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PROPERTY OR CURRENCY? THE TAX DILEMMA BEHIND BITCOIN

Scott A. Wiseman*

I. INTRODUCTION

As a result of monumental improvements in technology, a significant amount of currency is spent across the globe in daily transactions made on the internet. A recent trend in American culture is brick and mortar businesses shutting down in favor of online counterparts.¹ Some of the many possible reasons behind this online movement may be a decrease in overhead, a convenience factor for consumers, and a drastically expanded market of consumers. In the third quarter of 2015, Americans spent an estimated \$87.5 billion dollars on online shopping.² These e-commerce transactions comprise an impressive 7.4% of total retail sales made in the United States.³ This figure has increased dramatically from the 2.6% of total retail sales made in the first quarter of 2006 and continues to steadily rise.⁴ Aside from the major financial implication from online purchases made in America, the global market for e-commerce is astronomical. Since it is next to impossible to pay on the internet with cash, bank-issued credit cards are the predominate method of payment. With credit cards, currency can be exchanged on the internet in the blink of an eye. However, there are several drawbacks associated with the global use of these credit cards including fees imposed by major credit card companies and the high risk of credit card fraud. With a continually growing global economy that is largely fueled by internet transactions, the world could benefit tremendously from a safe and inexpensive globally accepted method of payment.

In 2009, the increase of global demand for e-commerce spurred a programmer—or group of programmers—operating under the name Satoshi

* © 2016 Scott A. Wiseman. J.D. 2016, S.J. Quinney College of Law, University of Utah. I would like to thank the editorial board and staff of the Utah Law Review for all of their thoughtful comments and hard work throughout this process. Go Utes!

¹ For one of the many examples of businesses shutting stores to go online, see Jim Kinney, *UMass Replacing On-campus Textbook Store with Amazon*, MASSLIVE (Jan. 13, 2015, 12:34 PM), http://www.masslive.com/business-news/index.ssf/2015/01/umass_replacing_on-campus_bookstore.html [<http://perma.cc/MYP9-TQ7Z>].

² Press Release, U.S. Census Bureau, Quarterly Retail E-Commerce Sales: 3rd Quarter 2015 tbl.1 (Nov. 17, 2015), <http://www2.census.gov/retail/releases/historical/ecom/15q3.pdf> [<http://perma.cc/7JYK-E2FG>].

³ *Id.*

⁴ Press Release, U.S. Census Bureau, Quarterly Retail E-Commerce Sales: 1st Quarter 2006 tbl.1 (May 8, 2006), <http://www2.census.gov/retail/releases/historical/ecom/06q1.pdf> [<https://perma.cc/P64T-5ZAT>].

Nakamoto to create Bitcoin: a virtual currency.⁵ Bitcoin is one of many types of virtual currencies based on an algorithm that creates a direct peer-to-peer transaction system.⁶ Bitcoin operates as a currency just like dollars, except Bitcoin does not exist in a physical form and it is not backed by any government treasury, precious metal, or commodity.⁷ Bitcoin functions as a unit of value for any person who is willing to accept it. Its worth is entirely dictated by the fluctuations in demand in the Bitcoin user community. Bitcoin can be used in a wide variety of transactions on the internet as well as off. Bitcoin is accepted as payment at thousands of physical businesses across the globe and various online merchants such as WordPress and Reddit.⁸ Off of the internet, a Bitcoin user can pay with Bitcoin to buy almost anything imaginable, such as food at Lean Crust Pizza in New York⁹ or a pint of beer at Downtown Johnny Brown's in San Diego.¹⁰ Nakamoto and various supporters of Bitcoin claim that the currency¹¹ is superior to traditional payment methods because the algorithms used offer a much higher degree of security to prevent fraud and the system drastically cuts transaction fees.¹²

For five years, Bitcoin did not have a taxation status in the United States. On March 26, 2014, the Internal Revenue Service (IRS) issued a news release, IRS Notice 2014-21,¹³ which announced that virtual currencies such as Bitcoin do not have legal tender status in any jurisdiction and will be treated as property for United

⁵ Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System 1 (unpublished manuscript), <https://bitcoin.org/bitcoin.pdf> [<http://perma.cc/TQB2-MBYF>] (last visited Oct. 7, 2014).

⁶ *Id.*

⁷ Derek A. Dion, Note, *I'll Gladly Trade You Two Bites on Tuesday for a Byte Today: Bitcoin, Regulating Fraud in the E-conomy of Hacker-Cash*, 2013 U. ILL. J.L. TECH. & POL'Y 165, 167.

⁸ See Cade Metz, *Overstock.com Becomes First Major Retailer to Accept Bitcoin Worldwide*, WIRED (Sept. 11, 2014, 9:20 AM), <http://www.wired.com/2014/09/overstock-com-becomes-first-major-retailer-accept-bitcoin-worldwide/> [<https://perma.cc/HH6P-RDMV>]; Drew Olanoff, *Reddit Starts Accepting Bitcoin for Reddit Gold Purchases Thanks to Partnership with Coinbase*, TECHCRUNCH (Feb. 14, 2013), <http://techcrunch.com/2013/02/14/reddit-starts-accepting-bitcoin-for-reddit-gold-purchases-thanks-to-partnership-with-coinbase/> [<https://perma.cc/3GHA-MGSZ>].

⁹ *Use Bitcoins at Lean Crust Pizza*, BITCOIN RESTAURANTS, <http://bitcoinrestaurants.net/restaurant/ny/brooklyn/1600426/lean-crust-pizza> [<https://perma.cc/CGF8-H88J>] (last visited Apr. 9, 2016).

¹⁰ *Use Bitcoins at Downtown Johnny Brown's*, BITCOIN RESTAURANTS, <http://bitcoinrestaurants.net/restaurant/ca/san-diego/228/downtown-johnny-brown-s> [<https://perma.cc/ZS3D-USK8>] (last visited Apr. 9, 2016).

¹¹ Throughout this Note, I refer to Bitcoin as a "currency" for convenience and for argument's sake. This usage does not assume that Bitcoin is a currency from the perspective of the IRS.

¹² See Nakamoto, *supra* note 5, at 5–6.

¹³ I.R.S. Notice 2014-21, 2014-16 I.R.B. 938. Throughout this Note, I refer to the IRS Notice 2014-21 as the "decision" or "ruling" for convenience's sake.

States federal tax purposes.¹⁴ This decision means that virtual currency users will be subjected to general tax principles applicable to property transactions analogous to real property, stocks, and bonds.¹⁵ The decision to classify Bitcoin as property for tax purposes will lead to difficulties with reporting taxes for many of the users. The IRS decision has received criticism from various supporters of virtual currencies, implying that it will become more difficult for virtual currencies to function as currencies used to purchase everyday items.¹⁶ Average consumers will likely feel the biggest negative impact of the tax reporting challenges.¹⁷

On May 7, 2014, Representative Steve Stockman introduced the Virtual Currency Tax Reform Act,¹⁸ which proposed changing the tax status of virtual currencies from property to foreign currency.¹⁹ Stockman, a known supporter of Bitcoin and other virtual currencies, claimed the need for the proposed legislation in a press release stating that “cryptocurrency is the future. We need to encourage it, not discourage it.”²⁰ Representative Stockman based the Act on congressional findings that “classifying virtual currencies as property subjects users to capital gains tax on any transaction using the virtual currency based on any gain or loss relative to the change in the virtual currency’s value from the time of purchase.”²¹ Representative Stockman recognized the difficulties placed on the “everyday” users who are now responsible for performing a difficult tax calculation every time a Bitcoin transaction takes place. With the sheer volume of transactions occurring daily, the current method of taxation is extremely impractical, if not impossible. The effect of the Act’s reclassification would allow users of virtual currency to forgo the hassle of calculating capital gains or losses on a yearly IRS Form 1040 and instead report income taxes normally and pay a sales tax whenever the currency is exchanged.²² Representative Stockman claims this is “a more proper way of taxing

¹⁴ I.R.S. News Release IR-2014-36 (Mar. 25, 2014).

¹⁵ I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, 938.

¹⁶ Alex Hern, *Bitcoin Is Legally Property, Says US IRS. Does That Kill It as a Currency?*, GUARDIAN (Mar. 31, 2014, 7:41 AM), <http://www.theguardian.com/technology/2014/mar/31/bitcoin-legally-property-irs-currency> [<https://perma.cc/H3NV-6RLT>].

¹⁷ Chris Davis, *IRS Will Tax Bitcoin as Property Not Currency*, ROYSE LAW (May 2014), <http://rroyselaw.com/irs-will-tax-bitcoin-as-property-not-currency/> [<http://perma.cc/DV7R-FZGJ>].

