TO TAX OR NOT TO TAX OR HOW TO TAX: TAX POLICY AND ITS ROLE IN CRYPTOCURRENCY ADOPTION

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ABSTRACT

The recent boom of cryptocurrency and crypto-based assets has highlighted the need for cohesive regulatory and taxation frameworks. Multiple U.S. agencies attempted to classify, regulate, and tax the use of such assets, but without a consensus, the users find themselves facing unexpected charges or tax bills. This Article discusses certain nuances that have not been addressed by the Internal Revenue Service in its treatment of cryptocurrencies and assets and showcases how complicated the current regime is when it comes to both compliance and enforcement. The Article ultimately reaches the conclusion that this emerging asset class does not fit into any existing classifications and rules, and that the government may benefit from halting its taxation until it creates a new approach that would not disadvantage this new digital economy or individual taxpayers.

I. INTRODUCTION

[1] Cryptocurrency is no longer an obscure concept—the new digital money has gained millions of followers, created a new culture, and gone mainstream. The goal of this decentralized system is to operate outside of existing banking institutions, but the price of going mainstream is the attention of regulators and policymakers. It was not unexpected that governments would take interest in a new asset that they might not be able to control but could derive tax revenue from. It was, however, entirely expected that various U.S. agencies would take a long time to decide which one should be the primary crypto regulator. Bitcoin, the world's first and largest decentralized cryptocurrency, was launched in 2009, and it took the Internal Revenue Service ("IRS") almost five years to create a barebones taxation framework that attempted to cover transactions involving cryptocurrency—from mining to bartering—and applicable tax treatments.[1] Those regulations are often criticized for lacking depth and cohesion, and enforcement still presents a significant challenge for the IRS.

[2] Tax policy often serves a broader purpose than its primary goal of creating enough revenue to allow a government to execute its core functions.[2] The dominant approach is based on economics; it views tax policy as a system of incentives and disincentives that drives human

[1] *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

[2] *But see* Scott A. Hodge, *What Would Income Equality Really Look Like?*, TAX FOUND. (Mar. 5, 2020),-https://taxfoundation.org/income-inequality-redistribute-income/ [https://perma.cc/FL8P-J8P8].

behavior in a way that would create the most benefit for the society at large.[3] In the case of taxation of cryptocurrency and crypto-based assets, a number of countries took creative steps to incentivize their citizens to embrace the new technology and find ways to implement it in the economy.[4] The United States, however, characterized cryptocurrency as property for tax purposes, without careful enough consideration of the inherent nuances and potential policy implications of the cryptocurrency space.[5] This paper discusses some of these implications, identifying the nuances the Internal Revenue Service ("IRS") missed.

[3] The urgency of identifying potential issues and developing appropriate frameworks is quickly becoming apparent with the wide-spread adoption of cryptocurrencies by individuals, institutions, and governments. AT&T now allows customers to pay their bills with Bitcoin;[6] Microsoft accepts Bitcoin for payments through its online Xbox store;[7] Japan's Virtual

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[3] *See* Joy S. Mullane, *Incidence and Accidents: Regulation of Executive Compensation Through the Tax Code*, 13 LEWIS & CLARK L. REV. 485, 489–92 (2009) (noting that the U.S. Tax Code does not necessarily prohibit or permit nontax behavior, it only provides how certain items are taxed, thus influencing nontax taxpayer behavior); *see generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705, 705–07, 711–13 (1970) (contemplating the logic behind using tax laws to accomplish policy goals).

[4] *See infra* Section IV.B.

[5] *See infra* Section III.

[6] Jamie Redman, *Telecom Giant AT&T Now Accepts Bitcoin Cash Payments*, BITCOIN.COM (May 23, 2019), https://news.bitcoin.com/telcom-giant-att-now-accepts-bitcoin-payments/ [https://perma.cc/2XRA-QM4J].

[7] Sebastian Anthony, *Microsoft now accepts Bitcoin across all of its online stores: Windows, Xbox, apps, everything*, EXTREMETECH (Dec. 11, 2014, 10:54 AM), https://www.extremetech.com/extreme/195759-microsoft-now-accepts-bitcoin-across-all-of-its-online-stores-windows-games-apps-everything [https://perma.cc/KAT8-UTXK].

Currency Act recognizes virtual currency as legal tender;[8] China has created Digital Yuan;[9] and Miami-Dade County in Florida is contemplating allowing residents to use cryptocurrencies to pay for taxes and government services, following in Ohio's footsteps.[10] Companies acquire and keep cryptocurrency on their balance sheets and use it to conduct business and compensate their employees and executives, thus putting more cryptocurrency into circulation.[11]

[4] Section II of this paper provides a brief overview of current usage and technical aspects of various crypto-based assets, addressing the discrepancy in the regulatory definitions and treatments. Section III

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[8] Luke Graham, *As China cracks down, Japan is fast becoming the powerhouse of the bitcoin market*, CNBC (Sep. 29, 2017, 12:12 PM), https://www.cnbc.com/2017/09/29/bitcoin-exchanges-officially-recognized-by-japan.html [https://perma.cc/5W2L-7HPL]; Arjun Kharpal, *Bitcoin value rises over $1 billion as Japan, Russia move to legitimize cryptocurrency*, CNBC (Apr. 12, 2017, 11:44 AM), https://www.cnbc.com/2017/04/12/bitcoin-price-rises-japan-russia-regulation.html [https://perma.cc/C2QS-DKR6].

[9] James T. Areddy, *China Creates Its Own Digital Currency, a First for Major Economy*, WALL ST. J. (Apr. 5, 2021, 10:48 AM), https://www.wsj.com/articles/china-creates-its-own-digital-currency-a-first-for-major-economy-11617634118 [https://perma.cc/GE9K-YFCK].

[10] Joshua Ceballos, *Miami-Dade Commissioner Wants to Let Residents Pay Taxes With Cryptocurrency*, MIAMI NEW TIMES (Apr. 15, 2021, 8:00 AM), https://www.miaminewtimes.com/news/miami-dade-county-may-let-people-pay-taxes-with-bitcoin-12117680 [https://perma.cc/P4AJ-K6QA]; Yogita Khatri, *Ohio Becomes First U.S. State to Allow Taxes to be Paid in Bitcoin*, COINDESK (Sept. 13, 2021, 4:37 AM), https://www.coindesk.com/ohio-becomes-first-us-state-to-allow-taxes-to-be-paid-in-bitcoin [https://perma.cc/V6DE-Z4JQ].

[11] *See* Roger Huang, *What Publicly Traded Companies Have Bitcoin On Their Balance Sheet — And Why*, FORBES (Jan. 12, 2021, 12:30 PM), https://www.forbes.com/sites/rogerhuang/2021/01/12/what-publicly-traded-companies-have-bitcoin-on-their-balance-sheet---and-why/?sh=7b4776eb4564 [https://perma.cc/5U2X-BU2Y].

discusses the current tax treatment of crypto-based assets in the United States, highlighting how the regime interplays with different kinds of assets used as payment, investment, or compensation. Section IV evaluates the shortcomings of the policy and the consequences it creates for both the taxpayers and the IRS. It will further look at how cryptocurrency is treated internationally and suggest how the IRS can improve its approach. Lastly, Part V summarizes the arguments and recommendations.

II. Brief Overview of Crypto Assets

A. What Is it and Why Do We Care?

[5] In its simplest form, cryptocurrency is a digital currency that is not tethered to any asset or controlled by any government. Instead, it is kept honest by the peer-to-peer network of its users, who utilize blockchain technology to maintain a public ledger of transactions.[12] A blockchain serves as a digital signature that verifies the exchanges, which eliminates the need for intermediaries and provides security to an otherwise decentralized system.[13] The blockchain technology also enables creation of cryptographic tokens, which are fully programmable digital assets that represent access rights to underlying economic value (like property) or a permission to access the property or services of someone else.[14] "Programmable" means that tokens can run on software protocols and utilize "smart contracts" to dictate the network's rules of engagement and

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[12] LabCFTC, A CTFC Primer on Virtual Currencies 5 (2017), https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf [https://perma.cc/S3DT-QHY3] [hereinafter *CTFC Primer*].

[13] *Id.* at 5.

