cryptocurrency.<sup>253</sup> Before its enactment, judicial and administrative decisions treated foreign currency as personal property.<sup>254</sup> Similarly, in Notice 2014-21, the IRS proposed that virtual currency be classified as personal property, as opposed to foreign currency.<sup>255</sup> Importantly, the same reporting concerns that resulted in the enactment of the Tax Reform Act are beginning to manifest in the case of cryptocurrency.<sup>256</sup> By treating foreign currency as personal property, Congress found that it resulted in inconsistent judicial decisions and erroneously filed tax returns, along with increased spending costs to both taxpayers and the IRS to ensure compliance.<sup>257</sup> Likewise, in cryptocurrency transactions, unsophisticated taxpayers are faced with the same challenges of calculating and recording accurate basis and dollar values.

Many commentators believe that the current reporting requirements and enforcement scheme is likely to deter people from using virtual currencies all together.<sup>258</sup> The ambiguous definition of "convertible virtual currency," coupled

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248. *Id.*

249. *Id.*

250. 26 U.S.C. § 988(c)(2) (2018).

251. *Id.* § 988(c)(1)(A).

252. *Id.*; *History of the Web*, WORLD WIDE WEB FOUND., <https://webfoundation.org/about/vision/history-of-the-web/> (last visited Mar. 24, 2019).

253. 26 U.S.C. § 988(c)(1)(C)(ii) (2018).

254. Antonikova, *supra* note 167, at 449.

255. I.R.S. Notice 2014-21, *supra* note 4.

256. Antonikova, *supra* note 167, at 444–46.

257. *Id.* at 450.

258. *Id.* at 446.

with the strenuous record-keeping requirements, may turn away bona fide users.<sup>259</sup> While these requirements may be enough to discourage bona fide users from using cryptocurrency, it may not be enough to deter users who choose to use cryptocurrency for illegal purposes.

Without the widespread use of bona fide users, virtual currency will soon become the default instrument of choice for illegal transactions.<sup>260</sup> If that happens, the number of cryptocurrency transactions expected to be reported on tax returns will fall exponentially, potentially even to zero. As an effect, such a dynamic shift in the use of cryptocurrency will also prevent society from tapping into benefits virtual currencies have to offer—from lowering transaction costs for the financially distressed to stimulating financial technology innovation.<sup>261</sup>

These rigid and outdated reporting regulations are unnecessarily burdensome, and both taxpayers and the IRS would be better off if smaller cryptocurrency transactions were afforded similar Section 988 protections.<sup>262</sup> As illustrated in the *Coinbase* case, the court narrowed the IRS summons to apply only to users who conducted annual transactions of more than \$20,000.<sup>263</sup> In its brief, the IRS itself suggested that these big-time users were who they were most interested in, rather than small-time users.<sup>264</sup> So why hasn't Congress adopted similar standards for the treatment of cryptocurrency as it has for foreign currency?

One reason why Congress is unwilling to expand the definition of foreign currency may be attributed to the decentralized nature of virtual currency.<sup>265</sup> Foreign currency has always been generally understood to mean currency issued and backed by a sovereign power.<sup>266</sup> In contrast, the anonymity and volatility of cryptocurrency, as well as the fact that it is not backed by any government may be viewed as too great of an economic risk.<sup>267</sup> Thus, while possible, it appears that Congress is unlikely to expand the definition of foreign currency to include stateless cryptocurrencies.<sup>268</sup>

### 3. *De Minimis Exemption for Cryptocurrency*

The final offered suggestion is to simply create a de minimis exemption for certain cryptocurrency transactions. Section 132 of the Code defines a list of fringe benefits that are excluded from gross income.<sup>269</sup> Gross income will not

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259. *Id.*

260. *Id.*

261. *Id.*

262. *Id.* at 435–36.

263. *United States v. Coinbase, Inc.*, 2017 WL 3035164, at \*3 (N.D. Cal. 2017).

