VIRTUAL CURRENCY AS REAL CURRENCY

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ABSTRACT

Convertible virtual currency is increasingly equated with the notion of real currency. Indeed, the increased acceptance of virtual currency as a payment method among retailers and consumers, the evolution of new types of virtual currency that alleviate price volatility, and the recent expansion of foreign country initiatives confirm the strong trajectory toward virtual currency's function as a transactional currency. Yet, the tax system continues to classify all forms of virtual currency as "property," and not "currency," which results in immediate taxation every time someone buys something with virtual currency. This Article argues that the adopted tax treatment of virtual currency creates inequities, inefficiencies, and administrative burdens that could be remedied if a de minimis tax exemption were available like the one currently applicable to personal purchases using foreign currency.

Recent developments in the virtual currency space allow the government to reconsider its tax approach. As our view of currency changes over time, our tax characterizations should be re-examined. Virtual currencies are not a homogenous group; thus, adhering to a rigid, one-size-fits-all tax classification is unsound. This Article proposes a new principle-based classification system in which the government could isolate several criteria by which to judge the true nature of a virtual currency as either property (subject to general tax principles related to investment assets) or currency (subject to special tax rules applicable to foreign currency)—and tax it accordingly for all owners of that virtual currency.

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INTRODUCTION

In 2023, the Internal Revenue Service ("IRS") reaffirmed that convertible virtual currency is treated as *property*, and not *currency*, for U.S. federal tax purposes.[1] The federal income tax implications of distinguishing virtual currency from real currency will be explored fully below. For present purposes, however, virtual currency is subject to general tax principles applicable to normal property transactions.[2] Virtual currency is *not* subject to special tax rules applicable to foreign currency transactions.[3] This tax distinction can produce unfavorable results for many taxpayers, especially those who use virtual currency to buy personal goods or services.[4]

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1. I.R.S. Notice 2023-34, 2023-19 I.R.B. 837, § 1–2 (modifying I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 2, by removing the statement that "virtual currency does not have legal tender status in any jurisdiction and to make other changes"). The IRS defines virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 2. Often virtual currency is described as "cryptocurrency" because it uses cryptographic protocols to secure transactions recorded on publicly available decentralized ledgers called "blockchains." *See Digital Assets*, IRS [hereinafter IRS, *Digital Assets*], https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets [https://perma.cc/MA75-DDVV] (Mar. 14, 2025). The focus of this paper is on virtual currencies that are *convertible*—i.e., can be used to purchase goods or services or that can be converted into real-world fiat money via virtual currency exchanges.

2. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4. To no surprise at the time, the IRS identified Bitcoin as an "example of convertible virtual currency" treated as property. *Id.* § 2. First mined in 2009, Bitcoin was the first popular virtual currency. *See* Anshu Siripurapu & Noah Berman, *The Crypto Question: Bitcoin, Digital Dollars, and the Future of Money*, COUNCIL ON FOREIGN RELS., https://www.cfr.org/backgrounder/crypto-question-bitcoin-digital-dollars-and-future-money [https://perma.cc/5L2R-8VMR] (Jan. 17, 2024, 1:00 PM).

3. I.R.S. Notice 2023-34, 2023-19 I.R.B. 837, § 3; *see* I.R.C. §§ 985–989 (establishing a framework for the taxation of foreign currency). Thus, convertible "virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes" under section 988 of the Internal Revenue Code. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (A-2); I.R.S. Notice 2023-34, 2023-19 I.R.B. 837, § 3. The IRS has defined foreign currency as "the coin and paper money of a country other than the United States that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance." Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. This follows the definition provided by the Department of the Treasury Financial Crimes Enforcement Network ("FinCEN"). *See* DEP'T OF THE TREASURY FIN. CRIMES ENF'T NETWORK, FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES 1 (2013) [hereinafter FIN-2013-G001].

4. For example, treating convertible virtual currency as a foreign currency would have allowed individual taxpayers to take advantage of a personal-use exemption. *See* I.R.C. § 988(e); *see also* discussion *infra* Section I.C.

The IRS's tax classification of virtual currency as property and not currency has remained unchanged since its initial classification announcement in 2014.[5] At that time, convertible virtual currency did not fit within the government's traditional understanding of currency.[6] Real, or fiat, currency, according to the IRS, is "the coin and paper money of the United States or of any other country that is designated as legal tender and circulates and is customarily used and accepted as a medium of exchange in the country of issuance."[7] In 2014, no central bank had issued virtual currency; no country had designated it as legal tender.[8] It was viewed more as an investment asset than something that served the function of real currency.[9] Since then, however, we have increasingly seen virtual currency performing real currency functions—both around the world and within the United States. Some foreign countries have enacted laws characterizing Bitcoin as legal tender.[10] El Salvador, in 2021, became the first country to do so.[11] Other countries (like Mexico)

5. *See supra* note 1 and accompanying text.