[14] Shermin Voshmgir, *Tokens, Cryptocurrencies & other Cryptoassets*, Blockchainhub Berlin (Jul. 2019), https://blockchainhub.net/tokens/ [https//perma.cc/BHU9RZB3].

the features and functions of the token.[15] The potential applications of blockchain token technology are endless.

[6] Cryptocurrencies are largely perceived as an investment opportunity in the current market, though the Bitcoin creator envisioned it as a global currency of the future, free of borders, government control, banking fees, and clearing house requirements.[16] The sentiment is echoed by a number of financial experts, who see the cryptocurrency's potential to revolutionize international banking systems by cutting down on transaction time and costs.[17] While Bitcoin is the most well-known cryptocurrency, there are currently more than 10,000 digital currencies mined and circulated globally, as of November 2021.[18] Due to its popularity and notorious volatility,

[15] *Digital Assets: Cryptocurrencies vs. Tokens*, GEMINI: CRYPTOPEDIA (May 17, 2021), https://www.gemini.com/cryptopedia/cryptocurrencies-vs-tokens-difference [perma.cc/S3YB-MTVD].

[16] *See* Sylvain Saurel, *The Bitcoin Must Return To The Original Vision Of Its Creator Satoshi Nakamoto*, MEDIUM (Nov. 26, 2019), https://medium.com/swlh/the-bitcoin-must-return-to-the-original-vision-of-its-creator-satoshi-nakamoto-9f4dc31692c8 [https://perma.cc/4QPB-9QKF]; *see generally* SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM 1 (2008), https://bitcoin.org/bitcoin.pdf [https://perma.cc/VQ2K-LJA2] (describing Bitcoin as "a purely peer-to-peer version of electronic cash [that] would allow online payments to be sent directly from one party to another without going through a financial institution").

[17] Tal Elyashiv, *Op-ed: A new global arms race in digital finance is heating up*, CNBC (Jan. 21, 2021, 11:19 AM), https://www.cnbc.com/2021/01/21/op-ed-a-new-global-arms-race-in-digital-finance-is-heating-up.html [https://perma.cc/9KMT-5JYC].

[18] Luke Conway, *10 Important Cryptocurrencies Other Than Bitcoin*, INVESTOPEDIA (Nov. 19, 2021), https://www.investopedia.com/tech/most-important-cryptocurrencies-other-than-bitcoin/ [https://perma.cc/XWH8-4AS5].

Bitcoin took only twelve years to reach $1.1 trillion market capitalization, making it the fastest growing asset in history.[19]

B. Cryptocurrency, Virtual Currency, and Tokens

[7] Classifying cryptocurrency is an undeniably challenging task. Cryptocurrency can be used to buy and sell goods and services, similar to a traditional currency; it can be mined, bought, and sold in cash markets and via derivative instruments, similar to commodities like oil and gold; it can be issued in an Initial Coin Offering (ICO) and represent value and ownership, similar to securities and stocks.[20] Regulators around the world are faced with a choice: either wedge the new asset class within an existing framework based on select attributes that are similar to an already-defined classification, or create an entirely new set of rules.

1. Issues with Inconsistent Terminology

[8] Another layer of complexity is added by the fact that "not all virtual currencies are created equal"—a large part of the mainstream finance and tax community has been using the terms "token," "cryptocurrency," and "virtual currency" interchangeably, often glossing over the distinct features associated with each technology and failing to create a tailored regulatory

[19] Aran Ali, *Bitcoin is the Fastest Asset to Reach a $1 Trillion Market Cap*, VISUAL CAPITALIST (Apr. 12, 2021), https://www.visualcapitalist.com/bitcoin-is-the-fastest-asset-to-reach-a-1-trillion-market-cap/ [https://perma.cc/88ER-NY9B] (comparing Bitcoin's twelve-year timeline to Microsoft (forty-four years) and Apple (forty-two years)).

[20] *CTFC Primer*, *supra* note 12, at 4–5, 7.

framework for each.[21] Cryptocurrency and tokens are unique subclasses of digital assets that utilize cryptography, an advanced encryption technique that assures the authenticity of crypto assets by eradicating the possibility of counterfeiting or double-spending.[22] Confusion arises from the fact that most of these assets are built on (or in some way utilize) the distributed ledger (blockchain) technology, which are fully digital, intangible, and do not have a non-digital analogue that would provide for an easy comparison.[23] Justifiably, the technology that underlies all digital assets is very complex, and the constant development of new assets with different features is difficult to keep up with even for more technologically advanced practitioners.[24] However, with the growing number of subclasses of digital assets and associated algorithms being created and integrated into the economy, a need for a clear terminology framework is apparent in order to ensure they are regulated (and taxed) appropriately.

[9] A simplified summary for the purposes of this paper is based on the classification proposed by Shermin Voshmgir, an Austrian economist and author of *Token Economy*. Cryptocurrency is a fungible store of value managed by a blockchain network (on which it is a native token—but let us avoid more confusion here), also capable of immediate and effortless transfer or exchange, thus adding the benefit of liquidity.[25] Tokens, on the

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[21] Allen Kogan, *Not All Virtual Currencies Are Created Equal: Regulatory Guidance in the Aftermath of CFTC v. McDonnell*, 8 AM. U. BUS. L. REV. 199, 200–02 (2019); Denitza Dimitrova, *Malta: The Difference Between Digital Coins And Tokens?*, MONDAQ (Oct. 22, 2018), https://www.mondaq.com/fin-tech/747496/the-difference-between-digital-coins-and-tokens [https://perma.cc/8DPH-M7RW].

[22] GEMINI: CRYPTOPEDIA, *supra* note 15.

[23] Voshmgir, *supra* note 14.

[24] *Id.*

[25] *Id.*

other hand, represent *assets* (or fractions of assets) and/or access to rights that are collectively managed by a blockchain network.[26] Tokens are not always fungible or even tradeable, and by incorporating "smart contracts" can be used to reward participation, grant membership, grant and share ownership of any asset, and represent "anything from an asset to an access right."[27] The process of creating crypto tokens to serve these various functions is known as tokenization.[28] Many tokens were never designed for the purpose of representing currency, unlike cryptocurrencies like Bitcoin or Ethereum.[29]

2. Issues with Regulatory Classifications

[10] The U.S. regulators (other than the Federal Reserve)[30] set sights on establishing jurisdiction over crypto assets. In 2018, Commodity Futures Trading Commission ("CFTC") won a case against Coin Drop Markets, alleging fraud in connection with virtual currencies, including Bitcoin and Litecoin.[31] The court held for the first time that all virtual currencies were commodities, and thus subject to the CFTC jurisdiction, upholding the

[26] *Id*.

[27] *Id*.

[28] GEMINI: CRYPTOPEDIA, *supra* note 15.

[29] *See* Voshmgir, *supra* note 14.

[30] *See* Pete Rizzo, *Federal Reserve Chair: U.S. Central Bank Can't Regulate Bitcoin*, COINDESK (Sept. 11, 2021, 6:24 AM), https://www.coindesk.com/federal-reserve-chair-us-central-bank-cant-regulate-bitcoin/ [https://perma.cc/Y6CQ-RN8S] (discussing Chairwoman Janet Yellen's view that crypto currency development was "taking place outside the banking industry").

[31] *See* CFTC v. McDonell, 287 F. Supp. 3d 213, 216, 252, 260, 263 (E.D.N.Y. 2018).

CFTC's earlier order.[32] The court reasoned that "[v]irtual currencies are 'goods' exchanged in a market for a uniform quality and value" and thus fall within the common definition of commodity under U.S.C. §1(a)(9).[33] An important consideration was the fact that the CFTC lawfully had jurisdiction over "contracts deriving their value from underlying assets."[34] The court further established that simply because the CFTC had jurisdiction over virtual currencies as commodities, it did not prevent other agencies from exercising jurisdiction over products that are labeled as cryptocurrencies, but may exhibit characteristics that would make them, for example, securities.[35]

[11] The Securities and Exchange Commission (SEC) initially only focused on certain initial token offerings (ICOs) that were issued by online companies, projects, or communities to raise money, and found them to be securities based on the *Howey* test.[36] Recent statements by SEC Chairman Jay Clayton indicate that the SEC has differentiated between crypto assets that are used "as securities to raise capital for a venture," which would fall under the SEC's purview as a security, while Bitcoin was more of a

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[32] *Id.* at 226 (internal citations and quotation marks omitted) ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.").