¹⁸ Virtual Currency Tax Reform Act, H.R. 4602, 113th Cong. (2014).

¹⁹ *Id.* § 4.

²⁰ Press Release, U.S. Representative Steve Stockman, Stockman Plans to Introduce the “Virtual Currency Tax Reform Act” (Apr. 8, 2014) (on file with the Utah Law Review); see also Michael del Castillo, *Bitcoin Congressman Unveils Legislation to Redefine Cryptocurrency*, UPSTART BUS. J. (Apr. 8, 2014, 2:27 PM) (on file with the Utah Law Review), <http://upstart.bizjournals.com/entrepreneurs/hot-shots/2014/04/08/congressman-steve-stockman-on-bitcoin.html?page=all> (reporting on Congressman Steve Stockman’s proposed virtual currency legislation).

²¹ H.R. 4602 § 2.

²² See Press Release, U.S. Representative Steve Stockman, *supra* note 20.

such transactions.”²³ However, the Act failed to pick up any traction and never passed Congress.²⁴

Part II of this Note will address the background of Bitcoin and applicable general taxation principles. Section III.A will analyze the impact of the IRS decision on tax reporting procedures. Sections III.B and III.C will explain why the IRS decision favors people using Bitcoin for investment purposes and harms people using Bitcoin for daily transactional purposes. Section III.D will address why the IRS decision was wrongfully decided. Section III.E will explore the impacts of adopting the Virtual Currency Reform Act and propose recommendations for the future.

II. BACKGROUND

This Part will first serve to orient the reader by defining Bitcoin, demonstrating how Bitcoin operates, illustrating uses for Bitcoin, and providing a brief history. It continues by explaining reasons users choose to exchange the currency, including increased security and a reduction in transaction fees.

A. Defining Bitcoin

Virtual currencies are a digital representation of a value that is electronically traded and functions as a medium of exchange, a unit of account, or a store of value.²⁵ Virtual currencies are distinguished from real currency because virtual currencies do not have a physical representation and have not been designated as legal tender in any jurisdiction.²⁶ Virtual currencies have been popular among various internet communities since their official creation in 2009.²⁷ Currently, there are more than eighty different variations of virtual currencies.²⁸ Bitcoin²⁹ is the most popular

²³ *Id.*

²⁴ *H.R. 4602 (113th): Virtual Currency Tax Reform Act*, GOVTRACK, <https://www.govtrack.us/congress/bills/113/hr4602> [<http://perma.cc/HV4K-FDFE>] (last visited Nov. 29, 2015).

²⁵ FIN. ACTION TASK FORCE, VIRTUAL CURRENCIES: KEY DEFINITIONS AND POTENTIAL AML/CFT RISKS 4 (2014), <http://www.fatf-gafi.org/media/fatf/documents/reports/virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> [<http://perma.cc/HBP8-AY28>].

²⁶ *Id.*

²⁷ *Frequently Asked Questions*, BITCOIN, <https://bitcoin.org/en/faq> [<http://perma.cc/VG3J-4MDP>] (last visited Oct. 19, 2014).

²⁸ David Zeiler, *Why Virtual Currency Is Here to Stay—Bitcoin or No Bitcoin*, MONEY MORNING (Nov. 22, 2013), <http://moneymorning.com/2013/11/22/why-virtual-currency-is-here-to-stay-bitcoin-or-no-bitcoin/> [<https://perma.cc/67SZ-V86N>].

²⁹ This Note will consistently refer to Bitcoin for analogy purposes; however, the discussion that follows is applicable to all virtual currency.

choice of virtual currencies with an estimated user base of 1.3 million in 2014.³⁰ The number of users is estimated to rise to five million by 2019.³¹ Bitcoin is a virtual currency that is based on an algorithm that created a direct peer-to-peer transaction system.³² Nakamoto developed Bitcoin with the intention of creating a virtual currency that would “allow online payments to be sent directly from one party to another without going through a financial institution.”³³ Nakamoto described Bitcoin as an “electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.”³⁴ Nakamoto created Bitcoin with the goal that secure peer-to-peer financial transactions acting without the assistance of a financial institution would drastically cut down on transaction fees and therefore enable e-commerce transactions to become easier, more secure, and more affordable.³⁵

Bitcoin can be obtained in several different ways. The typical Bitcoin user can purchase and sell Bitcoin on an exchange website.³⁶ Bitcoin users can also accept Bitcoin from other people as a method of payment for goods or services.³⁷ Lastly, Bitcoin can be earned through a process known as “mining.”³⁸ Bitcoin mining is a process where any user can run software and specialized hardware to assist in verifying Bitcoin transactions across the globe.³⁹ This verification process replaces the need for a third-party bank to verify transactions, as is needed with credit card transactions. Mining also generates new Bitcoin and pays these newly generated Bitcoins as a reward to the miners for dedicating their hardware to the process.⁴⁰

Bitcoin users access their Bitcoins through anonymous electronic wallets that contain various public and private addresses called keypairs.⁴¹ These electronic wallets enable merchants to display their public address to other users. Users send Bitcoins to these public addresses using software that withdraws the currency from their wallet and transfers it to the new address. There are algorithms in place to timestamp Bitcoins after they are transferred, thus securing the transaction and preventing double spending.⁴² Simply put, Bitcoin transactions are diligently

³⁰ Everett Rosenfeld, *Bitcoin to Near 5M Active Users by 2019, Remain Niche: Study*, CNBC (Mar. 17, 2015, 6:20 PM), <http://www.cnbc.com/2015/03/17/bitcoin-to-near-5m-active-users-by-2019-remain-niche-study.html> [perma.cc/483H-8JBH].

³¹ *Id.*

³² Nakamoto, *supra* note 5, at 1.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Frequently Asked Questions*, *supra* note 27.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* The complex mining process will be discussed in detail *infra* subsection II.B.2.

⁴¹ Dion, *supra* note 7, at 167–68.

⁴² Nakamoto, *supra* note 5, at 2.

recorded by the global Bitcoin software, which in turn bolsters security against fraudulent Bitcoin transactions.⁴³

Bitcoin can be used just like currency as a payment to anyone who is willing to accept them. Bitcoin is used in a wide variety of transactions on the internet as well as physical locations across the globe. Across the internet, thousands of businesses accept Bitcoin as donations and payments for services. In January 2014, Overstock.com became the first major retailer to accept Bitcoin payments.⁴⁴ In August 2014, Overstock CEO Patrick Byrne stated that the company is selling goods worth an average of \$15,000 USD in Bitcoin per day.⁴⁵ Although at that point, Bitcoin accounted for only 0.25% of Overstock's sales, Byrne stated that the company's overall profits are expected to increase due to the Bitcoin sales.⁴⁶ While there is no comprehensive list of businesses that accept Bitcoin, there are estimates that as of December 2015, 160,000 merchants accept Bitcoin and could rise to 1.8 million by 2017.⁴⁷ There are also physical Bitcoin ATMs, located throughout the United States and in other countries that can exchange various currencies such as physical dollars for Bitcoin and vice versa.⁴⁸ There are several manufacturers of Bitcoin ATMs, but there are only a small number of known functional two-way machines that will "buy" Bitcoin and dispense cash.⁴⁹ The rest of the Bitcoin ATMs are one-way: insert cash and Bitcoin is deposited to an electronic wallet.

Although Bitcoin is used in many legal commercial markets, its degree of anonymity has attracted users to deal in the currency on the internet for various illegal purposes.⁵⁰ Since it is nearly impossible to track the identity of cautious

⁴³ The security aspects of Bitcoin will be discussed in detail *infra* subsection II.B.1.

⁴⁴ Nermin Hajdarbegovic, *Overstock CEO Reveals Bitcoin Sales Averaging \$15k Per Day*, COINDESK (Aug. 14, 2014, 2:57 PM), <http://www.coindesk.com/overstock-reveals-bitcoin-sales-averaging-15000-per-day/> [<http://perma.cc/N74P-CT29>]; Metz, *supra* note 8; *see also Bitcoin on Overstock.com*, OVERSTOCK™, <http://www.overstock.com/bitcoin> [<http://perma.cc/5VVH-7TY8>] (last visited Oct. 12, 2014) (announcing Overstock's partnership with Coinbase to accept Bitcoin payments).

⁴⁵ Hajdarbegovic, *supra* note 44.

⁴⁶ *Id.*

⁴⁷ Laura Shin, *Should You Invest in Bitcoin? 10 Arguments in Favor as of December 2015*, FORBES (Dec. 11, 2015, 11:44 AM) (on file with the Utah Law Review), <http://www.forbes.com/sites/laurashin/2015/12/11/should-you-invest-in-bitcoin-10-arguments-in-favor-as-of-december-2015/#712e5217540e>.