6. *See* Mindy Herzfeld, Jon Holbrook & Robert Daily, *Potential for Cryptocurrency To Be Treated as Foreign Currency (Giving Rise to Ordinary Gains/Losses)*, LUKKA, https://lukka.tech/potential-for-cryptocurrency-to-be-treated-as-foreign-currency-giving-rise-to-ordinary-gains-losses/ [https://perma.cc/X4EE-8BK2] (last visited Apr. 15, 2025).

7. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 2; *see also* 31 C.F.R. § 1010.100(m) (2024). On its website, the IRS explains: "Digital assets are not real currency (also known as 'fiat') because they are not the coin and paper money of the United States or a foreign country and are not digitally issued by a government's central bank." *Digital Assets 2023 Form 1040*, FOODMAN CPAS & ADVISORS (Feb. 2024), https://foodmanpa.com/digital-assets-2023-form-1040/ [https://perma.cc/K5DZ-NQBY] (emphasis added).

8. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 2 (noting virtual currency "does not have legal tender status in any jurisdiction").

9. According to the government, virtual currency "does not have all the attributes of 'real' currency, as defined in 31 C.F.R. § 1010.100(m), including legal tender status." DEP'T OF THE TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, INVESTORS, AND BUSINESSES 5 n.4 (2022) [hereinafter DEP'T OF THE TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS].

10. I.R.S. Notice 2023-34, 2023-19 I.R.B. 837, § 3 ("The Department of the Treasury and the Internal Revenue Service are aware that certain foreign jurisdictions have enacted laws that characterize Bitcoin as legal tender.").

11. *El Salvador, Primer País del Mundo en Reconocer al Bitcoin Como Moneda de Curso Legal*, ASSAMBLEA LEGISLATIVA (June 9, 2021), https://www.asamblea.gob.sv/node/11282 [https://perma.cc/UG5T-EJJG]; *see also* Caitlin Ostroff & Santiago Pérez, *El Salvador Becomes First Country to Approve Bitcoin as Legal Tender*, WALL ST. J., https://www.wsj.com/articles/el-salvador-

and local foreign jurisdictions (like the Swiss canton of Zug) now accept Bitcoin, in addition to their national currencies, as a means of paying taxes.[12] Several countries, including Japan[13] and Sweden,[14] have announced plans to issue their own digital

becomes-first-country-to-approve-bitcoin-as-legal-tender-11623234476 [https://perma.cc/P5S8-ZX9X] (June 9, 2021, 6:10 PM); Sarah Paez, *El Salvador Makes Bitcoin Legal Tender*, 171 TAX NOTES FED. 1830, 1830 (2021). One month after adoption, 12% of consumers had used Bitcoin and 7% of merchants had received Bitcoin payments. Reuters, *Bitcoin Use in El Salvador Grows Amid Setbacks Since Its Adoption as Legal Tender*, NBC NEWS [hereinafter Reuters, *Bitcoin Use in El Salvador Grows*], https://nbcnews.com/news/latino/Bitcoin-use-el-salvador-grows-setbacks-adopting-legal-tender-rcna2743 [https://perma.cc/BPQ4-7WEZ] (Oct. 7, 2021, 8:28 PM). In 2022, Bitcoin was adopted as legal tender by the Central African Republic (becoming the second country to do so). A year later, however, the country reversed its decision. Jonathan Buck, *The Fall of Bitcoin in the Central African Republic: Why This Legal Tender Experiment Failed* (Apr. 30, 2023), https://bitcoinmagazine.com/culture/why-bitcoin-failed-in-car [https://perma.cc/M9J4-9HDJ] (noting the country's limited internet access was a significant barrier to the success of the Bitcoin project); Joe Hall, *Bitcoin, Sango Coin and the Central African Republic* (Jan. 8, 2023), https://cointelegraph.com/news/Bitcoin-sango-coin-and-the-central-african-republic [https://perma.cc/M9J4-9HDJ] (noting the Central African Republic is "plagued by economic mismanagement, meager private and foreign investment, and systemic governmental issues").

12. Anshu Khanna, *Taxing Cryptocurrency: A Review and a Call for Consensus*, 101 TAX NOTES INT'L 981, 985 (2021) ("In a few jurisdictions, like the Swiss canton of Zug and a municipality within the canton of Ticino, cryptocurrencies are accepted as a means of payment, even by government agencies. The Isle of Man and Mexico also permit the use of cryptocurrencies as a means of payment in addition to their national currencies."); *see Tax Payments with Cryptocurrencies*, KANTON ZUG, https://zg.ch/de/steuern-finanzen/steuern/steuerbezug/taxpaymentswithcryptocurrencies [https://perma.cc/3ZBK-5LDR] (last visited Apr. 15, 2025) (starting in February 2021, individuals and entities liable for taxes in the canton of Zug have the option to settle their tax obligations using Bitcoin ("BTC") or Ether ("ETH") cryptocurrencies).

13. Martin Arnold & Leo Lewis, *Japan's Big Banks Plan Digital Currency Launch*, FIN. TIMES (Sept. 25, 2017), https://www.ft.com/content/ca0b3892-a201-11e7-9e4f-7f5e6a7c98a2 [https://perma.cc/PXG5-VFMR] (noting, in 2017, Japan's central bank and regulators greenlighted a group of banks to develop the J-coin, an electronic currency designed to encourage less use of cash).