[33] *Id.* at 228.

[34] *Id.* at 226.

[35] *Id.* at 228.

[36] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207, 117 SEC Docket 5 (July 25, 2017); *see generally* SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946) (establishing the four essential elements of the Howe*y* test: (1) an investment of money; (2) an investment in a common enterprise; (3) an expectation of profits from the investment; and (4) profits are generated solely from the efforts of others).

"payment mechanism and store of value" as opposed to a security.[37] Against its own rhetoric, however, the SEC is still pursuing a lawsuit against Ripple Labs Inc., pertaining to the cryptocurrency XRP, which is mainly used as a value-storing token and a medium of payment.[38]

[12] In 2014, the IRS released its first official Notice regarding crypto, in which it outlined how "existing general tax principles apply to transactions using virtual currency."[39] The IRS settled on an umbrella term, "virtual currency," using Bitcoin specifically as an example of the "convertible" kind of currency for the purposes of its regulations.[40] In 2019, in its only follow-up guidance, the IRS kept this definition, clarifying that "virtual currency" describes both "digital currency" and "cryptocurrency"; and "cryptocurrency" is broadly described as "virtual currency that uses . . . a distributed ledger, such as a blockchain."[41] This means that the same tax regime applies to all of the following assets: convertible cryptocurrencies, such as Bitcoin or Ether; any kind of blockchain-based token, including the NFTs or equity-based tokens issued by start-ups in lieu of stock;[42] and even

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[37] Kevin Helms, *SEC Chairman Jay Clayton Explains US Crypto Regulation, Calls Bitcoin a Store of Value*, BITCOIN (Nov. 23, 2020), https://news.bitcoin.com/us-cryptocurrency-regulation-sec-chairman-jay-clayton-bitcoin/ [https://perma.cc/UBL7-BPZJ].

[38] *See* Eric Lipton, *As Scrutiny of Cryptocurrency Grows, the Industry Turns to K Street*, N.Y. TIMES (Nov. 1, 2021), https://www.nytimes.com/2021/05/09/us/politics/cryptocurrency-regulation-sec-ripple-labs.html [https://perma.cc/6DHS-7MWQ].

[39] I.R.S. Notice 2014-21, *supra* note 1, § 1.

[40] *Id.* § 2.

[41] *Frequently Asked Questions on Virtual Currency Transactions*, I.R.S, https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions [https://perma.cc/N86P-GE7T].

[42] *Id.*

stablecoins that are pegged to the U.S. dollar or other "stable" assets and currencies.[43] All of these assets have incredibly different programming, characteristics, and uses. The need for a blanket definition is understandable from the regulatory and policy standpoint—the IRS likely did not want to get into a debate with taxpayers about the minutia of classification and chose to leave no room for ambiguity.

[13] Unlike other agencies, the IRS did not focus on the variety of characteristics and functions of different "virtual currencies" outside of "convertibility," and stated that any crypto asset that utilized distributed ledger technology would be treated as property for tax-levying purposes.[44] The IRS admitted that technical qualities of cryptocurrency—liquidity, transferability, fungibility—enable it to operate "like 'real' currency" in some circumstances and to be used to sell or purchase goods in a "real-world economy transaction."[45] At the time, no cryptocurrency had legal tender status in any U.S. jurisdiction, which led the IRS to adopt the property classification and treatment instead.[46] As illustrated earlier,[47] the situation has evidently changed.

[14] The classification does not create any significant conflict within the current framework—whether any crypto asset is better defined as a security

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[43] *See* Shehan Chandrasekera, *Stablecoins Are Booming, But What Are The Tax Consequences?*, FORBES (Apr. 23, 2020, 9:00 AM), https://www.forbes.com/sites/shehanchandrasekera/2020/04/23/stablecoins-are-booming-but-what-are-the-tax-consequences/?sh=e12f6011b04d [https://perma.cc/JK43-FHQH].

[44] I.R.S, *supra* note 41.

[45] *Id.* §§ 2–3.

[46] *Id.* §§ 2, 4; Deidre A. Liedel, *The Taxation of Bitcoin: How the IRS Views Cryptocurrencies*, 66 DRAKE L. REV. 107, 117 (2018).

[47] *See supra* text accompanying notes 6–11.

or a commodity (the only two available options) by other agencies—it is still treated as property under the Tax Code. However, the blanket approach creates several compliance issues, equally complicating the lives of taxpayers and the IRS staff alike. In this case, the IRS has an opportunity to take the lead in creating a new set of rules and urge other regulators, including the Treasury and policymakers in the Senate, to do the same.[48] After all, incentivizing certain actions through tax policy is within the IRS's unofficial mandate.[49]

III. Tax Treatment of Crypto-Based Assets in the United States

[15] Equating an entire class of incredibly diverse assets to property, without regard for the purposes and characteristics of each, adds unnecessary complexity to compliance rules and undermines several policy objectives that the IRS should have considered. While it would likely take an act of Congress to adopt any radical reclassification or deregulation proposal, the IRS is currently one of the few agencies that has unprecedented exposure to crypto assets, along with its' users, programmers, and exchanges, who all must pay taxes.[50] At the same time,

[48] *See generally* David C. McDonald, *Coining New Tax Guidance: How the IRS is Falling Behind in Crypto*, 28 Univ. Miami Int'l & Compar. L. Rev. 152, 176, 180 (2020) (discussing how the IRS could base changes to its current regulatory approach on other countries' to set new rules and regulations that could lay the groundwork for U.S. agencies, legislators, and courts to regulate cryptocurrency).

[49] Surrey, *supra* note 3, at 705–07.

[50] *See generally* Mike Orcutt, *America's cryptocurrency tax policy is confusing everyone*, MIT Tech. Rev. (Apr. 12, 2018), https://www.technologyreview.com/2018/04/12/67022/americas-cryptocurrency-tax-policy-is-confusing-everyone/ [https://perma.cc/4JF9-HX3Q].

it means that the current tax policy has the potential to make or break the future of cryptocurrency and crypto-based assets in the United States.

A. Property & Barters & Capital Gains

[16] Treatment of "convertible virtual currency" as property subjects it to gain or loss plus investment income tax treatment and the associated reporting requirements.[51] A purchase of a unit or a partial unit of cryptocurrency is not a taxable event.[52] However, "mining" or receiving virtual currency in exchange for products or services or exchanging it in a transaction that involves receipt of products or services, will fall within the definition of gross income under § 61.[53] Since cryptocurrency is classified as property, transactions that involve cryptocurrency are considered bartering agreements.[54] If the fair market value of property received in a transaction exceeds the taxpayer's adjusted basis in the cryptocurrency used in the exchange, the taxpayer is obligated to report a capital gain.[55]

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[51] I.R.S. Notice 2014-21, *supra* note 1 §§ 3, 4.

[52] David Rodeck & John Schmidt, *How Is Cryptocurrency Taxed?*, FORBES (Feb. 18, 2021, 2:15 PM), https://www.forbes.com/advisor/investing/what-are-cryptocurrency-taxes/ [https://perma.cc/AE2Y-73XK] (specifying that the exchange or sale of cryptocurrency is only taxable when a gain or loss over the purchase price can be calculated).

[53] I.R.S. Notice 2014-21, *supra* note 1 § 4(A-8); *see generally* 26 I.R.C. § 61 (defining gross income in the U.S. federal tax code).

[54] CARLOS MOLINA-JIMENEZ ET AL., A CASE FOR A CURRENCYLESS ECONOMY BASED ON BARTERING WITH SMART CONTRACTS 16 (Oct. 8, 2020).

[55] *See* I.R.S. Notice 2014-21, *supra* note 1, § 4(A-7).