⁴⁸ *See* Kurt Wagner, *World's First Bitcoin ATM Opens in Vancouver, Canada*, MASHABLE (Oct. 30, 2013), <http://mashable.com/2013/10/30/bitcoin-atm-2/> [<https://perma.cc/9B9K-MC8T>]; Rob Wile, *Think Fees on Normal ATMs Are Expensive? Check Out What It Costs to Use a Bitcoin ATM*, BUS. INSIDER (Mar. 10, 2014, 5:20 PM), <http://www.businessinsider.com/using-a-bitcoin-atm-is-actually-pretty-expensive-2014-3> [<https://perma.cc/6W6P-BM9X>].

⁴⁹ Wile, *supra* note 48.

⁵⁰ David Milliken, *Bank of England Sees Bitcoin Fraud Risk, Deflation Danger*, REUTERS (Sept. 11, 2014, 5:06 PM), <http://uk.reuters.com/article/2014/09/11/uk-britain-boe-bitcoin-idUKKBN0H61HL20140911> [<http://perma.cc/GXB7-Y9T3>].

Bitcoin users, Bitcoin gained popularity for illegal use in connection with “Silk Road,” a popular “deepnet”⁵¹ website that was primarily used to trade narcotics and illegal weapons.⁵² Silk Road accepted only Bitcoin payments as a tactic for dealing anonymously and avoiding detection.⁵³ Since Bitcoin operates like cash by retaining no data about its users, Bitcoin’s anonymity allowed Silk Road to operate successfully at a high volume for a long period of time. Eventually, Silk Road was shut down by the FBI in October 2013, and the owner, Ross William Ulbricht, was arrested.⁵⁴ The FBI subsequently seized 26,000 of Ulbricht’s Bitcoins, which were worth approximately \$3.6 million USD at the time.⁵⁵ As Bitcoin became linked with criminal use, it gained controversial media attention.

Due to recent rampant media attention, Bitcoin and other virtual currencies have spiked in usage and popularity. In addition to being used as a currency, Bitcoin has gained popularity among investors. Bitcoin can be purchased and traded on private exchanges, which function much like stock exchanges. Although Bitcoin operates like traditional currencies, the main difference between the two is that Bitcoin’s value fluctuates dramatically in short time periods. This is much different than the U.S. dollar, which is notoriously stable with gradual inflation. Recently, massive Bitcoin value spikes have led to sky-high gains for early investors. In 2010, one Bitcoin was worth \$0.05.⁵⁶ In mid-2013, the price rose to approximately \$100 per Bitcoin.⁵⁷ On November 29, 2013, Bitcoin set a record exchange value of \$1,132 per Bitcoin.⁵⁸ Similar to a stock, the price of Bitcoin fluctuates constantly. On January 21, 2016, Bitcoin was valued at around \$395 per Bitcoin.⁵⁹ As of January 21, 2016 there were over 15 million Bitcoins in existence (nearly \$6 billion USD) and that number constantly increases.⁶⁰ As a frame of reference, an estimated transaction volume of \$135 million USD worth of Bitcoin was exchanged globally

⁵¹ Deepnet sites are websites that host completely anonymous users and are non-indexed, meaning they cannot be found on traditional search engines such as Google.com. See Dion, *supra* note 7, at 166.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ James Ball et al., *FBI Claims Largest Bitcoin Seizure After Arrest of Alleged Silk Road Founder*, GUARDIAN (Oct. 2, 2013, 11:54 AM), <http://www.theguardian.com/technology/2013/oct/02/alleged-silk-road-website-founder-arrested-bitcoin> [<https://perma.cc/JR4B-YTDH>].

⁵⁵ *Id.*

⁵⁶ *Bitcoin Price Chart with Historic Events*, BITCOIN HELP (on file with the Utah Law Review), <https://bitcoinhelp.net/know/more/price-chart-history> (last updated Nov. 3, 2015).

⁵⁷ *Id.*; *Charts of Bitcoin Metrics*, COINBASE (on file with the Utah Law Review), <https://coinbase.com/charts> (last visited Nov. 30, 2015).

⁵⁸ See *Bitcoin Price Chart with Historic Events*, *supra* note 56.

⁵⁹ See *Markets*, BLOCKCHAIN INFO, <https://markets.blockchain.info/> [perma.cc/FHD2-YSLB] (last visited Jan. 22, 2016).

⁶⁰ *Total Bitcoins in Circulation*, BLOCKCHAIN INFO, https://blockchain.info/charts/total-bitcoins?timespan=30days&showDataPoints=false&daysAverageString=1&show_header=true&scale=0&address= [perma.cc/38RY-DEK9] (last visited Jan. 22, 2016).

on January 21, 2016.⁶¹ The volatility and constantly fluctuating value of Bitcoin has attracted numerous Wall Street investors, which makes Bitcoin a recently popular investment.⁶² Bitcoin became an immensely popular topic in the financial investing world. Several investors put large amounts of money into Bitcoin as the value was skyrocketing. Since the currency is not backed by any standards or governments, Bitcoin value can fluctuate drastically as investor and user demand increases, thereby potentially driving the investment value up. Bitcoin is worth exactly as much as users are willing to pay for it.

B. Driving Forces Behind the Use of Bitcoin

As technology has increased, our society's use of currency has changed dramatically. For example, a typical person has his paycheck directly deposited into his bank account. He can go out to eat and swipe his credit card to pay. He can transfer money to his friends digitally via PayPal or Venmo, two popular apps used to send money. He could go days, months, even years without seeing a single physical dollar bill. Our society is heading in a direction where physical currency is increasingly scarce. Although it may seem strange that Bitcoin does not exist in physical form, a tremendous amount of currency is transferred every day without any exchange of physical currency.

People use Bitcoin for an unlimited number of reasons. Some people use it as an investment. Some people use it as a currency. Others use it because it is new technology. Bitcoin enables global transactions to become much easier because it is a common unit of currency that can be accepted by anyone in any nation. A common unit of currency used on the internet enables users to forgo the hassle of converting money to foreign currencies to send to other countries. In addition, Bitcoin offers users a system that (1) features a high degree of security and (2) cuts down on transaction fees.

1. Security

Credit cards are old technology. Pioneer John Biggins created the first modern bank-issued credit card in 1946.⁶³ Although there have been numerous technological updates to credit cards, the banking industry has not been able to keep up with the

⁶¹ *Estimated USD Transaction Volume*, BLOCKCHAIN INFO, [https://blockchain.info/charts/estimated-transaction-volume-usd?showDataPoints=true×pan=30days&show_header=true&daysAverageString=1&scale=0&address=\[perma.cc/R8KE-URDQ\]](https://blockchain.info/charts/estimated-transaction-volume-usd?showDataPoints=true×pan=30days&show_header=true&daysAverageString=1&scale=0&address=[perma.cc/R8KE-URDQ]).

⁶² See, e.g., Shin, *supra* note 47; Neer Varshney, *Is the Number of Investors Preferring Bitcoin Over Fiat Growing?*, COINTELEGRAPH (Jan. 14, 2016, 5:03 PM), <http://cointelegraph.com/news/116057/is-the-number-of-investors-preferring-bitcoin-over-fiat-growing> [<http://perma.cc/GG7S-KYWJ>].

⁶³ Ben Woolsey & Emily Starbuck Gerson, *The History of Credit Cards*, CREDITCARDS.COM, <http://www.creditcards.com/credit-card-news/credit-cards-history-1264.php> [<https://perma.cc/UM8Y-X779>] (last updated May 11, 2009).

increases in technology. A current major problem with credit cards and e-commerce is the continuous security breaches that compromise user identities and bank accounts.⁶⁴ People commit credit card fraud in several different ways. Most of the schemes include the unauthorized use of another's personal information to hijack an existing bank account or open new bank accounts.⁶⁵ Another common scheme, called "skimming," involves a person fraudulently obtaining personal information from a credit card reader and using the information to commit identity theft.⁶⁶ One of the biggest issues with credit card security is the relative ease with which a hacker can lift personal information from a physical credit card or a credit card transaction.