14. *See* SVERIGES RIKSBANK, THE RIKSBANK'S E-KRONA PROJECT: REPORT 1, 3 (2017). In 2017, Riksbank, Sweden's central bank, started investigating the use of a digital currency known as "e-krona." *Id.* In 2020, Riksbank officially launched a year-long test program of the e-krona. Mike Orcutt, *Sweden Is Now Testing Its Digital Version of Cash, the E-Krona*, MIT TECH. REV. (Feb. 20, 2020), https://www.technologyreview.com/f/615266/sweden-riksbank-ekrona-blockchain/ [https://perma.cc/7SNQ-U6KQ]; Press Release, Sveriges Riksbank, The Riksbank to Test Technical Solution for the E-Krona (Feb. 20, 2020) [hereinafter Press Release, Riksbank to Test E-Krona], https://www.riksbank.se/en-gb/press-and-published/notices-and-press-releases/notices/2020/the-riksbank-to-test-technical-solution-for-the-e-krona/ [https://perma.cc/B3VV-LD6D] (launching a one-year test program of Sweden's digital central bank currency, e-krona); Alexander J. Johnson, *How Foreign Tax Policy Will Win the Wild West of Cryptocurrencies*, 161 TAX NOTES FED. 1595, 1597 (2018) ("Numerous central government banks and noteworthy financial institutions have taken steps to create and trade cryptocurrencies."). Countries that were

currency tokens while not adopting Bitcoin as legal tender.[15] These so-called central bank digital currencies ("CBDCs") will be a new digital form of money that will differ from balances in traditional reserve or settlement accounts and differ from other virtual currencies (because they will be guaranteed by central banks, similar to national currencies, and have legal tender status).[16]

Here in the United States, the acceptance of convertible virtual currency as a medium of exchange for goods or services has grown, as has its acceptance for making government payments.[17] People have used convertible virtual currencies to purchase everything from coffee and pizza to Teslas and Lamborghinis.[18] Indeed, thousands of businesses accept Bitcoin as a

planning to launch their own digital currencies included Iran, Venezuela, and Russia. *Id.* at 1597 n.14.

15. *See, e.g.*, Arnold & Lewis, *supra* note 13 (noting, in 2017, Japan's central bank and regulators greenlighted a group of banks to develop the J-coin, an electronic currency); Press Release, Riksbank to Test E-Krona, *supra* note 14 (launching a one-year test program of Sweden's digital central bank currency, e-krona); Johnson, *supra* note 14, at 1597 ("Numerous central government banks and noteworthy financial institutions have taken steps to create and trade cryptocurrencies.").

16. OECD, TAXING VIRTUAL CURRENCIES: AN OVERVIEW OF TAX TREATMENTS AND EMERGING TAX POLICY ISSUES 47, 49 (2020) [hereinafter OECD, TAXING VIRTUAL CURRENCIES].

17. TREASURY INSPECTOR GEN. FOR TAX ADMIN., THE INTERNAL REVENUE SERVICE CAN IMPROVE TAXPAYER COMPLIANCE FOR VIRTUAL CURRENCY TRANSACTIONS 1 (2020) [hereinafter IRS CAN IMPROVE TAXPAYER COMPLIANCE] (citing IRS ADVISORY COUNCIL, PUBLIC REPORT 5316 72 (2018)) ("The use of virtual currency as a payment method continues to grow in popularity and is emerging as an alternative asset to U.S. or other fiat currencies."). The state of Ohio, as an example, became the first state to accept Bitcoin for business tax payments, but it was revoked a year later because the attorney general issued a legal opinion stating the State Board of Deposit must approve the policy. Karen Kasler, *A Republican Lawmaker Wants Ohio to Try Again with Allowing Tax Payments Via Cryptocurrency*, WOUB (Oct. 2, 2024), https://woub.org/2024/10/02/republican-lawmaker-ohio-tax-payments-via-cryptocurrency/ [https://perma.cc/3H6K-GU6G]. In 2022, Colorado accepted crypto as payment for state taxes after several city governments sought to promote the adoption of digital assets. *See* Michael J. Bologna, *Crypto Tax Payments Get Few Takers as More States Eye Programs*, BLOOMBERG TAX (Oct. 3, 2024, 4:45 AM), https://news.bloombergtax.com/daily-tax-report-state/crypto-tax-payments-get-few-takers-as-more-states-eye-programs-3 [https://perma.cc/F3QS-V7FA].