1. Realization Requirement

[17] Given that the idea behind cryptocurrency, especially "convertible" coins that the IRS specifically addressed, is to promote liquidity and ability to easily transfer it peer-to-peer, the regulations imposed on even simple transactions are conflicting and cumbersome.[56] Under the current rules, every time anyone uses Bitcoin to make a purchase, as simple as a cup of coffee or a hotel reservation, the IRS requires the taxpayer to record the amount, allocate cost basis to make the purchase or pay for the service, subtract cost basis from the price, and report the difference to the IRS, while calculating the taxable long- or short-term capital or ordinary gain or loss on the tax return.[57] Additionally, the treatment of crypto as property opens the door for some states to impose a sales tax on acquisition of cryptocurrency.[58] Such a "prohibitive quagmire" of regulatory framework has received hefty criticism from the crypto community.[59]

[18] Gains treatment is closely tied to the realization requirement ingrained within the Code—property is only subject to capital gains tax

[56] Orcutt, *supra* note 50.

[57] *See* Taxable and Nontaxable Income, I.R.S. Pub. 525, Cat. No. 15047D 4 (Jan. 16, 2018), https://www.irs.gov/pub/irs-pdf/p525.pdf [https://perma.cc/8V5E-BZUZ].

[58] *See* I.R.S. Notice 2014-21, *supra* note 1 § 3–4 (explaining that while several revenue agencies have advised that purchases of virtual currency are not subject to their state's sales and use tax, and a state may view virtual currency as intangible property, not personal property, there is still, however, no consensus); SCOTT SCHIEFELBEIN & TYLER GREAVES, UNCHARTED TERRITORY: THE STATE INCOME TAX IMPLICATIONS OF BLOCKCHAIN TECHNOLOGY AND CRYPTOCURRENCY 4 (2020) (explaining the state tax law implications).

[59] *See* Perianne Boring, *US Crypto Tax Policy Isn't Just Crazy, It's Cruel*, COINDESK (Sept. 13, 2021, 3:47 AM), https://www.coindesk.com/markets/2018/04/05/us-crypto-tax-policy-isnt-just-crazy-its-cruel/ [https://perma.cc/WZ9C-M95W].

when the taxpayer disposes of it in a taxable transaction.[60] This approach makes sense for property from a policy standpoint: property is often an illiquid asset and is part of the taxpayer's wealth, along with the gain inherent to it. When the taxpayer disposes of the property and gets cash in return, she is able to use the cash to cover the tax bill.[61] If the taxpayer wants to exchange property for something else, certain non-recognition provisions (i.e., like-kind exchange rules) are available to avoid the realization event and the tax associated with it.[62] In many cases, the way certain items are used makes a difference for tax purposes—vacation homes versus primary residences, investment art pieces versus depreciable ones, collectible coins versus common pennies.[63] These instances demonstrate that the IRS does consider the nature of assets and their uses in crafting its tax policy, and that same treatment could be extended to crypto-based assets.

[19] Cryptocurrency does not fit into any existing framework—just because it is "convertible" to fiat currency does not mean its primary

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[60] I.R.C. §§ 1222(1), (3), (5), (7), (9), (11); *cf.* Greg Leiserson & Will McGrew, *Taxing wealth by taxing investment income: An introduction to mark-to-market taxation*, WASH. CTR. FOR EQUITABLE GROWTH (Sept. 11, 2019), https://equitablegrowth.org/taxing-wealth-by-taxing-investment-income-an-introduction-to-mark-to-market-taxation/ [https://perma.cc/27PH-NCNS] (discussing mark-to-market taxation and how tax treatment would differ for Capital Gains under this form of taxation).

[61] *See* I.R.C. §§ 1001(a)–(b).

[62] *E.g.*, I.R.C. § 1031(a)(1).

[63] *See generally* Mark Kennan, *What Is the Federal Capital Gains Tax Rate?*, POCKETSENSE (July 27, 2017), https://pocketsense.com/federal-capital-gains-tax-rate-5731386.html [https://perma.cc/3GCD-WQ5H] (discussing exceptions to long-term capital gains rates).

purpose is to be converted to fiat currency at a certain point to realize gain.[64] It is not necessarily meant to be held for a long time or exchanged for another cryptocurrency, it is meant to be liquid and spent freely, so treatment of simply spending Bitcoin as a realization event conflicts with the nature of this asset.[65] Crypto tokens, on the other hand, are more analogous to property: they represent assets or rights, they are often used as investment, and are not meant to be a medium of exchange within the broader market. Yet, the IRS treats both the same way. In some instances, it does make sense, as a number of taxpayers buy into cryptocurrencies for the sole purpose of investment; in others, like when somebody wants to buy a cup of coffee or book a hotel, it does not.

2. Valuation Requirement

[20] Another issue arises with respect to cryptocurrency valuation. Regardless of how a cryptocurrency is used, when a transaction is reported for tax purposes, it must be reported in U.S. dollars.[66] Unlike most assets, which are fairly easy to value (for example, stock prices are available in real time, and the value of real estate is dictated by the market), cryptocurrency valuations are not easy to capture at any given moment.[67]

[64] *See* Riley Adams, *How Is Cryptocurrency Taxed? Here's What You Need to Know*, KIPLINGER (July 14, 2021), https://www.kiplinger.com/taxes/capital-gains-tax/603117/how-is-cryptocurrency-taxed-what-you-need-to-know [https://perma.cc/J644-KK53] (explaining many people are starting to view cryptocurrency as a viable alternative currency).

[65] *See* Kate Ashford & Benjamin Curry, *What Is Bitcoin And How Does It Work?*, FORBES ADVISOR (Oct. 26, 2021, 1:27 PM), https://www.forbes.com/advisor/investing/what-is-bitcoin/ [https://perma.cc/5FCE-EJXF].

[66] I.R.S. Notice 2014-21, *supra* note 1 § 4(A-3).

[67] *See* MacKenzie Sigalos, *Bitcoin's wild price moves stem from its design — you'll need strong nerves to trade it*, CNBC (May 20, 2021, 8:37 AM), https://www.cnbc.com/2021/05/19/why-is-bitcoin-so-volatile.html [https://perma.cc/L96H-WZ9D].

[21] According to the IRS Notice, the value of cryptocurrency can be determined based on the value listed on a cryptocurrency exchange.[68] However, some cryptocurrencies can be traded on several different exchanges, and since each exchange runs independently, the valuation variances can reach as high as 10%.[69] Some cryptocurrencies are not traded on any exchange and do not have a published value, which leaves the taxpayer with an obligation to establish the value herself, or through the services of a "blockchain explorer."[70] An additional level of complexity is introduced if the taxpayer is required to account for the "lots" and different tax bases associated with coins purchased at different times. Many platforms are not equipped to allow the taxpayer to choose which "lot" she wants to spend or exchange and do not provide any information on bases except the current average. This process is prohibitively cumbersome and leads to high levels of noncompliance.[71]

[22] Tokens are considerably less volatile and are often tethered to assets with established, accurate fair market values. However, in instances where the asset is a piece of art or an access right, or there is no secondary market to estimate the fair market value, the question of valuation can become

[68] I.R.S. Notice 2014-21, *supra* note 1 § 4(A-5).

[69] Liedel, *supra* note 46, at 122.

[70] *See generally* I.R.S. Notice 2014-21, *supra* note 1 § 4(A-5) (explaining the need to report transactions involving virtual currency in U.S. dollars); Tsung-Ting Kuo et al., *Comparison of Blockchain Platforms: A Systematic Review and Healthcare Examples*, 26 J. AM. MED. INFORMATICS ASS'N, 462, 469 (2019) (describing what information "explorer websites" provide).

[71] Manoj Viswanathan, *Tax Compliance in a Decentralizing Economy*, 34 GA. ST. UNIV. L. REV. 283, 298 (2018).

incredibly subjective.[72] The IRS has already developed methods for discouraging improper valuations,[73] but it is unclear if or how it will apply them to cryptographic tokens. For example, the IRS has established the Art Advisory panel for art valuations.[74] It is unclear whom the IRS would trust to serve on a similar panel for crypto-based tokens.

3. Capital or Ordinary Gain

[23] The character of gain or loss that must be reported depends on the purpose of the asset for that individual taxpayer. [75] Depending on whether cryptocurrency is held as a capital asset, the gain recognized will be taxed at either capital or ordinary rates.[76] The IRS further provides that "stocks, bonds, and other investment property are generally capital assets," while "[i]nventory and other property held mainly for sale to customers in a trade or business" are typically not capital assets.[77]

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[72] *E.g.*, Stephen C. Gara & Craig J. Langstraat, *Property Valuation for Transfer Taxes: Art, Science, or Arbitrary Decision?*, 12 AKRON TAX J., 125, 144 (1996) (discussing the difficulties inherent to the valuation of art).