In contrast, Bitcoin wallets offer several security options that are widely effective in preventing fraudulent transactions. Bitcoin wallets offer various levels of encryption to prevent fraudulent spending.⁶⁷ Several companies offer Bitcoin wallet software with various types of encryption and security options. Another security feature is storing Bitcoins in "cold wallets," which are secure wallets stored on a physical device such as a USB flash drive or a paper representation of the currency.⁶⁸ These wallets are secure against internet thieves because the wallets are completely offline and inaccessible unless physically taken—just like cash.⁶⁹

Since fraudulent credit card schemes often rely on collecting personal information, anonymity can help protect consumers. Although cash is almost 100% anonymous, credit card records divulge a lot of information about customers and their payment history. While Bitcoin is not completely anonymous, "the identity of the user behind an address remains unknown until information is revealed during a purchase or in other circumstances."⁷⁰ Unless information is divulged, the public Bitcoin address is a string of random characters that reveals nothing about the identity of the user. For example, a user can own several Bitcoin addresses, and

⁶⁴ See, e.g., Glenn Kapetansky, *Will Data Breaches Scare Away Consumers?*, FORTUNE (Sept. 25, 2014, 2:09 PM), <http://fortune.com/2014/09/25/will-data-breaches-scare-away-consumers/> [<http://perma.cc/4PK6-PRRM>]; Phil Rosenthal, *Just Assume Your Credit and Debit Card Data Were Hacked*, CHI. TRIB. (Sept. 30, 2014, 6:56 PM), <http://www.chicagotribune.com/business/columnists/ct-data-breach-credit-scam-rosenthal-1001-biz-20140930-column.html> [<https://perma.cc/QD92-LLGW>].

⁶⁵ *Credit Card Fraud*, CORNELL U. L. SCH.: LEGAL INFO. INST., http://www.law.cornell.edu/wex/credit_card_fraud [<http://perma.cc/A4E9-946X>] (last visited Oct. 17, 2014).

⁶⁶ *Id.*; Ben Woolsey & Emily Starbuck Gerson, *Skimming 101: How to Spot It, Avoid It, Deal with It*, CREDITCARDS.COM, <http://www.creditcards.com/credit-card-news/credit-card-skimming-scam-1282.php> [<https://perma.cc/M9EE-A3W2>] (last updated Jan. 6, 2011).

⁶⁷ *Securing Your Wallet*, BITCOIN, <https://bitcoin.org/en/secure-your-wallet> [<http://perma.cc/KS76-2T5X>] (last visited Oct. 17, 2014).

⁶⁸ *Cold Storage and Cold Wallets*, BITCOIN SECURITY PROJECT, <https://bitcoinsecurityproject.org/SecureStorage/ColdStorageAndColdWallets/> [<http://perma.cc/Q9RN-MSE5>] (last visited Oct. 17, 2014).

⁶⁹ *Id.*

⁷⁰ *Some Things You Need to Know*, BITCOIN, <https://bitcoin.org/en/you-need-to-know> [<http://perma.cc/VPP9-SRR8>] (last visited Oct. 19, 2014).

while the activity at an address is tracked, there is no way to tell who owns the address unless the user voluntarily discloses that information.⁷¹

On the other hand, every Bitcoin-based transaction is logged in the “blockchain,” a publicly available log of every Bitcoin transaction ever made.⁷² For example, if a business posted a public address to accept payments on its website and did not frequently change its address, any person could view its entire transactional history.⁷³ While there is a log and a detailed transaction history, it is easy for users to generate different addresses with the click of a mouse and subsequently mask their identities. Careful users can even create a different address for each separate transaction. The ability to hide personal information and achieve a greater sense of privacy than is available through credit card payments has made Bitcoin attractive to users who wish to remain anonymous while dealing in currencies over the internet. Anonymous payments enable users to exchange Bitcoin without the risk of divulging information that could compromise their financial security.

Although Bitcoin offers various degrees of anonymity and security while exchanging currency on the internet, the system is not perfect and thieves have exploited various security flaws. Bitcoin has been used in various Ponzi schemes, thefts, and fraudulent transactions.⁷⁴ The most famous security collapse to date involved the most popular Bitcoin exchange, Mt. Gox, which, in 2013, was handling an estimated 70% of all daily Bitcoin transactions.⁷⁵ In early 2014, Mt. Gox was hacked and lost \$460 million worth of users’ accounts.⁷⁶ This collapse prompted questions of whether Bitcoin needed regulation similar to banks to protect consumers.⁷⁷ Because Bitcoin is not regulated or backed by any institution, there is no recourse for a victim of fraud or hacking. This is dissimilar to a bank or a credit card company, where there are mechanisms in place by which the institution would compensate the victim for the loss. For this reason, arguably the biggest risk of using Bitcoin is the lack of consumer protection available to its users. While there is a

⁷¹ Danny Bradbury, *How Anonymous is Bitcoin?*, COINDESK (June 7, 2013, 10:04 AM), <http://www.coindesk.com/how-anonymous-is-bitcoin/> [<http://perma.cc/Q7JL-RGDF>].

⁷² *Id.*

⁷³ *See id.*

⁷⁴ *See, e.g.*, SEC v. Shavers, No. 4:13-CV-416, 2014 WL 4652121, at *8–11 (E.D. Tex. Sept. 18, 2014) (finding the defendant guilty of running a Ponzi scheme through a Bitcoin investment company); Andy Greenberg, *Another Bitcoin Startup Tanks After \$600,000 Theft*, FORBES (Mar. 4, 2014, 10:47 AM) (on file with the Utah Law Review), <http://www.forbes.com/sites/andygreenberg/2014/03/04/another-bitcoin-startup-tanks-after-600000-theft/> (describing the theft of approximately \$620,000 from an exchange company’s “hot wallet”).

⁷⁵ Paul Vigna, *5 Things About Mt. Gox’s Crisis*, WALL STREET J. (Feb. 25, 2014, 2:03 PM), <http://blogs.wsj.com/briefly/2014/02/25/5-things-about-mt-goxs-crisis/> [<https://perma.cc/TZT8-CBS6>].

⁷⁶ Robert McMillan, *The Inside Story of Mt. Gox, Bitcoin’s \$460 Million Disaster*, WIRED (Mar. 3, 2014, 6:30 AM), <http://www.wired.com/2014/03/bitcoin-exchange/> [<http://perma.cc/H9MC-ZUGK>].

⁷⁷ *Id.*

certain degree of risk involved with the use of Bitcoin, careful users can use Bitcoin's security features to hide their personal information and make themselves less susceptible to fraud.

2. *Credit Card Transactional Fees and International Exchange Fees*

Every credit card transaction incurs a fee charged to the merchant by the credit card company.⁷⁸ It is estimated that on average, "credit card transactions cost American merchants an average of six times the total cost of cash transactions."⁷⁹ When a credit card user swipes the card as payment at a store or enters the information on the internet, the credit card company must verify the transaction electronically.⁸⁰ This process involves communication from remote keypads to the company's computer servers in a centralized location.⁸¹ This verification incurs a small service fee, called an interchange fee, due to the high volume and maintenance of the credit card company's computer servers.⁸² The interchange fee is usually a "flat fee of 5 cents to 25 cents and a fee of 1 to 3 percent of the total transaction amount (including taxes and tips)."⁸³ For many small and even large business owners, interchange fees create additional and potentially burdensome expenses. While businesses can avoid transaction fees by accepting cash, it is virtually impossible to accept cash for transactions made on the internet. Approximately 55% of small businesses do not accept credit cards, however, only an estimated 27% of purchases are made with cash.⁸⁴ For large international businesses and particularly businesses that operate on the internet, international credit card processing fees are even higher.⁸⁵

Similar to credit card transactions, Bitcoin transactions need to be verified by a third-party computer to confirm the legitimacy of the transaction. Since Bitcoin operates on a decentralized platform, Bitcoin does not have a processing center like credit card companies do. Instead, Bitcoin uses a process called "mining" where any person across the world can run special software to dedicate their computer to

⁷⁸ See generally Adam J. Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV. 1321, 1329–34 (2008) (explaining different fee schedules issued by various American credit card companies to merchants).

⁷⁹ *Id.* at 1321–23.

⁸⁰ *Id.* at 1328–29.

⁸¹ *Id.*

⁸² *Id.* at 1329–31.

⁸³ *Id.* at 1333.

⁸⁴ TJ McCue, *Why Don't More Small Businesses Accept Credit Cards?*, FORBES (Aug. 16, 2013, 9:04 AM) (on file with the Utah Law Review), <http://www.forbes.com/sites/tjmccue/2013/08/16/why-dont-more-small-businesses-accept-credit-cards/>.

⁸⁵ Metz, *supra* note 8.

verifying Bitcoin transactions.⁸⁶ Mining enables the Bitcoin network to remain decentralized and operate in several countries with no individual being able to control the network.⁸⁷ New Bitcoins are constantly being issued at a set rate, and users who dedicate their computer power to assisting in transactions (“miners”) are then rewarded with newly generated Bitcoins for their services.⁸⁸ Many miners join forces into “mining pools” where many computers work together to verify transactions faster. Bitcoin mining and subsequent decentralization of a transactional facility enables Bitcoin transactions to remain “free” to users. Since the miners are automatically rewarded for their time and energy via the Bitcoin algorithm, there is no need for users to pay additional fees for transactional services as is necessary with credit cards.