18. *See* Johnson, *supra* note 14, at 1606 (citing instances of people buying pizzas and cars with Bitcoin); *see also* Jenna Hall, *Can You Buy a House with Bitcoin?*, BITCOIN MAG. (May 26, 2022), https://bitcoinmagazine.com/business/can-you-buy-a-house-with-bitcoin [https://perma.cc/G7MN-W9GQ] (citing a Redfin survey that found "one in nine first-time homebuyers saved for their down payment by selling cryptocurrency").

means of payment.[19] And, it is not just large firms accepting the digital medium of exchange. According to a 2020 study, many small and medium businesses also accept virtual currency payments.[20]

Virtual currency has gained acceptance among Americans,[21] with almost 11% believed to have used it to make a purchase in 2022.[22] It is no surprise that many major U.S. retail organizations and merchants report being receptive to meeting customers' needs and expectations and seeing benefits from embracing virtual currency payments, including gaining a competitive market advantage.[23] To support all this, banks and financial

19. *See* Adam Chodorow, *Bitcoin and the Definition of Foreign Currency*, 19 FLA. TAX REV. 365, 367 (2023) [hereinafter Chodorow, *Bitcoin and the Definition of Foreign Currency*] (citing Timothy R. Koski, *Bitcoin—Tax Planning in the Uncertain World of Virtual Currency*, 93 PRAC. TAX STRATEGIES 255, 255 (2014)). More businesses are accepting "digital currency payments with the hope of gaining a competitive advantage in the market and in the belief that the use of digital currency will continue to expand." TIM DAVIS, ROB MASSEY, AMY PARK, CARINA RUIZ SINGH, MICHAEL GAMAGE, CONOR O'BRIEN, SETH CONNORS, JARICK POULSON & KESAVAN THUPPIL, DELOITTE, THE USE OF CRYPTOCURRENCY IN BUSINESS 3 (2023) ("Roughly 2,352 US businesses accept [B]itcoin, according to one estimate from late 2022."). Wayfair, AirBnB, Zappos.com, and Microsoft are just a few examples of companies that have accepted virtual currency payments. *250+ Companies & Stores That Accept Cryptocurrency*, BITPAY, https://bitpay.com/directory/ [https://perma.cc/ZQL5-N4FT] (last visited Apr. 15, 2025) (listing various companies that currently accept virtual currency payments).

20. *See* Marko Vidrih, *Study: 36% of Small and Medium-Sized US Companies Now Accept Crypto Payments*, MEDIUM (Jan. 17, 2020), https://medium.com/thecapital/study-36-of-small-and-medium-sized-us-companies-now-accept-crypto-payments-e14e42d46626 [https://perma.cc/5H6M-ALC6].

21. Andrew Perrin, *16% of Americans Say They Have Ever Invested in, Traded or Used Cryptocurrency*, PEW RSCH. CTR. (Nov. 11, 2021), https://www.pewresearch.org/short-reads/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/ [https://perma.cc/86RB-BUQZ] (reporting that 16% of Americans said they have invested in, traded, or used a crypto such as Bitcoin). For a list of all virtual currencies and their market capitalization, see *All Cryptocurrencies*, COINMARKETCAP, https://coinmarketcap.com/all/views/all/ [https://perma.cc/L6TD-WSJ4] (last visited Apr. 15, 2025).

22. About 3.6 million, or 10.7%, of crypto owners in the United States were expected to actually use crypto to make a purchase in 2022. *See* Ezra Reguerra, *3.6M Americans to Use Crypto to Make a Purchase in 2022, Research Firm Predicts*, COINTELEGRAPH (Apr. 20, 2022), https://cointelegraph.com/news/3-6m-americans-to-use-crypto-to-make-a-purchase-in-2022-research-firm-predicts [https://perma.cc/R4KG-GPN3].

23. In a Deloitte survey of 2,000 senior executives at U.S. retail organizations, two-thirds (64%) indicated that their customers have significant interest in using digital currencies for payments. CLAUDINA CASTRO TANCO, DELOITTE, MERCHANTS GETTING READY FOR CRYPTO: MERCHANT ADOPTION OF DIGITAL CURRENCY PAYMENTS SURVEY 5 (2022) [hereinafter CASTRO

institutions are beginning to take steps to embrace virtual currency payments.[24] In 2023, for example, Mastercard, a global leader in the payment industry, took a major step in advancing its involvement in the virtual currency space by filing a new trademark—a clear intent to integrate virtual currency into its payment ecosystem.[25]

Despite gaining acceptance, virtual currency has its share of critics who usually point to its price volatility and the widely publicized bankruptcies and scandals.[26] We have seen, however, the recent emergence of new versions of virtual currencies

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TANCO, DELOITTE DIGITAL CURRENCY PAYMENTS SURVEY]. Around 85% of surveyed merchants expect that digital currency payments will be ubiquitous among suppliers in their industry in five years. *Id.* Eighty-five percent are giving high or very high priority to enabling cryptocurrency payments. *Id.* Organizations accepting virtual currencies are perceived to have a competitive market advantage (namely, customer experience is improved, customer base is increased, and their brand is perceived as cutting edge). *Id.* at 6.

24. JPMorgan Chase, Northern Trust, and Goldman Sachs have started to develop new products to hold virtual currencies in custody for customers. Andy Peters, *Banks Explore a Safe Deposit Box for Cryptocurrencies*, AM. BANKER (Aug. 8, 2018, 3:28 PM), https://www.americanbanker.com/payments/news/banks-explore-a-safe-deposit-box-for-cryptocurrencies [https://perma.cc/7AUY-YNLU]. Goldman Sachs has also announced plans to establish a Bitcoin trading operation. *See* Nathaniel Popper, *Goldman Sachs to Open a Bitcoin Trading Operation*, N.Y. TIMES (May 2, 2018), https://www.nytimes.com/2018/05/02/technology/bitcoin-goldman-sachs.html [https://perma.cc/TQ4H-SADG]; *see also* Reguerra, *supra* note 22 (noting networks are building crypto payments infrastructures).