[73] *See* Steven L. Walker, *IRS Will Not Let Investors off the Hook in Overvaluing Assets*, AICPA (Apr. 11, 2013), https://www.aicpastore.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2013/Tax/OvervaluingAssets.jsp [https://perma.cc/TH5X-VVFS].

[74] *See Art Appraisal Services*, I.R.S (Nov. 3, 2021), https://www.irs.gov/appeals/art-appraisal-services [https://perma.cc/8MUV-3929].

[75] I.R.S. Notice 2014-21, *supra* note 1 § 4(A-7).

[76] *Id.*

[77] *Id.*

[24] For example, if a taxpayer holds Bitcoin in a Robinhood account, where she cannot spend it because she does not own it (Robinhood does, as the broker), Bitcoin is easily classified as investment property and can serve no other purpose. If a taxpayer is actually in the trade or business of mining and/or dealing cryptocurrency, it may be arguable whether a taxpayer holds inventory for sale. However, consider a taxpayer who mines coins for herself and for sale and holds both sets of coins in a digital wallet, like Coinbase. She can spend a fraction of those coins on goods, sell some of those coins as a product, or liquidate them into fiat currency to capitalize on the gain. For a taxpayer like this, the classifications of her coins and their tax treatment will vary. Because the tax levied on capital gains is set at preferential rates, taxpayers are incentivized to pursue capital gains treatment,[78] often by disguising the true nature of the transactions. And because the IRS lacks the tools to differentiate between various types of holdings and transactions, as well as the staff to perform a deep dive into every tax return, the agency faces issues with compliance and enforcement.

[25] All of this is to illustrate how blanket treatment of cryptocurrency as property does not nearly properly address all of its functionality and creates a complicated reporting and compliance regimes.

B. New Tokens—New Issues

[26] The recent boom of nonfungible tokens ("NFTs") has raised even more tax-related questions.[79] NFTs are digital collectibles: each NFT is

[78] U.N. Conference on Trade and Development, *Tax Incentives and Foreign Direct Investigations: A Global Survey*, ASIT Advisory Studies No. 16 21–22 (Jan. 1, 2000), https://unctad.org/system/files/official-document/iteipcmisc3_en.pdf [https://perma.cc/F4KQ-7L48].

[79] *See* Ryan Browne, *People are paying millions for clips that can be viewed for free. Welcome to the world of 'NFTs'*, CNBC (Apr. 27, 2021, 5:55 AM), https://www.cnbc.com/2021/03/03/what-are-nfts-all-you-need-to-know-about-crypto-collectibles.html [https://perma.cc/9HT8-TE8V].

unique and acts as a collector's item that cannot be duplicated or exchanged for another NFT, which are features that are secured by smart contracts and the blockchain.[80] The market for NFTs is vast—everything from tweets to NBA highlight videos to art pieces has been turned into an NFT and sold, with collective sales already topping $500 million in 2021.[81] Many NFTs are priced in Ether (the digital currency of the Ethereum Blockchain), facilitating cryptocurrency-for-cryptotoken transactions.[82] Most taxpayers intuitively expect that spending Ether is exactly like spending currency on a good or service, and do not realize that they will be subject to capital gains treatment on the gain they incurred on Ether.[83] If they want to later resell the NFT, any appreciation of that NFT will also be taxed as capital gains.[84] Because an NFT is often characterized as a work of art and can represent a tangible asset, the IRS could impose a higher rate of 28% on such gain if it made a case for its inclusion under §408(m)(2).[85] However, this step would require the IRS to delve into the specifics of token functionality.[86]

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[80] *Id.*

[81] *See id.*

[82] *Id.*

[83] Robert Frank, *Tax surprise looms for NFT investors who use crypto*, CNBC (Mar. 17, 2021, 11:06 AM), https://www.cnbc.com/2021/03/17/tax-surprise-looms-for-nft-investors-who-use-crypto-.html [https://perma.cc/C644-TWG3].

[84] *Id.*

[85] *Id.*

[86] *See* Walter Effross et al., *Tax consequences of nonfungible tokens (NFTs)*, J. ACCT. (June 24, 2021), https://www.journalofaccountancy.com/news/2021/jun/tax-consequences-of-nfts-nonfungible-tokens.html [https://perma.cc/TEF3-6CUA].

[27] For the IRS to be able to correctly levy taxes, the taxpayers and the platforms that facilitate the trades must keep track of the bases and the gains—and neither does so accurately, or at all, absent proper guidance from the IRS.[87] As mentioned earlier, platforms have inconsistent rules for keeping track of and reporting bases of different lots held by taxpayers. The big platforms that buy and sell NFTs, like Flow by Dapper Labs or OpenSea, can report a sale, but are not able to report a buyer's gain on the crypto used for the purchase.[88] The taxpayers who own large amounts of cryptocurrency that was mined or received at different prices might not even know the tax basis of the coins they spend, given the cryptocurrency's fungibility. Overall, tax experts remark that it is almost impossible to know the total amount owed or unpaid to the IRS from the NFT boom—indeed, it could be tens of millions of dollars. [89]

C. Emerging Trend of Crypto-Based Compensation

[28] Employers can use convertible cryptocurrency, like Bitcoin, as compensation for both employees and independent contractors in a manner similar to making payments in cash.[90] It seems that by drawing parallels between cryptocurrency and stock, the SEC and the IRS inspired some companies to develop compensation packages around token-based assets.[91]

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[87] *See generally id.* (explaining that taxpayers' unfamiliarity with NFTs and trading platforms' insufficient reporting has made calculating taxes from the NFT boom difficult for the IRS).

[88] *Id.*

[89] *Id.*

[90] I.R.S. Notice 2014-21, *supra* note 1 § 4(A-10–11).

[91] *See* Alfredo B. D. Silva et al., *Cryptocurrency Compensation: A Primer on Token-Based Awards*, HARVARD L. SCH. F. ON CORP. GOVERNANCE (May 19, 2018), https://corpgov.law.harvard.edu/2018/05/19/cryptocurrency-compensation-a-primer-on-token-based-awards/ [https://perma.cc/K3J7-MTEY].

Businesses are increasingly looking to leverage the low costs, efficiency, and flexibility of crypto tokens to compensate and incentivize founders, directors, and other service providers.[92] This trend is expected to disrupt the market, as tokens can be programmed to simulate every aspect of a stock, but often without the same limitations. For example, companies like TokenSoft provide equity tokenization services for private companies, allowing employees to exercise and sell their stock options once vested, without waiting for an IPO to get access to liquidity.[93]

[29] "Executive compensation" refers to a wide variety of arrangements that are designed to attract, retain, and incentivize the best executive talent, and align executives' interests with those of shareholders.[94] The outrage over executive compensation takes many forms, mainly public outrage over exuberantly high compensation packages that are deemed to be inherently unfair, or shareholder outrage over poorly designed and ineffective compensation structures.[95] Congress enacted a number of tax penalty provisions designed to reign in certain compensation strategies; however, the legislation failed to reduce overall compensation levels or achieve other goals.[96] The question now is whether these rules are rendered obsolete by the invention of cryptocurrency or token-based compensation.

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[92] *See id.*

[93] *See* Chris Walker, *The Tokenized Stock Option*, MEDIUM (June 19, 2019), https://medium.com/tokensoft/the-tokenized-stock-option-fec6229754bc [https://perma.cc/C6AY-C79V].

[94] *See* Mullane, *supra* note 3, at 498.

[95] *See* Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 725–27 (1995).

[96] *See* Mullane, *supra* note 3, at 490–93 n. 20 (citing to a compilation of academic articles that highlight structural failures and policy shortcomings of § 162(m), § 409A, § 280G, and § 4999).