264. *See id.*

265. Brito, *supra* note 164.

266. *Id.*

267. Antonikova, *supra* note 167, at 439; Brito, *supra* note 164.

268. Brito, *supra* note 164.

269. 26 U.S.C. § 132(a)(1)–(8) (2018).



include any fringe benefit that qualifies as “(1) a non-additional-cost service, (2) qualified employee discount, (3) working condition fringe, (4) de minimis fringe, (5) qualified transportation fringe, (6) qualified moving expense reimbursement, or (7) qualified retirement planning services.”<sup>270</sup>

In the context of cryptocurrency, a de minimis exemption can be created in a number of ways. The first possibility is to create a new section in the Code explicitly for virtual currencies that mirrors the language in Section 988(e).<sup>271</sup> A second, simpler alternative would be to amend Section 988 itself by adding a new provision stating that the foreign currency personal transactions exemption is applicable to convertible virtual currency.<sup>272</sup> A third option takes the form proposed in the CTFA.<sup>273</sup> This Amendment inserts a de minimis exemption for cryptocurrency within Section 139 of the Code.<sup>274</sup> The placement of this proposed bill, however, which is tucked behind exemptions associated with health and welfare benefits, can easily be overlooked.<sup>275</sup>

Each suggestion as to how best treat cryptocurrency offers unique results. But, as examined in Part IV, the most effective reform includes aspects from each.

#### IV. RECOMMENDATION

The use of cryptocurrency for every day consumer transactions is becoming increasingly popular. With it, the risk of noncompliance of tax laws grows as more and more taxpayers lack the knowledge of the tax requirements regarding how to accurately report and characterize cryptocurrency gains. The current reporting requirements are not only outdated but fail to keep pace with modern technological growth: IRS Notice 2014-21 too broadly defines virtual currency, and its information reporting requirements does not consider the nature of most virtual currencies.<sup>276</sup>

While the CTFA marks a positive step towards encouraging the use of cryptocurrency, the current proposed version does not fully address all concerns related to the taxability of virtual currency. Accordingly, this Note proposes a number of statutory modifications that would help make taxing and reporting virtual currency transactions less cumbersome. The proposed modifications would allow taxpayers to keep more accurate records, resulting in improved compliance with the current tax reporting requirements.

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270. *Id.* § 132(a)(1)–(7).

271. Brito, *supra* note 164.

272. *Id.*

273. H.R. Bill 3708, *supra* note 8.

274. *Id.*

275. 26 U.S.C. § 139 (2018).

276. I.R.S. Notice 2014-21, *supra* note 4.

First, the CTFA should be reintroduced as Section 133 of the Code.<sup>277</sup> Section 133 formerly laid out guidelines regarding the exclusion of interest on certain loans used to acquire employer guidelines from one's gross income, but has since been repealed.<sup>278</sup> Addressing gains from the sale or exchange of virtual currency with its own section, as opposed to tucking it behind other unrelated de minimis exemptions, will allow taxpayers to better educate themselves on their reporting requirements. Section 133 should be amended by inserting the above-mentioned CTFA along with some new modifications, indicated in bold.

SECTION 1: VIRTUAL CURRENCY

(a) IN GENERAL:

Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by inserting in **Section 133** the following new section:

SEC: 133: GAIN FROM SALE OR EXCHANGE OF VIRTUAL CURRENCY

(A) IN GENERAL:

Gross income shall not include gain from the sale or exchange of virtual currency for other than cash or cash equivalents.

(B) LIMITATION:

(1) IN GENERAL

The amount of gain excluded from gross income under subsection (a) with respect to a sale or exchange shall not exceed **\$300**.

(2) AGGREGATION RULE

For purposes of this subsection, all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

(C) VIRTUAL CURRENCY:

(1) IN GENERAL

For purposes of this section, the term *virtual currency* means a digital representation of value that is used as a medium of exchange and is not otherwise currency under Section 988.