25. *See* Husen Memon, *Mastercard Makes Crypto Advancements with New Trademark Filing*, INT'L INTELL. PROP. L. ASS'N (June 20, 2023), https://iipla.net/mastercard-makes-crypto-advancements-with-new-trademark-filing/ [https://perma.cc/6VHT-KNRD]. "Mastercard aims to expand its offerings and provide users with more diverse and flexible payment options. The integration of cryptocurrencies into Mastercard's payment ecosystem could potentially facilitate faster, more secure, and borderless transactions, catering to the evolving needs of consumers and businesses alike." *Id*. The exchange-traded funds ("ETFs") will allow "investors to gain exposure to the price of [B]itcoin without the complications and risks of owning [B]itcoin directly," which "include setting up crypto wallets and accounts with crypto exchanges, some of which have poor cyber security records and are prone to hacks." Hannah Lang, *Why a US Bitcoin ETF Is a Game-Changer for Crypto*, REUTERS (Jan. 11, 2024, 2:29 AM), https://www.reuters.com/technology/why-us-bitcoin-etf-is-game-changer-crypto-2024-01-10/ [https://perma.cc/B4H3-RB4G].

26. For summary, see generally Xuan-Thao Nguyen & Jeffrey A. Maine, *Crypto Losses*, 2024 U. ILL. L. REV. 1119. *See also The Crypto Infrastructure Cracks*, THE ECONOMIST (May 12, 2022), https://www.economist.com/finance-and-economics/2022/05/12/the-crypto-infrastructure-cracks [https://perma.cc/9U32-5TVP] (emphasizing that in May 2022 "[m]ore than half the market capitalisation of cryptocurrencies ha[d] been wiped out since November [2021]"); Paul Krugman, *Crashing Crypto: Is This Time Different?*, N.Y. TIMES (May 17, 2022), https://www.nytimes.com/2022/05/17/opinion/crypto-crash-bitcoin.html [https://perma.cc/SFD9-AU8F] (describing the rationale behind why crypto has crashed in the past and why it can happen again).

designed to alleviate asset volatility.[27] Companies are developing so-called "stablecoins" to maintain a stable price by pegging them to a fiat currency like the U.S. dollar or Euro.[28] Additionally, 130 countries, accounting for 98% of the global economy, are actively exploring digital iterations of their currencies,[29] a response to the development of cryptocurrency and its "potential threat to their monetary policy and money issuance monopoly."[30] The emergence of these new versions of virtual currencies—stablecoins and CBDCs—is likely to spur further interest in virtual currency as a payment method.[31] Indeed, retailers report less concern about accepting payments with virtual currencies like stablecoins.[32]

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27. *See* Reguerra, *supra* note 22. Indeed, the U.S. Securities and Exchange Commission's recent approval of eleven spot Bitcoin ETFs is expected to boost prices in the long term. *See* Colin Z. McVicker, Carl Fornaris, Kimberly A. Prior & Daniel T. Stabile, *Road to Bitcoin Investment Cleared with SEC's Approval of 11 Spot Bitcoin ETFs*, WINSTON & STRAWN LLP (Jan. 11, 2024), https://www.winston.com/en/blogs-and-podcasts/non-fungible-insights-blockchain-decrypted/road-to-bitcoin-investment-for-sec-registered-investment-advisors-cleared-with-secs-approval-of-11-spot-bitcoin-etfs [https://perma.cc/BDZ3-SPYS].

28. With a 500% yearly increase in 2021, stablecoins, most often based on the U.S. dollar, have continued their meteoric growth. N.Y. STATE BAR ASS'N TAX SECTION, REP. NO. 1461, REPORT ON CRYPTOCURRENCY AND OTHER FUNGIBLE DIGITAL ASSETS 34 (2022) [hereinafter NYSBA REPORT NO. 1461] (citing Gordon Y. Liao & John Carmichael, *Stablecoins: Growth Potential and Impact on Banking* 1 (Bd. of Governors of Fed. Rsrv. Sys., Int'l Fin. Discussion Paper No. 1334, 2022)). Facebook's "Libra" is being put forward as a real international currency. *See generally* FRANCESCO RAMPONE, ITALIAN BLOCKCHAIN ASS'N, FROM BARTER TO LIBRA: DO MONEY AND CRYPTOCURRENCIES LIE ALONG THE SAME EVOLUTIONARY LINE? 1 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589775 ("[C]hange seems unstoppable and is destined to significantly affect the daily life of each of us.").