There are several companies that offer streamlined services to businesses that wish to accept Bitcoin. Most of these companies do not charge any fees for their services, but some charge a small fee for larger business that require detailed attention.⁸⁹ Coinbase, a full-service Bitcoin exchange, allows users and merchants to send or receive Bitcoin for zero fees and charges a small 1% fee to exchange Bitcoin for USD and vice versa.⁹⁰ Bitpay, a popular Bitcoin payment processor, does not charge any transaction fees unless businesses want to pay for additional premium services such as a high volume of daily transactions and priority technological support.⁹¹ While describing his decision to accept Bitcoin, Overstock.com CEO Patrick Byrne explained that the company pays Coinbase a fee to handle all of its transactions, but this fee is “significantly lower” than the fees charged by credit card companies.⁹² Presumably, Coinbase or other exchanges will charge service fees to a large business like Overstock.com because of the amount of detailed service that is performed for the single client. This allows domestic business owners and individuals to cut down on costly 2–3.5% credit card transaction fees. While larger companies such as Overstock.com may pay a transaction fee because of the high level of service they receive, small businesses and individuals gain the most benefit by cutting transaction fees completely and increasing their profit margins.

In addition to eliminating credit card fees, Bitcoin alleviates the need for individuals or businesses to spend money and time exchanging international

⁸⁶ *How Bitcoin Mining Works*, COINDESK, <http://www.coindesk.com/information/how-bitcoin-mining-works/> [<https://perma.cc/XMG4-2KYH>] (last updated Dec. 22, 2014).

⁸⁷ *Frequently Asked Questions*, *supra* note 27.

⁸⁸ *Id.*

⁸⁹ See Metz, *supra* note 8 (explaining that Overstock.com pays a fee to Coinbase to process transactions, but this fee is much lower than credit card fees); *Pricing*, BITPAY, <https://bitpay.com/pricing> [<http://perma.cc/PQY2-ENM2>] (last visited Oct. 17, 2014) (describing bitpay’s free plan as “unlimited payment processing, free forever.”).

⁹⁰ *What Is Coinbase and How Much Does It Cost to Use?*, COINBASE (Feb. 25, 2016), <https://support.coinbase.com/customer/portal/articles/585625-what-is-coinbase-and-how-much-does-it-cost-to-use-> [<https://perma.cc/KHF9-6CL5>].

⁹¹ *Pricing*, *supra* note 89.

⁹² Metz, *supra* note 8.

currency. Since Bitcoin is a uniform unit of currency that is accepted by users in many countries, there is no need to have an intermediary currency conversion when making a transaction across borders. There are two sets of fees for converting currency from a bank account—a standard 1% charge from Visa or Mastercard, and an additional bank fee.⁹³ For example, Wells Fargo charges consumers an additional currency conversion rate of 3% of the foreign transaction amount.⁹⁴ By avoiding conversion fees, no-fee Bitcoin exchanges also allow people to send and accept money from all across the globe without incurring costly international surcharges. Since Bitcoin exchanges do not discriminate by location, global trade is streamlined and more cost effective.

III. THE IRS'S CLASSIFICATION OF BITCOIN AS A PROPERTY HAS TREMENDOUS TAX IMPLICATIONS FOR USERS

After the influx of Bitcoin usage and the creation of several other virtual currencies, the IRS recognized a need for tax regulation on this large number of transactions consummated each day. Congress has the constitutional authority to regulate legal currency, including the power to restrain the circulation of any notes not issued under its authority.⁹⁵ The IRS is responsible for classifying and issuing taxes.⁹⁶ With trading volumes amounting to as much as \$114,454,232 each day, the IRS was missing out on a tremendous amount of tax revenue.⁹⁷ There are several different tax classifications that the IRS can assign various items.⁹⁸ In this context, the relevant classifications are property and currency.⁹⁹

When deciding which classification to assign to Bitcoin, the IRS needed to determine whether it sought to tax Bitcoin as property, similar to an investment such as a stock or bond, or as a foreign currency.¹⁰⁰ Although Bitcoin was designed to be an unregulated, global currency and means of exchange, it is unique because it has

⁹³ Emily Starbuck Gerson, *Top Credit Card Issuers' Foreign Transaction Fees*, CREDITCARDS.COM, <http://www.creditcards.com/credit-card-news/foreign-transaction-conversion-fees-1276.php> [<https://perma.cc/TC99-CMV3>] (last updated Nov. 21, 2008).

⁹⁴ *Id.* (listing foreign transaction fees for major banks including Wells Fargo Bank).

⁹⁵ *Veazie Bank v. Fenno*, 75 U.S. 533, 548 (1869).

⁹⁶ *The Agency, its Mission and Statutory Authority*, IRS, <https://www.irs.gov/uac/The-Agency,-its-Mission-and-Statutory-Authority??> [<https://perma.cc/KC7T-C394>] (last updated Oct. 26, 2015).

⁹⁷ *Estimated USD Transaction Volume*, BLOCKCHAIN, <http://www.blockchain.com> [<https://perma.cc/YC62-87U6>] (last visited Apr. 10, 2016) (click on the button “Explore the Blockchain”; on the top banner, click the heading “Stats”; find “Estimated Transaction Volume (USD)” and, at the end of that row, click the chart button; hover mouse over April 4, 2016 to see the estimated transaction volume of bitcoins in USD for that day).

⁹⁸ *See* 26 U.S.C. § 6334 (2012) (classifying property and exempting certain property from levy).

⁹⁹ *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, 938 (concluding that virtual currency is to be treated as property, not currency).

¹⁰⁰ *See id.* at 938–39.

recently become a popular investment vehicle.¹⁰¹ In March 2014, the IRS issued a news release announcing that Bitcoin and other virtual currencies would be taxed as property analogous to stocks and other investments.¹⁰²

Presumably, the IRS saw that many investors were profiting from Bitcoin investments and decided to tax it similarly to other investments. Although it is impossible to quantify a percentage of Bitcoin users who are holding the currency for long-term investment, it can be assumed by the fluctuating market prices that many investors are holding it as currency. The IRS decided to classify Bitcoin as property to extract taxes from any gain in the virtual currency's value.¹⁰³ If the majority of Bitcoin users utilize the currency purely as a long-term investment, this decision would make fiscal sense for the IRS to gain maximum tax revenue. However, the sheer number of transactions and Bitcoins exchanged each hour is evidence that a significant number of users are not holding the currency for investment purposes and instead are exchanging it on a daily basis similar to a normal currency.¹⁰⁴ Either way, the IRS classification and subsequent tax regulation of virtual currencies allows users of virtual currency to have an official method to file their taxes.¹⁰⁵ However, classifying virtual currencies as property for tax purposes poses significant problems to everyday users.

Section III.A will address what the IRS ruling means and the impact the ruling will have on Bitcoin users. Section III.B will discuss the positive impacts of the ruling on Bitcoin investors and the negative impacts associated with daily use of Bitcoin.

A. Significance of the IRS Ruling

First, it is important to note that it is highly likely that the complex nuances of tax law and IRS regulations are not widely understood by a large majority of small business owners and everyday consumers.¹⁰⁶ This creates a difficult issue because consumers are naturally less likely to comply with tax regulations that they are unaware of or do not understand. Simply put, the IRS, state governments, and local governments collect taxes in several different ways and at several different rates

¹⁰¹ See Michael McDonald, *Bitcoin Goes Mainstream as an Investment Vehicle*, NASDAQ (Sept. 25, 2015, 7:49 AM), <http://www.nasdaq.com/article/bitcoin-goes-mainstream-as-an-investment-vehicle-cm523775> [<https://perma.cc/7VBR-TH23>].

¹⁰² I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, 938.

¹⁰³ Jose Pagliery, *New IRS Rules Make Using Bitcoins a Fiasco*, CNN (Mar. 31, 2014, 7:01 AM), <http://money.cnn.com/2014/03/31/technology/irs-bitcoin/> [<http://perma.cc/GT5F-NPTV>].

¹⁰⁴ See *Estimated Transaction Volume*, *supra* note 97.

¹⁰⁵ See I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, 938 (describing the potential tax liability arising from the sale, exchange, or use of virtual currency).