[30] The guidance the IRS has issued to date only covers "convertible virtual currencies" and advises on tax consequences on the receipt and payment of virtual *currency* as regular wages, but does not specifically address the use of crypto-based *tokens* for the purposes of executive compensation.[97] Given the Notice's broad coverage and the absence of other guidance, some experts reason that it will likely "apply to token-based compensation to service providers."[98] Essentially, because the IRS treats all crypto assets as property, drawing parallels to stock treatment, companies may rely on that guidance and simply substitute stocks for tokens for purposes of § 83, § 409A, and other compensation-related regulations.[99] As a result, token-based awards tend to follow the structure of traditional equity-based awards, including restricted tokens, token options, and restricted token units, and companies hope that the IRS will treat them in the same manner.[100]

[31] For instance, Section 409A was enacted in response to perceived widespread tax avoidance through nonqualified deferred compensation arrangements.[101] The arrangements are attractive to many employers because they help to attract and retain key employees without an immediate cash expenditure, and tokens have proven to be easier and cheaper to issue than stock options. One of the unsettled questions is whether token options will be exempt from or subject to the rules under § 409A.[102] Options are generally exempt from § 409A if they are granted "at the money" and cover

[97] I.R.S. Notice 2014-21, *supra* note 1.

[98] *See* Silva et al., *supra* note 91.

[99] *See id.*

[100] *See id.*

[101] *Id.*

[102] *Id.*

"service recipient stock," but there is no definitive guidance to suggest that the IRS would consider tokens awarded to service providers as "service recipient stock."[103] The issue requires a technical understanding of what a certain token is programmed to be and how it is valued, highlighting the need for regulations that are tailored to the nature of the token. In this case, the IRS might want to work in tandem with the SEC to come up with a guidance that addresses the complexities of both tax and securities laws.

IV. IS THERE A BETTER APPROACH?

A. Evaluating U.S. Tax Policy Position on Crypto-Based Assets

[32] One of the first times the U.S. government concerned itself with regulating cryptocurrencies, which was in connection with black market transactions, potential terrorist organizations, and Silk Road,[104] may have set the tone for future regulations. The negative rhetoric continues to prevail on the government level,[105] despite the wide-spread adoption of

[103] Silva, et al., *supra* note 91 ("[I]ssuers should generally assume that token options are subject to Section 409A of the Code and take great care to comply with the requirements of Section 409A.").

[104] *See* Andy Greenberg, *FBI Says It's Seized $28.5 Million in Bitcoins from Ross Ulbricht*, *Alleged Owner Of Silk Road*, FORBES (Oct. 25, 2013, 12:50 PM), https://www.forbes.com/sites/andygreenberg/2013/10/25/fbi-says-its-seized-20-million-in-bitcoins-from-ross-ulbricht-alleged-owner-of-silk-road/?sh=38898f562765 [https://perma.cc/N9PP-XAQK].

[105] *See* Nikhilesh De, *Crypto Use in Terrorism 'a Growing Problem,' Yellen Says*, COINDESK (Sept. 14, 2021, 8:10 AM), https://www.coindesk.com/policy/2021/02/11/crypto-use-in-terrorism-a-growing-problem-yellen-says/ [https://perma.cc/C6JY-SNCJ] ("Cryptocurrencies have been used to launder the profits of online drug traffickers; they've been a tool to finance terrorism. . . Treasury Secretary Janet Yellen said Wednesday.").

cryptocurrency and evidence that it can help battle corruption, track and capture illegal activity, and democratize the financial system.[106]

[33] It seems that the IRS has approached cryptocurrencies in the same spirit, treating the taxpayers that were involved in cryptocurrency transactions as de facto tax evaders. In 2016, the IRS went after Coinbase customer data through a John Doe summons, forcing the exchange to disclose the identities of its users.[107] In 2019, the IRS began sending "educational" letters (read—warning letters) to taxpayers regarding their potential failure to report or pay tax on cryptocurrency transactions.[108] At the same time, the IRS lacks staff, technological expertise, and resources that it can expend on assessing liability for taxpayers who have honestly disclosed their holdings.[109]

[34] Many crypto experts are not happy with the government's "disjointed approach to technology" and its consistently "incoherent

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[106] *See* Enrique Aldaz-Carroll & Eduardo Aldaz-Carroll, *Can cryptocurrencies and blockchain help fight corruption?*, BROOKINGS (Feb. 1, 2018), https://www.brookings.edu/blog/future-development/2018/02/01/can-cryptocurrencies-and-blockchain-help-fight-corruption/ [https://perma.cc/2HEN-D6ZA].

[107] *See* Stan Higgins, *A Judge Just Cleared the Way for the IRS to Seek Coinbase Customer Data*, COINDESK (Sept. 11, 2021, 8:38 AM), https://www.coindesk.com/bitcoin-judge-approved-irs-coinbase-users [https://perma.cc/F8P5-ESVL].

[108] *See* Shehan Chandrasekera & Chandan Lodha, *IRS Sends Cryptocurrency Tax Warning Letters: 6173, 6174, and 6174-A*, COINTRACKER (Nov. 12, 2020), https://www.cointracker.io/blog/irs-sends-letter-6173-6174-6174-a-cryptocurrency-warnings-what-to-do [https://perma.cc/VBU7-F5X7].

[109] *See* Chye-Ching Huang, *Depletion of IRS Enforcement Is Undermining the Tax Code*, CTR. ON BUDGET & POL'Y PRIORITIES (Feb. 11, 2020), https://www.cbpp.org/research/federal-tax/depletion-of-irs-enforcement-is-undermining-the-tax-code [https://perma.cc/RBT4-UR9P].

policies."[110] Contradictory views and classifications are putting users, exchanges, and merchants at a disadvantage, hindering the development and growth of cryptocurrency in the United States.[111]

[35] At the same time, current policy makes it difficult for the IRS itself to be effective in enforcing its own mandate and raising sufficient revenue from crypto-based transactions. Cryptocurrency is a huge market, with theoretically unlimited future growth.[112] As this paper discusses, the current tax regime is a compliance nightmare for taxpayers who want to use cryptocurrency as money. Levying a property-like tax on an asset that has "currency" in its name is counterintuitive, and novice investors and miners might not even know that they are subject to tax at all.[113] Business and individuals can be dissuaded from using or investing in cryptocurrency due to valid concerns that such use may attract negative attention from the IRS. At the same time, other taxpayers who have resources to get expert tax advice may end up better off by capitalizing on the ambiguities unaddressed by the limited IRS guidance.

[36] The current policy has created another rift between wealthy taxpayers who have the resources to optimize their tax burden, or even find ways to avoid reporting, and those who buy and mine cryptocurrencies while unaware of the IRS requirements. Taxpayers with access to sophisticated tax advisers are electing, for example, to hold the bulk of their

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110 Boring, *supra* note 59.

111 *See* Liedel, *supra* note 46, at 139.

112 *See* Trevor I. Kiviat, *Beyond Bitcoin: Issues in Regulating Blockchain Transactions*, 65 DUKE L.J. 569, 572–73 (2015).

113 James Royal, *Bitcoin Taxes in 2021: A Guide to Tax Rules for Cryptocurrency*, NERDWALLET (Sept. 28, 2021), https://www.nerdwallet.com/article/investing/bitcoin-taxes [https://perma.cc/Z9FG-6XXD].

investment for longer than a year, or utilizing "opportunity zones" to get preferential rates.[114] Others, mostly younger people who have never learned about the capital gains tax, are facing thousands of dollars in unexpected tax liability. There is a stark difference between the resources available to an investor who acquires Bitcoin through a wealth adviser and can optimize the tax treatment from the very beginning, and a teenager who is mining Bitcoin in his parents' basement. For many of the newly minted crypto-millionaires, this is their first exposure to any income outside of their W-2s, and they are the ones getting swept up in the IRS hunt for crypto-related tax evasion.[115]

[37] Enforcement and collection efforts are complicated from a technological standpoint, and it could cost millions for the IRS to design, implement, and maintain a system capable of addressing these concerns.[116] However, considering the scale of the crypto-economy, it may be a worthwhile investment. It is reasonable to assume that compliance rates could be higher (and instances of fraud could be lower) if the reporting requirements were simple to follow and were consistent with the many ways taxpayers utilize cryptocurrency and tokens.