29. Marc Jones, *Study Shows 130 Countries Exploring Central Bank Digital Currencies*, REUTERS (June 28, 2023, 7:40 PM), https://www.reuters.com/markets/currencies/study-shows-130-countries-exploring-central-bank-digital-currencies-2023-06-28/ [https://perma.cc/E4DS-VU7K]. President Biden signed an executive order to explore a CBDC. *See* Ensuring Responsible Development of Digital Assets, Exec. Order No. 14067, 87 Fed. Reg. 14143 (Mar. 9, 2022).

30. OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 46 (noting the movement has been accelerated by the development of stablecoins). CBDCs are a stable digital form of fiat currency issued and backed by a sovereign or central public authority. *Id.* (defining CBDCs as "a digital form of central bank money that is different from balances in traditional reserve or settlement accounts," i.e., "a digital form of currency that is issued by a central public authority that would co-exist alongside cash and bank deposits but not replace them"). CBDCs are "a new form of money that would represent a central bank liability, denominated in an existing unit of account, serving as a medium of exchange and a store of value." *Id.* at 47. CBDC pilots have also been launched or planned in a number of other countries. *Id.*

31. *See also* Reguerra, *supra* note 22.

32. CASTRO TANCO, DELOITTE DIGITAL CURRENCY PAYMENTS SURVEY, *supra* note 23, at 12.

These recent developments—e.g., expansion of foreign country initiatives, increased acceptance of virtual currency as a payment method among retailers and consumers, and the evolution of new types of virtual currency that alleviate price volatility—confirm the strong trajectory toward virtual currency's function as real currency. Interestingly, U.S. tax authorities have acknowledged the trajectory while continuing to refuse to treat virtual currency as real currency for tax purposes. Back in 2018, the IRS acknowledged that "[t]he use of virtual currency as a payment method continues to grow in popularity and is emerging as an alternative asset to U.S. or other fiat currencies."[33] In 2022, the U.S. Treasury Department acknowledged that "stablecoins purport to provide features to make them . . . more stable than non-asset-backed crypto-assets as a means of payment . . . [and] more broadly useful."[34] Most recently, in 2023, the IRS acknowledged that "[i]n certain contexts, virtual currency may serve one or more of the functions of 'real' currency."[35]

Despite acknowledging virtual currency's growing role as a digital payment method, the IRS still adheres to its position that all forms of virtual currency are "property" and not "currency," which can produce unfavorable income tax results for owners. Consider an individual who buys a Bitcoin when it is worth $100 and spends it when it is worth $150. If virtual currency

33. IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 1; *see also* IRS ADVISORY COUNCIL, PUBLIC REPORT NO. 5316 42 (2018) (emphasizing the growing popularity and use of electronic payment methods).

34. DEP'T OF THE TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, *supra* note 9, at 21. *But see* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 47 (noting stablecoins "might still be too volatile to perform the functions of money or currency").

35. I.R.S. Notice 2023-34, 2023-19 I.R.B. 837, § 3 (modifying the background section of the IRS's cornerstone guidance, I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, and noting, however, that the use of virtual currency to perform "real" currency functions is still limited). The U.S. Treasury also acknowledged that "payment services are available to businesses and consumers directly through crypto-asset platforms and some payment platforms." DEP'T OF THE TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, *supra* note 9, at 20 n.75 ("It is important to note that, since sending crypto-assets from one wallet to another typically requires an on-chain transaction, there is a non-deterministic fee that these platforms will pass on to users, to pay the miner or the validator a gas fee; these fees can be high in times of peak congestion.").

were classified as currency for tax purposes, the individual would have no income tax consequences when he or she spends the Bitcoin.[36] Because virtual currency is classified as property, he or she would have $50 of taxable gain to self-report when he or she spends it.[37] This Article questions this result in light of the growing acceptance and inevitable widespread adoption of virtual currency as a medium of exchange. In other words, does it make sense to continue applying income tax rules governing investment assets every time an owner uses virtual currency to buy a cup of coffee, a slice of pizza, a sporting event ticket, a car, or anything else?

Whether to tax someone every time they buy something with virtual currency (on the difference in its value between the time acquired and the time spent) is a vexing but important policy question. Indeed, the tax issue "may have the biggest impact on Bitcoin's viability as an alternate currency."[38] Despite the tax issue's significant impact on adoption and use, little scholarly attention has been devoted to the question. Most tax scholars and commentators who have weighed in generally come down on one side or the other in the classification debate—virtual currency should be classified as "property" subject to the capital gain and loss tax rules applicable to investment assets,[39] or, instead, it should be classified as "currency" subject to the special tax rules applicable to foreign currency.[40] The analysis, one of

36. As explained later, this is because of a personal-use exemption in the foreign currency tax rules. I.R.C. § 988(e), discussed *infra* Section I.C.

37. As explained later, this is because the transaction is viewed as a taxable barter exchange. *See infra* Section I.B.

38. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 376. *See also* Jason Schwartz, *The Taxation of Decentralized Finance*, 174 TAX NOTES FED. 767, 769 (2022) ("It is hard to imagine taxpayers regularly using virtual currency as money without a de minimis exception similar to the one in section 988(e).").