¹⁰⁶ See James W. Colliton, *Standards, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265, 265 (1995) (“[T]ax law is the most complex body of statutory law that exists in our legal system.”).

depending on the item being taxed. For example, wages and income are taxed differently than Social Security. Stocks and other investments are taxed differently than sales. The most familiar method of taxing transactions is a sales tax, also known as a “point-of-sale” tax.¹⁰⁷ Sales taxes are a set percentage, determined by the state or local entity, charged to consumers each time a purchase is made.¹⁰⁸ Consumers do not need to worry about calculating these kinds of taxes and instead pay a predetermined percentage dependent on the state and local tax rate at the time of purchase.¹⁰⁹ Most other forms of taxes, including income tax, are calculated using different formulas after each year’s end during tax reporting times.¹¹⁰

Assuming that Congress will most likely never grant Bitcoin status as legal United States tender, the IRS has two plausible choices of classifications for Bitcoin generated income: foreign currency or property.¹¹¹ The main difference between these classifications is that foreign currency is usually a representation of ordinary income, while property is an investment subject to gains or losses.¹¹² This means that the actual foreign currency received is the income that someone earns, while the income from property is the gains or losses relative to the change in the property’s investment value.¹¹³ In addition, currency is used much differently than property. People typically use currency to purchase consumable items, make transactions, and exchange it for payment.¹¹⁴ There is a much smaller percentage of people who purchase foreign currencies for investment purposes hoping to derive gains from fluctuation in the currency’s value.¹¹⁵

¹⁰⁷ See Charles E. McLure, Jr., *Sales and Use Taxes on Electronic Commerce: Legal, Economic, Administrative, and Political Issues*, 34 URB. LAW. 487, 488 (2002) (“All but five states and the District of Columbia tax sales made within the state, and almost 7,000 local jurisdictions also levy sales taxes.”).

¹⁰⁸ See *id.* at 488–89.

¹⁰⁹ See *id.*

¹¹⁰ See, e.g., 26 U.S.C. §§ 1–1564 (2012) (Income Taxes); *id.* §§ 2001–2801 (Estate and Gift Taxes).

¹¹¹ See I.R.S. News Release IR-2014-36, *supra* note 14.

¹¹² See Victor Fleischer, *Taxes Won’t Kill Bitcoin, but Tax Reporting Might*, N.Y. TIMES (Mar. 26, 2014 10:02 AM), http://dealbook.nytimes.com/2014/03/26/taxes-wont-kill-bitcoin-but-tax-reporting-might/?_php=true&_type=blogs&_r=0 [<http://perma.cc/B956-G382>].

¹¹³ See *id.*

¹¹⁴ See *id.*; *Currency*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/currency.asp> [<https://perma.cc/GZ8R-USHS>] (last visited Apr. 4, 2016).

¹¹⁵ See Christian Weller, *Currency Speculation: How Great a Danger?*, DOLLARS & SENSE (May/June 1998), <http://www.dollarsandsense.org/archives/1998/0598weller.html> [<https://perma.cc/VEJ3-P7BV>]; see also Bryan Borzykowski, *4 Ways to Protect Yourself from Foreign-Currency Risk*, CNBC (Apr. 2, 2014, 8:33 AM), <http://www.cnbc.com/2014/04/02/4-ways-to-protect-yourself-from-foreign-currency-risk.html> [<https://perma.cc/RWU5-JCUX>] (describing the inherent risks associated with foreign currency).

The IRS could have decided to tax Bitcoin as it does transactions made with foreign currencies such as the Euro. While foreign currency tax principles are complex, they are broken down into two categories: “(1) a transactional component in which foreign currency is received as part of a sale or exchange, and (2) a foreign currency exchange gain or loss component relative to the U.S. dollar.”¹¹⁶ When citizens and permanent United States residents have any income in foreign currency, they need to pay taxes on this income after the foreign income is translated into U.S. dollars.¹¹⁷ In addition, these taxpayers will also be responsible for paying gains or losses tax if the foreign currency changes in value.¹¹⁸ However, there is a narrow exemption to the requirement to report and pay gains or losses tax on foreign currencies. This exemption applies to small, everyday transactions. When a transaction is made, such as when the currency is converted to USD or the currency is sold or exchanged for goods, and gains derived from these transactions are less than \$200, there is no requirement to report and pay gains or losses tax.¹¹⁹ This exemption is significant because national currencies are—for the most part—stable. Aside from severe market crashes or hyperinflation, major national currencies do not fluctuate in value as wildly as Bitcoin does.¹²⁰ Since national currencies do not have dramatic fluctuations in value, nearly all of small, typical transactions made with foreign currencies will not yield a total gain or loss of more than \$200 and therefore consumers who make small daily transactions with foreign currencies will not be subject to capital gains tax or reporting.

For example, a tourist exchanges USD to Euro in preparation for a trip to Munich. Imagine the tourist exchanges 200 USD for 200 Euro, a perfect 1-to-1 ratio. After a beautiful week in Munich, the tourist returns home with 100 Euro, but realizes that the new exchange rate is 1.1 USD to 1 Euro. He has realized a gain of 10 USD because his 100 Euro returned him 110 USD instead of the 100 USD that

¹¹⁶ Steven Chung, Note, *Real Taxation of Virtual Commerce*, 28 VA. TAX REV. 733, 763 (2009) (citing *Nat'l-Standard Co. v. Comm'r*, 80 T.C. 551, 555 (1983), *aff'd*, 749 F.2d 369 (6th Cir. 1984)).

¹¹⁷ *Id.* at 763–64.

¹¹⁸ *See id.* at 763 (“Any difference between the amount reported as income and the dollar value of the foreign currency at the time it is collected will be treated as foreign currency gain or loss.” (quoting CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS* 713 (3d ed. 2006)).

¹¹⁹ 26 U.S.C. § 988(e)(2) (2012); *see* Nika Antonikova, *Real Taxes on Virtual Currencies: What Does the I.R.S. Say?*, 34 VA. TAX REV. 433, 450 (2015).

¹²⁰ *Compare Interactive Charts*, YAHOO! FIN. (on file with the Utah Law Review), [http://finance.yahoo.com/echarts?s=EURUSD%3DX+Interactive#{"range":"5y","allowChartStacking":true}](http://finance.yahoo.com/echarts?s=EURUSD%3DX+Interactive#{) (last visited Nov. 30, 2015) (demonstrating that a comparison of the value of the Euro to the U.S. Dollar over the last five years shows a high price of 1.484 USD to 1 EUR to a low price of 1.057 USD to 1 EUR for a total change in value of 28.8%), *with Bitcoin Price Chart with Historic Events*, *supra* note 56 (demonstrating that a comparison of the value of Bitcoin to the U.S. Dollar over the last two and a half years shows a high price of 1,145 USD to 1 Bitcoin to a low price of 43 USD to 1 Bitcoin for a total change in value of 2,662.8%).

he previously paid for it. This kind of transaction would be exempt because the gains as a result of the foreign currency exchange were less than \$200. However, in this example, if Euro were replaced with Bitcoin, the tourist would have to file the transaction to be taxed as a \$10 capital gain.

Instead of choosing to tax Bitcoin like a foreign currency, the IRS's current decision to regulate Bitcoin as property means that investors who purchase Bitcoin will treat the virtual currency as capital assets, which could potentially qualify them for the lower tax rate applicable to certain long-term capital gains or losses.¹²¹ This is analogous to tax reporting of stocks or other investments. For each exchange of Bitcoin, no matter how small the transaction, Bitcoin holders will be required to calculate a capital gains or losses tax based on the valuation of the currency.¹²² This process involves recording the date and exchange value at which the Bitcoin was obtained and comparing it with the date and exchange value at which the Bitcoin was sold or exchanged. The difference in value is then subjected to a gains tax.

Capital gains are taxed differently than foreign currency transactions, which are taxed as ordinary income or loss.¹²³ The difference between the two is that capital gains are taxed at different rates than ordinary income depending on how long the investment is held.¹²⁴ If the capital gains are held for less than one year, they are considered short term and are taxed at the same rate as normal income.¹²⁵ If the capital gains are held for longer than one year, they are considered long term and taxed at a lower rate.¹²⁶ Currently, this rate is a maximum of 20%.¹²⁷ This is drastically less than the maximum federal income tax bracket, which taxes income at 39.6%.¹²⁸ While this lower tax rate may seem appealing to Bitcoin users, the decision to classify Bitcoin as property creates largely negative effects.

B. The IRS Decision Favors Investors and Disfavors Daily Users

The decision to tax Bitcoin as a property is favorable to investors because income derived from long-term capital gains from investments is taxed at a lower rate than normal income and it is easier to report a small number of transactions during tax season.¹²⁹ This is unfavorable to the people who use Bitcoin as a currency

¹²¹ Fleischer, *supra* note 112.

¹²² Fed. Tax Coordinator 2d (RIA) ¶ P-6038.

¹²³ 26 U.S.C. § 988(a)(1)(A); Fleischer, *supra* note 112.

¹²⁴ 47A C.J.S. *Internal Revenue* § 128 (2008).

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ See KATHERINE PRATT ET AL., *FEDERAL INCOME TAX: EXAMPLES & EXPLANATIONS* 4 (7th ed. 2014).