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[114] *See* Blake Christian & Joseph B. Darby III, *Cryptocurrency investors turn to opportunity zones for tax relief and social good*, ACCOUNTING TODAY (Feb. 19, 2021, 1:56 PM), https://www.accountingtoday.com/opinion/cryptocurrency-investors-turn-to-opportunity-zones-for-tax-relief-and-social-good [https://perma.cc/JKY6-VLVL].

[115] Laura Saunders, *The IRS Is Coming for Crypto Investors Who Haven't Paid Their Taxes*, WALL ST. J. (May 14, 2021, 5:30 AM), https://www.wsj.com/articles/bitcoin-irs-comes-for-crypto-investors-who-havent-paid-their-taxes-11620937095 [https://perma.cc/X27P-9V2Y].

[116] *See* Greg Iacurci, *Cryptocurrency poses a significant risk of tax evasion*, CNBC (May 31, 2021, 8:30 AM), https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html [https://perma.cc/U5K8-K539].

[38] While there is always the chance that cryptocurrency is merely a trend that will dissipate in a few years, there is the equally likely chance that this technology will revolutionize finance and banking. The goal should be to educate the U.S. citizens on its potential and make it easy for them to use it, starting with a clear and easy taxation regime.

B. International Examples of Crypto-Friendly Policies

[39] The U.S. regulators' first choice when confronted with the new asset class was to apply existing regulations and levy a tax.[117] Other countries, however, recognized the innovation potential of the emerging digital asset class and chose to structure policies to encourage its adoption and use.

[40] For example, Germany utilizes a new legal designation—private money, similar to foreign currencies—and any cryptocurrency held for over a year is exempt from taxes.[118] This kind of tax expenditure allows the German economy to invest in major crypto coins and introduce more cryptocurrency into its markets while shifting the risk of loss in excess of its tax rates to the taxpayers.[119] At the same time, this framework makes compliance easy for taxpayers, reducing the need for the tax authorities to expend resources on vigilant enforcement.

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[117] *See* I.R.S. Notice 2014-21, *supra* note 1.

[118] Zach Wright, *How to do cryptocurrency trading taxes – the answers you need for Spain, Italy, Portugal, Germany, Greece, and Turkey*, SIMPLEFX (Nov. 16, 2018), https://blog.simplefx.com/2018/11/16/how-to-do-cryptocurrency-trading-taxes-the-answers-you-need-for-spain-italy-portugal-germany-greece-and-turkey [https://perma.cc/AH2W-BMQU].

[119] *See Germany Crypto Tax Guide 2021*, KOINLY (May 17, 2021), https://koinly.io/guides/crypto-tax-germany/ [https://perma.cc/794G-QT6V].

[41] Belarus considers mining and investing in cryptocurrencies personal investments, exempt from income tax and capital gains until at least 2023.[120] As a result, the country is on track to become the crypto-capital of Europe, attracting international investments to build a vast crypto infrastructure, including exchanges and payment systems.[121] The policy also has the effect of allowing citizens to build wealth at a low cost to the government, reducing the need for welfare programs.[122] Similar to Germany, Belarus can introduce cryptocurrency into its economy without significant risk and does not need to spend resources on tax audits and enforcement efforts.

[42] Singapore considers Bitcoin "intangible property" and not a legal tender, so in a barter trade the payment token is not taxed, encouraging use of cryptocurrencies in lieu of fiat and eliminating the need to track bases and gains.[123] This creates disparity between U.S. and foreign cryptocurrency users. For example, the buyer of the $69 million NFT auctioned off at Christie's is based in Singapore, where there is no tax on

[120] Roger Huang, *Seven Countries Where Cryptocurrency Investments Are Not Taxed*, FORBES (June 24, 2019, 3:12 PM), https://www.forbes.com/sites/rogerhuang/2019/06/24/seven-countries-where-cryptocurrency-investments-are-not-taxed/?sh=38f6eef17303 [https://perma.cc/5M78-JUHF].

[121] *See* Andrei Makhovsky, *Belarus adopts crypto-currency law to woo foreign investors*, REUTERS (Dec. 22, 2017, 5:01 AM), https://www.reuters.com/article/us-belarus-cryptocurrency/belarus-adopts-crypto-currency-law-to-woo-foreign-investors-idUSKBN1EG0XO [https://perma.cc/6YY6-FUVS].

[122] *See, e.g.*, Weng Cheong, *Here are all the ways bitcoin could help address income inequality in the 2020s*, BUS. INSIDER (Dec. 20, 2019, 3:08 PM), https://www.businessinsider.com/this-is-how-bitcoin-can-end-income-inequality-in-2020 [https://perma.cc/JD7U-87FF].

[123] Danny Nelson, *Singapore Won't Tax Airdrops or Hard Forks Under New Crypto Guidance*, COINDESK (Sept. 21, 2021, 4:30 AM), https://www.coindesk.com/markets/2020/04/20/singapore-wont-tax-airdrops-or-hard-forks-under-new-crypto-guidance/ [https://perma.cc/UZ3Q-YJEX].

capital gains.[124] Had he been a U.S. citizen, he could have owed more than $10 million in capital gains taxes.[125] The disparity may discourage U.S. citizens from participating in certain transactions, all while other countries are encouraging their citizens to partake in the new digital economy.

[43] Even though some countries did not adopt fully tax-free treatment, their policies promote use of cryptocurrency in other ways. For instance, France still taxes gains incurred from cryptocurrency sales as capital gains on "movable property," but has slashed the applicable rate from 45% to 19%,[126] presumably to encourage investment in and use of cryptocurrencies, as well as development of an economic infrastructure to support its' use.[127] The State Council agreed that in principle, cryptocurrency falls under moveable property, similar to jewelry or intellectual property, at least attempting to dig deeper into the characteristics of the digital asset. [128]

[124] Frank, *supra* note 83.

[125] *Id.*

[126] *See* Patrice Navarro, *France cuts cryptocurrency tax rate*, HOGAN LOVELLS (May 1, 2018), https://www.engage.hoganlovells.com/knowledgeservices/news/france-cuts-cryptocurrency-tax-rate [https://perma.cc/88WW-GZBU].

[127] *See* Philip Stafford, *France tests crypto assets in series of government bond deals*, FIN. TIMES (Oct. 19, 2021), https://www.ft.com/content/23c2572a-29a2-4ef4-aa8a-27f8ad30ba09 [https://perma.cc/EP45-88YG].

[128] Navarro, *supra* note 126.

C. What Can the U.S. Do?

1. Argument for Currency Treatment

[44] The Chamber of Digital Commerce's official policy position states that the fairest treatment of virtual currencies is as alternative currencies.[129] The Chamber argues that the current IRS regime hinders the use of virtual currencies as a method of payment or as a facilitator of micro-payments, which have the potential to reach a "wide spectrum of potential participants in the financial system."[130] Notably, its position leaves out tokens and focuses specifically on coins used as payment. The Chamber released a separate statement on tokens that supports wide promotion of new technology with appropriate disclosure regimes to protect purchasers and investors.[131]

[45] The initial arguments for not recognizing cryptocurrency as a currency are becoming outdated—major coins are now accepted as payment for goods, services, even state taxes, and have received legal tender status in a number of jurisdictions.[132] The issue that remains unsolved is the

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[129] *Tax*, CHAMBER DIGIT. COM., https://digitalchamber.org/policy-positions/taxation-of-convertible-virtual-currencies/ [https://perma.cc/E3N9-B63Z].

[130] *Id.*

[131] *Tokens*, CHAMBER DIG. COM., https://digitalchamber.org/policy-positions/tokens/ [https://perma.cc/U767-WMUP].

[132] *See, e.g.*, Glenn Fleishman, *PayPal now lets you spend cryptocurrency at millions of U.S. merchants*, FAST CO. (Mar. 30, 2021), https://www.fastcompany.com/90620101/paypal-cryptocurrency-bitcoin [https://perma.cc/CX3D-UUSV]; Joe Tidy, *Fear and excitement in El Salvador as Bitcoin becomes legal tender*, BBC (Sept. 7, 2021), https://www.bbc.com/news/technology-58473260 [https://perma.cc/7GQU-FZGH]; Paul Vigna, *Pay Taxes With Bitcoin? Ohio Says Sure*, WALL ST. J. (Nov. 26, 2018, 9:41 AM), https://www.wsj.com/articles/pay-taxes-with-bitcoin-ohio-says-sure-1543161720 [https://perma.cc/HZP9-PQ3N].

decentralized nature of cryptocurrency, because cryptocurrency does not represent a claim on the issuer (government), similar to recognized currencies.[133] It instead represents a claim on a peer-to-peer network, essentially millions of lines of code and nodes that keep the system running and give value to an otherwise worthless asset. There is no precedent to solve this issue, which means it is time for creative thinking.