39. *See, e.g.*, Eric D. Chason, *Crypto Assets and the Problem of Tax Classifications*, 100 WASH. U. L. REV. 765, 804 (2023) ("Bitcoin and other crypto assets should not be classified as foreign currency."); Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 398 (concluding that developments in El Salvador should not convert Bitcoin into foreign currency for U.S. tax purposes).

40. *See generally* Paul N. McCullum, *Bitcoin: Property or Currency?*, 148 TAX NOTES 867, 867–71 (2015) (arguing Bitcoin should be treated as currency and not as property); Herzfeld et al.,

legal interpretation, usually centers on whether virtual currency meets (or should meet) the definition of currency that has been arbitrarily adopted by the IRS.

The Internal Revenue Code ("Code") does not provide general definitions for the terms "property" or "currency,"[41] even though they are subject to different income tax rules. In this absence, the IRS has chosen to adopt a rigid definition of "currency" and has concluded that no virtual currency fits the definition.[42] This all-or-nothing approach causes every virtual currency transaction to be treated as a taxable property barter transaction, resulting in inequalities, inefficiencies, and administrative and compliance burdens. Some have deemed this unsatisfactory, and calls for alternate tax approaches have been made.[43]

One alternate framework, for example, might be to generally classify all virtual currency as property for tax purposes, but then cherry-pick and adopt select tax rules that are applicable to foreign currency in order to remedy deficiencies with the general property classification. Bipartisan tax legislation has recently been proposed in Congress doing just that—i.e., continuing to characterize all virtual currency as property but proposing the adoption of a de minimis exemption similar to the one

supra note 6 (noting at least some of the newer types of crypto might be considered currency, and not property, for tax purposes).

41. *See* I.R.C. § 7701. The word "property" appears in many sections of the Code, and special definitions of "property," of limited applicability, are sometimes provided. *See, e.g.*, *id.* §§ 351, 721 (providing corporate and partnership formations may be tax-free if "property" is exchanged solely for stock or partnership interests); *Id.* §§ 1221(a), 1222 (providing capital gain and loss treatment for certain property held by the taxpayer). Sometimes "property" is instead "defined . . . by the negative implication arising from the exclusion of services." J. Denny Moffett, *The Elusive Definition of Property Under Internal Revenue Code Section 351*, 15 TULSA L.J. 230, 231 (1979); *see* I.R.C. § 317(b).

42. *See* 31 C.F.R. § 1010.100(m) (2024); *see also infra* Section III.A (explaining that virtual currency does not meet the rigid definition of currency that the IRS has adopted).

43. *See, e.g.*, Reuven S. Avi-Yonah & Mohanad Salaimi, *A New Framework for Taxing Cryptocurrencies*, 77 TAX L. 1, 46–47 (2023) (proposing to tax virtual currency depending on how long each individual owner held the virtual currency).

that appears in existing foreign currency tax rules for certain personal purchase transactions.[44]

Another alternate approach, just as an example, might be to treat all virtual currency as property in dictating substantive tax results but to treat it as currency for purposes of reporting and enforcing those results. Congress has shown some movement in this direction as well. The Infrastructure Investment and Jobs Act of 2021, for instance, made changes to the Code to ensure that virtual currencies valued at $10,000 or more can be considered "cash" for certain reporting purposes.[45] Thus, "any person engaging in a trade or business that receives more than $10,000 in cryptocurrency must file a Form 8300."[46] The Treasury's Financial Crimes Enforcement Network ("FinCEN") and some federal courts have also adopted a similar hybrid approach for *non*-tax purposes, classifying certain virtual currencies as "money" for purposes of enforcing currency reporting and anti-money laundering statutes.[47]

Hybrid approaches like those just described are not completely satisfactory. Indeed, there is something peculiar about generally adopting one tax regime applicable to property for virtual currency, but then having to adopt certain rules from a different tax regime applicable to foreign currency to ameliorate problems with the general regime and to achieve desirable policy objectives. There is something also peculiar about generally

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44. The proposals would adopt a de minimis exemption in the foreign currency tax rules of up to $200 for personal purchase transactions made with virtual currency. *See, e.g.*, Virtual Currency Tax Fairness Act, H.R. 6582, 117th Cong. § 139J(a) (2022). This bill (H.R. 6582) was introduced by Suzan K. DelBene, D-Wash. *See id.* H.R. 6582 was previously introduced in 2020. *See* Virtual Currency Tax Fairness Act, H.R. 5635, 116th Cong. § 139G(a) (2020). Similar provisions have been introduced in other proposed legislation. *See* Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. § 139J(b) (2022). This bill was introduced by Senators Cynthia Lummis, R-Wyo., and Kirsten E. Gillibrand, D-N.Y., and provides a de minimis exclusion of up to $200 per virtual currency transaction. *See id.*

45. I.R.C. § 6050I(d)(3) (extending the definition of cash to include digital assets as defined in I.R.C. § 6045(g)(3)(D)).

46. Mary Katherine Browne, *ABA Section of Taxation Meeting: Crypto Transaction Guidance Has Treasury Facing Tough Choices*, 178 TAX NOTES FED. 1259, 1259 (2023).