¹²⁹ *Id.* at 5 (explaining that a taxpayer who earned \$1 million through capital gains would save \$196,000 in taxes compared to a taxpayer who earned \$1 million of ordinary gain).

because the long list of transactions creates a nearly impossible nightmare for tax reporting.¹³⁰

Presumably, this means that the IRS is incentivizing investors of virtual currency if they are holding the virtual currency for longer than one year. “This is a favorable ruling for most investors given Bitcoin’s stellar performance to date, as accrued long-term gains and losses will be taxed at the taxpayer’s applicable capital gains rate . . . rather than ordinary income rates”¹³¹ Investors who are purchasing virtual currency purely for long-term investment purposes will see a taxation benefit and most likely will not be burdened by the more difficult tax reporting methods. Long-term investors will presumably have a limited number of transactions because they are not spending the Bitcoin on a daily basis. Most likely, the investor will hold the Bitcoin for periods longer than one year. Because the investor is holding the Bitcoin, the investor is not amassing a list of microtransactions, as would a user frequently exchanging Bitcoin for goods and services. Since the number of transactions is limited, this kind of capital gains calculation is simple because the investor will need to perform the calculation only a limited number of times.

While this is good news for Wall Street and other investors, this could harm Bitcoin, as the point of currency is to use it in a marketplace, not to hold it for a long period of time as an investment. While virtually everyone saves cash and traditional currency, spending and open exchange of currency is generally recognized as a sign of a healthy economy.¹³² Additionally, the IRS’s classification of Bitcoin as property could incentivize its use predominantly as a tool for investment—something creator Nakamoto and early Bitcoin advocates never intended.

In contrast, the IRS’s current decision disfavors those who use virtual currency to make a high volume of transactions, such as purchasing everyday goods. In addition to paying any applicable sales tax,¹³³ users will realize a capital gain or loss upon purchasing any item. Instead of simply paying a sales tax upon purchase, users will be required to determine the fair market value of the currency on the date of the

¹³⁰ See Pagliery, *supra* note 103.

¹³¹ Ryan Selkis, *Bitcoin Tax Guide: An Introduction*, INVESTOPEDIA, <http://www.investopedia.com/university/definitive-bitcoin-tax-guide-dont-let-irs-snow-you/> [<https://perma.cc/UP3A-RKKS>] (last visited Apr. 11, 2016).

¹³² See, e.g., Rana Foroohar, *Finally, Americans are Spending More—Exactly What the Economy Needs*, TIME (Dec. 20, 2013), <http://business.time.com/2013/12/20/finally-americans-are-spending-more-exactly-what-the-economy-needs/> [<http://perma.cc/NV63-G6PC>]; Brad Tuttle, *For the Good of the Economy, You Should Spend Money You Don’t Have*, TIME (Oct. 6, 2010), <http://business.time.com/2010/10/06/for-the-good-of-the-economy-you-should-spend-money-you-dont-have/> [<http://perma.cc/593U-P2FA>].

¹³³ Very few states have adopted sales tax policies specifically targeting virtual currency. New York recently issued guidance on how to tax the transactions. See Technical Memorandum from the N.Y. State Dep’t of Taxation & Fin. (Dec. 5, 2014), https://www.tax.ny.gov/pdf/memos/multitax/m14_5c_7i_17s.pdf [<https://perma.cc/DP3T-XXE6>].

payment received and subsequent payment made.¹³⁴ Because this process incurs difficult calculations of capital gains and losses, daily users of virtual currency will be forced to “keep a strict record of every purchase made all year long [and] then perform difficult calculations to account for the changing value of a bitcoin.”¹³⁵

IV. WHY THE IRS DECISION WAS WRONG

The IRS decision to classify virtual currencies as property was wrongfully decided because it essentially prevents Bitcoin from being able to be used as a currency to make everyday purchases. The United States government is discouraging the use of Bitcoin by making a tax ruling with such complex requirements for consumers. “Consumers will probably be the group faced with the biggest tax reporting challenges and this is going to be a stumbling block for the wider adoption of Bitcoin and other virtual currencies.”¹³⁶ In particular, this decision is erroneous because it (A) causes an extreme inconvenience to daily users and because (B) the IRS will have considerable difficulty tracking anonymous Bitcoin users to enforce it.¹³⁷

A. *Extreme Inconvenience to Daily Users*

The IRS’s decision to classify Bitcoin and other virtual currencies as property has a tremendous impact on the way that businesses and individual users need to report their taxes. The most complex and painful result of the decision will come at the end of each year when it is time to report taxes. To comply with the tax regulations, users will need to keep a detailed log of their transactions made during each year and calculate capital gains or losses based on the market price of Bitcoin at the time of every single transaction.¹³⁸

This process of keeping immensely detailed accounting records for every gain and loss associated with the currency’s value is completely impractical. Imagine if every time a routine purchase was made for everyday goods like pizza, shoes, etc., the consumer needed to keep a detailed accounting log of each transaction, the exact amount spent, the current market exchange price for the currency used, and finally complete a comparison calculation of when that currency was originally received to see if gains or losses were associated with the currency. Many people do not even typically review their monthly credit card statements, let alone compare it to an exchange rate chart. Even a simple purchase such as a cup of coffee would need to be diligently recorded.¹³⁹ It sounds like a farfetched and completely inefficient

¹³⁴ Fed. Tax Coordinator 2d (RIA) ¶ P-6038.

¹³⁵ Pagliery, *supra* note 103.

¹³⁶ Davis, *supra* note 17.

¹³⁷ See Pagliery, *supra* note 103.

¹³⁸ *Id.*

¹³⁹ See Richard Rubin & Carter Dougherty, *Bitcoin is Property Not Currency in Tax System, IRS Says*, BLOOMBERG (Mar. 25, 2014, 2:25 PM),

method of reporting taxes, however, this is exactly what Bitcoin users will be faced with if they desire to use the currency for everyday purchases.¹⁴⁰

The market for Bitcoin and other virtual currencies typically fluctuates by more than \$10 per day, which causes a problem for users attempting to make accurate reports of their gains or losses.¹⁴¹ This causes a severe accounting problem for users and could lead them to avoid using virtual currency altogether.¹⁴² Although items with volatile markets such as stocks are often regulated as property, the typical stock investor is using stocks only as a method of long-term investment, not a method of purchasing power similar to currency. Bitcoin and other virtual currencies differ from stock because the virtual currencies were created for use in frequent transactions, not to be vehicles of long-term investment. The sheer inconvenience to daily users will simply take away the benefits of using Bitcoin as a viable payment option because the once-convenient and efficient method of purchasing will be dragged down by the need to keep detailed accounting and report taxes accordingly.

B. Enforcement Difficulty of IRS Tracking Anonymous Users

Since Bitcoin and other virtual currency platforms are relatively anonymous, the IRS will have a nearly impossible endeavor attempting to implement these taxes on daily users.¹⁴³ If the IRS wanted to monitor users' virtual currency wallets, it would need to force online exchanges to follow tax regulations, which would include reporting of Social Security numbers and other user information not readily available.¹⁴⁴ Many Bitcoin users might not desire to share this personally identifiable information with the Bitcoin exchanges or other users. This creates a nightmare for the IRS to track down users, as well as no real reason for users to identify themselves and comply with the regulations.¹⁴⁵ If the IRS were unable to identify users, there would be a serious disincentive to voluntarily report these taxes. This also creates a burden on users inconsistent with the goals of Bitcoin and other virtual currencies because virtual currencies were created with the goal of obtaining a quick,

<http://www.bloomberg.com/news/2014-03-25/bitcoin-is-property-not-currency-in-tax-system-irs-says.html> [<https://perma.cc/Q72G-6LCF>] (“Purchasing a \$2 cup of coffee with Bitcoins bought for \$1 would trigger \$1 in capital gains for the coffee drinker and \$2 of gross income for the coffee shop.”).

¹⁴⁰ See Kashmir Hill, *How I Paid my Bitcoin Taxes*, FORBES (Apr. 15, 2014, 2:26 PM) (on file with the Utah Law Review), <http://www.forbes.com/sites/kashmirhill/2014/04/15/how-i-paid-my-bitcoin-taxes/#24445da82c92> (describing how one journalist “made a detailed expense report that included what [she] spent on Bitcoin that week and its value when [she] spent it” and how she used it to accurately report her Bitcoin related taxes).

¹⁴¹ See Pagliery, *supra* note 103.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

convenient, and anonymous currency used for transactions and wages.¹⁴⁶ While it is impossible for Bitcoin to remain completely unregulated, the IRS's interference with the daily operation of the most basic functions of the exchanges and its policies may eliminate the desire for many users to continue to use Bitcoin.