(2) **CLASSES OF VIRTUAL CURRENCY**

For purposes of this section, there are three distinct classes of virtual currencies—

**(A) Closed-Flow Virtual Currency**

**Virtual currency that can be used to purchase virtual goods or services only**

**(B) Hybrid Virtual Currency**

277. 26 U.S.C. § 133 (2018).

278. *See id.* § 133 (1994).

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**Virtual currency that can be used to purchase virtual goods or services,  
and may be used to purchase real goods or services**

**(C) Open-Flow Virtual Currency**

**Virtual currency that can be used to purchase both real and virtual  
goods and services, and is freely convertible into fiat currency**

**(D) EXCEPTIONS:**

**(1) IN GENERAL**

**For purposes of this section, any type of virtual currency classified  
as closed-flow will not be subject to any of the above limitations**

**(E) INFLATION ADJUSTMENT:**

In the case of any taxable year beginning in a calendar year after 2018, the  
dollar amount in subsection (b) shall be increased by an amount equal  
to—

(1) such dollar amount, multiplied by

(2) the cost-of-living adjustment determined under Section 1(f)(3) for  
the calendar year in which the taxable year begins, determined by sub-  
stituting calendar year 2017 for calendar year 1992 in subparagraph (B)  
thereof.

Any increase determined under the preceding sentence shall be rounded to  
the nearest multiple of \$50.

First, in subsection (b), the amount of excludable gain is reduced to \$300.  
The original proposal called for a buffer of \$600, meaning when a cryptocurrency  
transaction resulted in less than \$600 of gain, the taxpayer would be relieved of  
his responsibilities to report and pay taxes.

However, it is unlikely that the IRS will be willing to exempt such a large  
amount right off the bat. A \$300 limitation seems to fall more in line with the  
other de minimis exceptions under the Code. For example, the Code provides for  
a \$200 tax-free haven for foreign currency gains on personal transactions. While  
it may be plausible that cryptocurrency users engage in consumer transactions  
well above \$300, this lesser amount provides a good starting point in easing the  
IRS into accepting virtual currency as a legitimate form of payment. As more  
individuals continue to use virtual currency, this limitation can be adjusted up-  
wards or downwards to better address tax reporting concerns. Most importantly,  
by allowing for a de minimis exemption, more users will be encouraged to use  
cryptocurrency without having to subject themselves to challenging and complex  
reporting requirements.

Second, subsection (c)(2) reflects the addition of a new subsection defining  
the three classes of virtual currency in the market—closed flow virtual currency,  
hybrid virtual currency, and open-flow virtual currency.<sup>279</sup> In order to keep up

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279. Antonikova, *supra* note 167, at 455–65.

with the growth of modern technology, the tax implications must vary depending on which system the virtual currency in question falls within. In doing so, both the taxpayer and the IRS will yield significant benefits.<sup>280</sup>

Taxpayers will benefit from simplified procedures requiring only hybrid and open-flow transactions to be reported, as the inclusion of virtual goods that can never be exchanged for fiat currency when computing gross income.<sup>281</sup> In return, the IRS will be able to efficiently allocate its already limited resources to a smaller number of transactions and collect taxes on virtual currency transactions in a more consistent manner.<sup>282</sup>

The final revision adds subsection (d), which addresses the tax consequences for taxpayers in a closed-flow virtual currency system. There is no rational basis behind taxing an individual who has not received something tangible in return.<sup>283</sup> As such, for purposes of the entire section, taxpayers who engage in transactions in a closed-flow virtual currency system will never realize any taxable income.<sup>284</sup> This line of reasoning appears to follow the tendencies of the IRS.<sup>285</sup> In *Coinbase*, the IRS agreed to narrow the scope of its administrative summons to only certain individuals whose cryptocurrency transactions exceeded \$20,000.<sup>286</sup> In effect, they decided that users participating in cryptocurrency transactions of minimal amounts were not worth their limited time and resources. Simply put, if the IRS is not pursuing users who failed to report small gains on open-flow transactions, why would it be concerned with virtual currencies that do not yield any real-world gain?