[46] Who will actually have the authority to make the decision that cryptocurrency should be recognized as a currency? The U.S. Congress could regulate virtual currency through its power to coin money and restrict private currencies, which would potentially give it the jurisdiction to declare that certain crypto is "money."[134] The U.S. Federal Reserve is allegedly considering digitizing the dollar—potentially opening the door to recognizing other digital currencies.[135] For the purposes of public and market attitude, however, analysts predict that the litmus test will be whether the IRS starts accepting taxes in crypto, as "taxes seem to be the origin of money in many ways."[136]

[47] Imposing currency classification and treatment on cryptocurrencies for the purposes of taxation is not a perfect answer. In such case, digital

[133] EUROPEAN BANKING AUTHORITY, EBA OPINION ON VIRTUAL CURRENCIES 11–13 (2014).

[134] *See* Kevin V. Tu & Michael W. Meredith, *Rethinking Virtual Currency Regulation in the Bitcoin Age*, 90 WASH. L. REV. 271, 315–16 (2015).

[135] *See* Nikhilesh De, *The Federal Reserve Is Experimenting With a Digital Dollar*, COINDESK (Sept. 14, 2021, 5:43 AM), https://www.coindesk.com/the-federal-reserve-is-experimenting-with-a-digital-dollar [https://perma.cc/7UY5-WUTB].

[136] *See* Lawrence Lewitinn, *Crypto Won't Be Money Until IRS Accepts It for Taxes, Top Forex Strategist Says*, NASDAQ (Apr. 6, 2021, 5:19 PM), https://www.nasdaq.com/articles/crypto-wont-be-money-until-irs-accepts-it-for-taxes-top-forex-strategist-says-2021-04-06 [https://perma.cc/H28N-DHMW].

currency will be governed by the character and source rules of subpart J of the Tax Code (IRC §§985–989), which does not release taxpayers from tracking gains and losses on crypto-to-fiat exchanges, along with extra reporting requirements.[137] It may, however, eliminate the tax on spending a fraction of Bitcoin on a cup of coffee.

2. Argument for a New Framework and Eliminating Tax on Crypto Gains

[48] Lack of education and a complicated taxation regime led to high levels of noncompliance.[138] The IRS is under criticism for its lack of upkeep with taxpayer education and enforcement due to lack of resources and crypto-savvy personnel.[139] The problem is not specific to crypto-based assets, but their decentralized nature does not make the regulators' job easier—the latest estimate for the cost of possible tax evasion, including undisclosed use of cryptocurrency, is topping $1 trillion a year.[140]

[49] If the IRS continues to treat all crypto assets as property until it creates a better classification, it should consider a proposition to temporarily eliminate the capital gains tax on crypto altogether, similar to Singapore. This step will eliminate the cumbersome calculation, reporting, and

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[137] *See* I.R.C. §§ 985–89.

[138] Robert Farrington, *The Crypto Tax Nightmare Facing New Traders*, FORBES (May 11, 2021, 10:10 AM), https://www.forbes.com/sites/robertfarrington/2021/05/11/the-crypto-tax-nightmare-facing-new-traders/?sh=5c52c8ca2f1a [https://perma.cc/P954-TLPF].

[139] *See* David C. McDonald, *Coining New Tax Guidance: How the IRS Is Falling Behind in Crypto*, 28 U. MIAMI INT'L & COMPAR. L. REV. 152, 152–53 (Feb. 17, 2021).

[140] *See* Laura Davison & Bloomberg, *The IRS says it has a $1 trillion tax cheat problem*, FORTUNE (Apr. 13, 2021, 2:05 PM), https://fortune.com/2021/04/13/tax-evasion-avoidance-irs-us-cryptocurrency-offshore-illegal-income-underreporting-taxes-chuck-rettig/ [https://perma.cc/9J8N-A57C].

valuation requirements, cut down on enforcement spending, and give the IRS time to develop a cohesive set of rules. The expenditure/subsidy will also allow the United States to introduce cryptocurrency into the economy at little risk to the government itself, incentivize the development of infrastructures and businesses to support its use, and put the U.S. citizens on equal footing with citizens of other countries when it comes to participating in the digital markets. Some investors view cryptocurrency as an opportunity to close the racial wealth gap, and minority investors are on track to become the largest group of individuals in the United States to own cryptocurrencies.[141] Allowing cryptocurrency to become a widely accepted feature of the economy will promote adoption and education. If digital currency is indeed the future, the United States should not disadvantage its citizens and economy.

[50] The IRS, in coordination with the Congress, must create an approach that would simplify compliance and promote usage of cryptocurrency out in the open, instead of driving investors underground. The IRS should consider implementing a central reporting system for cryptocurrency and token exchanges to accurately capture and value transactions and streamline the reporting process. It must also work with other agencies to create a framework that addresses various uses of crypto-based assets and currencies. These efforts will require the IRS to hire specialists who are well-versed in the technology and tax policy and can propose solutions that meet the regulatory and policy goals. If the IRS does not create such a framework, it risks discouraging cryptocurrency users from properly reporting their transactions, and considering the semi-anonymous crypto environment, enforcement will become even more difficult. If taxpayers choose to acquire coins anonymously and through international wallets that

[141] *See* Akayla Gardner, *Black Americans Are Embracing Stocks and Bitcoin to Make Up for Stolen Time*, BLOOMBERG (Apr. 13, 2021, 7:00 AM), https://www.bloomberg.com/news/articles/2021-04-13/black-americans-embrace-stocks-and-bitcoin-btc-to-make-up-for-stolen-time [https://perma.cc/MB8M-V227].

are not subject to the IRS jurisdiction,[142] or are otherwise incentivized to create ways to avoid detection, the government will not be able to effectively track, regulate, or tax any of the holdings.

[51] Introducing a pause in taxation of cryptocurrency gains will give the government time to come up with new classifications and laws to better address the emerging crypto-based economy. Tax policy, once again, has an opportunity to nudge society towards something new.

V. CONCLUSION & RECOMMENDATION

[52] Early adopters of new technologies often benefit from the "lawlessness of new frontiers," as regulation catches up with the times and creates frameworks to address new public policy challenges.[143] In the case of cryptocurrency, the United States took more than a few years to address the rise of a new asset class, and when it did, just as major coins skyrocketed in value and new types of tokens were developed, it created a punishing regime that lacked nuance and imposed cumbersome compliance requirements. Tokens can be used to represent anything from equity rights, to access rights, to art pieces, and such diversity can only be addressed with a tailored approach.[144] Cryptocurrency is meant to be used as currency, and the IRS can spearhead the initiative to classify and treat it as such, or at least not penalize taxpayers for using it. Alternatively, the IRS can play a role in promoting adoption of cryptocurrencies and propel the U.S. economy forward by temporarily eliminating tax on crypto-related gains.

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[142] *See* Kai Sedgwick, *How to Anonymously Buy Bitcoin Online and in Person*, BITCOIN NEWS (Feb. 24, 2020), https://news.bitcoin.com/how-to-anonymously-buy-bitcoin/ [https://perma.cc/75QB-EL5X].

[143] *See* Steven R. Salbu, *Who Should Govern the Internet?: Monitoring and Supporting a New Frontier*, 11 HARV. J.L. & TECH. 429, 431 n.8 (1998).

[144] *See* Voshmgir, *supra* note 14.

[53] The IRS is perhaps the only agency that directly and continuously interacts with every American citizen and resident, and the policies it sets have the potential to affect behaviors on the largest scale.[145] It is imperative that the IRS coordinates with other agencies and the U.S. Congress to craft a policy that addresses the differences between classes of crypto-based assets and their uses, promotes compliance by centralizing and automating the process, and encourages the adoption of new technology.

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[145] *See* I.R.S., PROGRESS UPDATE: FISCAL YEAR 2020 1, 2 (2020).