Although some have speculated that the IRS decision is a "warning shot" and will only be enforced against businesses and large traders, it will have a trickling effect even to the smallest consumer.¹⁴⁷ If virtual currencies were treated as currency for tax purposes, the problem of anonymity would disappear because it would be regulated by normal income and sales tax instead. With sales tax, users could still exchange the currency anonymously, just as when someone makes an everyday transaction with a merchant in cash. This would lead to the IRS being able to actually collect a larger portion of taxes and derive more revenue out of Bitcoin transactions. Once again, income taxes would be reported as normal income and the tedious capital gains or losses calculations would disappear.

V. RECOMMENDED CHANGES TO IRS NOTICE 2014-21

Taxing Bitcoin creates unique issues because while the currency was designed with the intentions of being used as a currency, many users have latched onto Bitcoin for investment purposes. Due to the surge in popularity, the market for and subsequent value of Bitcoin fluctuates wildly.¹⁴⁸ For the IRS, this is problematic because it is difficult to place a classification label on something that is used as an investment vehicle for some users and a daily currency for other users. "Virtual currencies are tricky assets to categorize. Sometimes they behave like currencies, sometimes like commodities, and sometimes like stocks. This unique quality is reflected by several wrinkles in the IRS's approach to virtual currencies"¹⁴⁹ Another hurdle to address is the fact that Bitcoin is used across the globe, which just adds additional complications to a uniform regulation and taxation system. Regardless of the unique qualities of Bitcoin, the taxation method imposed on Bitcoin by the IRS is inefficient at best and downright impossible at worst. Simply put, the current tax laws regarding Bitcoin need to be changed. Section V.A. will address the effects that the Virtual Currency Reform Act would have had on the taxation of Bitcoin. Section V.B will propose a unique solution to the tax problems caused by the IRS ruling.

¹⁴⁶ See Nakamoto, *supra* note 5.

¹⁴⁷ Pagliery, *supra* note 103.

¹⁴⁸ *Bitcoin Price Chart with Historic Events*, *supra* note 56.

¹⁴⁹ Johannes Schmidt et al., *IRS Says Bitcoin to Be Taxed as Gains: New Rule Is Retroactive*, TAX FOUND. (Mar. 28, 2014), <http://taxfoundation.org/blog/irs-says-bitcoin-be-taxed-gains-new-rule-retroactive> [<http://perma.cc/WLP9-MKHT>].

A. *The Virtual Currency Reform Act*

In late 2013, Representative Steve Stockman became known as a supporter of Bitcoin and other virtual currencies when he began soliciting Bitcoin donations for his recent Senate campaign.¹⁵⁰ Approximately six weeks after the IRS issued its decision to regulate Bitcoins as property, Representative Stockman introduced the “Virtual Currency Reform Act,” which would have “change[d] the tax status of virtual currencies from property to foreign currency.”¹⁵¹ Stockman said he introduced the bill with the purpose of furthering the use of Bitcoin and other virtual currencies, and his bill reflects the intention to preserve the use.¹⁵²

Representative Stockman’s “Virtual Currency Reform Act” would have alleviated some of the concerns facing the IRS’s recent decision to classify virtual currencies as property. The proposed Act provided that Bitcoin was a currency, since it acted “as a medium of exchange, a unit of account, and/or a store of value.”¹⁵³ By changing the tax classification, the IRS would derive tax revenue by collecting normal income tax on Bitcoins earned and charging a percentage of sales tax on each transaction, which is consistent with transactions made with legal tender.¹⁵⁴ Most importantly, this proposed Act would have enabled Bitcoin users to avoid the extreme hassle of calculating capital gains or losses every time they made a transaction with Bitcoin.¹⁵⁵ Unfortunately for Bitcoin users, the Virtual Currency Reform Act failed to pass Congress.¹⁵⁶ Despite the fact that the Act is no longer up for consideration, this does not change the need for the revision of IRS Notice 2014-21.

B. *Virtual Currencies Are Unique—Adopting a Unique Solution to the Tax Issues*

Because the use of Bitcoin as an investment vehicle as well as a global currency exchanged for goods and services creates a unique scenario for the IRS, the IRS should adopt a unique solution for the taxation treatment of Bitcoin. Similar to foreign currency, Bitcoin users need an exemption to the tedious capital gains and losses tax reporting. As outlined above, the current taxation method benefits investors and harms daily users. Therefore, the IRS should allow Bitcoin users to declare whether they are using Bitcoin as an investment or as a method of exchange and tax the transactions accordingly.

¹⁵⁰ Julian Hattem, *Stockman Introduces Bill to Impose Sales Taxes on ‘Virtual’ Bitcoin*, HILL (Apr. 7, 2014, 6:19 PM), <http://thehill.com/policy/technology/202875-stockman-introduces-bitcoin-tax-bill> [<https://perma.cc/6Q9G-GUY2>].

¹⁵¹ Virtual Currency Tax Reform Act, H.R. 4602, 113th Cong. pmb. (2014).

¹⁵² Castillo, *supra* note 20.

¹⁵³ H.R. 4602 § 3.

¹⁵⁴ Hattem, *supra* note 150.

¹⁵⁵ *Id.*

¹⁵⁶ H.R. 4602 (113th): *Virtual Currency Tax Reform Act*, *supra* note 24.

The IRS and the Bitcoin industry needs to design a method to implement a standard sales tax every time Bitcoin is exchanged to a merchant and a traditional sale is made. For example, if a pizza restaurant accepts Bitcoin, the restaurant would set a tag on their transaction as a “merchant transaction” and thus would trigger the automatic payment of any applicable sales tax. Each of these transactions made by a Bitcoin user are thus exempt from capital gains and losses reporting because the correct tax on the transaction has already been collected. When investors buy and sell Bitcoin on the various Bitcoin exchanges, these transactions would continue to be taxed as capital gains and losses as all other investments are taxed. This way, both daily users and investors can obtain the most desirable tax treatment depending on how they use their Bitcoin. Daily users would see a benefit by avoiding the excruciating task of diligently recording and reporting each transaction. Investors would see a benefit because they would still be able to retain the much lower capital gains and losses tax bracket. Finally, if Bitcoin adopted a method to classify the different purposes in which the currency was being used, the IRS would benefit because it would be able to collect more taxes from users who otherwise would fail to comply with the outrageous tax reporting requirements.

For Bitcoin and other virtual currencies to survive legally, the IRS will need to tax the transactions. The change to tax Bitcoin depending on its usage makes the most sense because of the benefits given to both the users and the IRS due to the less complex means of tax reporting. If the IRS declines to adopt this suggestion, it should at least carve out an exception similar to foreign currency for personal users of Bitcoin who are making microtransactions with the virtual currency.

VI. CONCLUSION

At Bitcoin’s peak in November 2013, there were 93,000 global transactions made in a single day.¹⁵⁷ These users purchased everyday items such as personal services, food, and real estate.¹⁵⁸ This alone suggests that Bitcoin is not primarily used as a long-term investment tool, but rather is used as a currency and a vehicle for global transactions.¹⁵⁹ Congress and the IRS should regulate it accordingly. Representative Stockman’s Virtual Currency Reform Act offered an attempt to negate the IRS decision and officially classify Bitcoin and other virtual currencies as currency instead of property.¹⁶⁰ A tax reclassification would alleviate typical users’ many inconveniences caused by burdensome accounting and tax reporting. A reclassification would also allow and encourage the use of Bitcoin and other virtual currencies because imposing a sales tax on transactions similar to everyday currencies is a small change that most users would not find prohibitive or restrictive. While it is evident that there needs to be some form of IRS taxation of virtual

¹⁵⁷ Schmidt, *supra* note 149.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ Virtual Currency Tax Reform Act, H.R. 4602, 113th Cong. § 4 (2014).

currencies, attempting to classify Bitcoin according to existing tax principles is challenging and ineffective.

Although this is new technology and subsequently uncharted territory for many doctrines of law, the technology should be embraced and encouraged to prosper. For example, typical sales tax on transactions made on the internet are currently an unsolved dilemma.¹⁶¹ It gets even trickier trying to throw virtual currencies into the mix. Between complex tax law, jurisdictional issues, and the constant globalization of our economy, challenging legal questions will arise. Classifying certain Bitcoin transactions for a sales tax instead of a capital gains and losses tax is the first step in the right direction toward answering these difficult questions and encouraging the use of Bitcoin and other virtual currencies to further global trade in the future.

¹⁶¹ See, e.g., Bernie Becker, *Congress to Push Internet Sales Tax After Midterm Elections*, HILL (Sept. 23, 2014, 6:00 AM), <http://thehill.com/policy/finance/domestic-taxes/218576-congress-to-push-internet-sales-tax-after-midterms> [<https://perma.cc/837A-RSE8>].