The proposed suggestion will also be relatively simple for the IRS to administer.<sup>287</sup> In fact, it no longer requires the IRS to handle complicated case-by-case factual analysis for every virtual currency transaction.<sup>288</sup> Instead, it allows the IRS to issue clear and simple guidelines regarding how to classify virtual currencies as closed-flow, hybrid, and open-flow.<sup>289</sup> In its guidelines, the IRS should also be sure to include examples of known virtual currencies within each system to help ease the compliance efforts for taxpayers.<sup>290</sup>

The aforementioned amendments provide an avenue for Congress and the IRS to mitigate the risk of noncompliance from virtual currencies in a manner that is relatively low-cost and effective. In addition, this bill will help educate

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280. *Id.*

281. *Id.*

282. *Id.*

283. *See id.*

284. *Id.*

285. *United States v. Coinbase, Inc.*, 2017 WL 3035164, at \*5 (N.D. Cal. 2017); Antonikova, *supra* note 167, at 455–65.

286. *Coinbase*, 2017 WL 3035164, at \*3.

287. Antonikova, *supra* note 167, at 455–65.

288. *Id.* at 465.

289. *Id.*

290. *Id.*

taxpayers who own or are looking at owning cryptocurrency but are unaware of its taxable nature. The uncertainty surrounding virtual currency in taxable transactions has led to a litany of misinformation circulating throughout the Internet.<sup>291</sup> In order to promptly combat this issue and mitigate future noncompliance risks, it is in the best interest of the IRS to swiftly issue specific guidance regarding the treatment of virtual currency.

## V. CONCLUSION

The use of virtual currencies intended as an alternative form of payment to government-issued currencies is a recent phenomenon, and the extent to which their use results in taxable income and noncompliance is hard to know for certain.<sup>292</sup> Given this uncertainty, the IRS has failed to provide taxpayers with adequate compliance guidelines that specifically address the different natures of these evolving virtual currencies.<sup>293</sup> Without such guidance, many taxpayers are left in the dark regarding whether or not their virtual currency transactions result in taxable income.<sup>294</sup> The increasing number of taxpayers aware of their tax-reporting requirements has resulted in costly compliance efforts by the IRS.<sup>295</sup> Thus, the growth in the use of virtual currencies suggests that it would be meaningful for the IRS to take steps towards mitigating these compliance risks.<sup>296</sup>

This Note recommends a structure to mitigate the risk of noncompliance from virtual currencies. First, the IRS needs to issue specific guidelines that supplement Notice 2014-21 in order to properly narrow the definition of what qualifies as virtual currency.<sup>297</sup> In doing so, the IRS should turn to the more sensible definition that is based on the GAO's proposed classification of virtual currency systems.<sup>298</sup> Second, Congress should adopt the proposed version of the CTFA, subject to the above-mentioned modifications.<sup>299</sup> Under this recommendation, the use of cryptocurrency as a medium of every-day exchange will no longer be stifled.

In proposing these amendments, the benefits of using virtual currency and their related tax consequences under the Code will become more apparent. This affords virtual currency users with the necessary knowledge to properly identify

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291. *Bitcoin's Biggest Enemy Is Still Fake News and Misinformation*, BITSTARZ (Apr. 25, 2018), <https://www.bitstarz.com/blog/bitcoins-biggest-enemy-is-still-fake-news-and-misinformation>.

292. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 13.

293. *Id.* at 16.

294. I.R.S. Notice 2014-21, *supra* note 4; U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 12-13.

295. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 17.

296. *Id.*

297. *Id.* at 3-6; Antonikova, *supra* note 167, at 466.

298. Antonikova, *supra* note 167, at 451.

299. *See id.* at 455-65.

income earned through virtual currencies as taxable income.<sup>300</sup> As the use of virtual currencies expands, such guidelines will better ensure that the IRS can more efficiently ensure tax compliance.<sup>301</sup>

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300. U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-516, *supra* note 1, at 12–13.

301. *Id.* at 17.