47. *See* Chason, *supra* note 39, at 800 (citing United States v. Harmon, 474 F. Supp. 3d 76, 90 (D.D.C. 2020)).

treating virtual currency as property for purposes of determining substantive tax obligations, but treating it as currency for purposes of determining procedural reporting obligations of taxpayers and assisting with government enforcement. In either case, having to adopt some "fix" (e.g., an exemption similar to one in the substantive tax rules governing foreign currency or a procedural reporting rule applicable to currency) signals flaws with the IRS's arbitrary decision that no virtual currency should be treated as currency for substantive tax purposes.

A decade ago, the IRS made a blanket administrative decision that virtual currency should be taxed under general tax principles applicable to property without considering the impact of the approach on the fairness, efficiency, and simplicity of the tax system.[48] Since then, virtual currency has increasingly become equated with the notion of real currency, and the continued application of property taxation principles has increasingly raised a number of tax policy questions. In response, this Article explores fresh approaches to the tax treatment of virtual currency when used as real currency.

Because virtual currencies are not a homogenous group and appear in many different forms,[49] this Article rejects the current rigid definition of currency adopted by the IRS, under which no virtual currency fits. The Article also rejects any new definition of currency that would only include digital currency issued by a central bank or public authority. This Article proposes instead a principle-based taxation scheme in which a number of factors could be applied in a facts-and-circumstances balancing act to answer the ultimate question of whether a particular virtual currency is a property or currency for tax purposes. Such an approach would recognize the "temporarily dynamic" nature of virtual currency; as Justice Breyer has suggested, our

48. *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4.

49. *See* CFI Team, *Types of Cryptocurrency*, CFI, https://corporatefinanceinstitute.com/resources/cryptocurrency/types-of-cryptocurrency/ [https://perma.cc/EPC7-JX24] (last visited Apr. 15, 2025).

understanding of currency must be tested and retested over time.[50] The same holds true for our tax characterizations.

The Article proceeds as follows. Part I provides a brief overview of the tax distinctions among the three major forms of payment—domestic currency, normal property, and foreign currency. These distinctions are the catalyst for ongoing debates over the proper tax treatment of virtual currency when used to transact.

Part II explores three possible methods of taxing virtual currency when used as a payment method—immediate taxation, deferred taxation, and tax exemption. The IRS's adopted tax treatment, immediate taxation in all cases, stems from its arbitrary decision that all virtual currencies are property and no virtual currencies are foreign currencies. Part II argues that immediate taxation raises a number of equity, efficiency, and administrative concerns that could be remedied if a de minimis tax exemption were available for personal purchases using virtual currency like the one currently applicable to personal purchases using foreign currency. Several design options would be available. While continuing to view virtual currency as "property" for tax purposes, for example, the government could start from scratch and craft a new de minimis exemption for personal transactions. Or, while continuing to view virtual currency as "property," it could give virtual currency foreign currency status in limited circumstances (e.g., when an owner used it to personally transact or if the virtual currency met some defined benchmark such as a short-term holding period in the owner's hands).

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50. Wis. Cent. Ltd. v. United States, 585 U.S. 274, 285, 287–88 (2018) (Breyer, J., dissenting) (arguing that the statutory phrase "compensation," defined as "any form of money remuneration paid . . . for services rendered," includes stock options). "[T]he Court suggested that our understanding of these definitions must be tested and retested over time, both from an exclusive and inclusive perspective. Items that are considered a 'medium of exchange' may fall out of favor conversely new commonly accepted mediums may arise." Ted R. Stotzer, *Are Central Bank Cryptocurrencies Currency for U.S. Tax Purposes?*, 165 TAX NOTES 223, 223 (2019) (noting the definition of currency is "temporally dynamic," and exploring CBDCs and their potential effect on the conclusions in I.R.S. Notice 2014-21 regarding what may be considered currency).

Part III proposes, however, a new tax framework—one that attempts to ascertain the true nature of a particular virtual currency and tax it accordingly in all transactions (either under general tax principles governing property or under the special tax rules governing foreign currency). Under a flexible facts-and-circumstances classification regime, some virtual currency would be considered property, which would subject all transactions in such virtual currency to the capital gain and loss rules governing investment property. Others would be considered currency, which would subject all transactions in such virtual currency to the tax rules applicable to foreign currency (including the de minimis personal-use exemption and formulaic basis accounting rules).[51] Thus, while CBDCs or even certain stablecoins (e.g., fiat-backed stablecoins) might be classified as foreign currency under the proposal, Bitcoin too might be deemed currency if and when it achieves certain hallmarks of "currency."

While the Article's proposal may not satisfy a desire for tidiness, it is consistent with established areas of tax law where the true nature of an investment is uncertain. For example, a similar process is employed to determine whether corporate instruments are "debt" or "equity" for tax purposes, both of which are subject to sharply different tax rules. The government has not made some blanket determination that all "hybrid" corporate instruments are debt or all are equity; instead, courts apply a number of criteria to judge the true nature of an instrument. Considering the variations in the types of virtual currency, the article concludes that the absence of a precise standard may be justified as well in the "property" versus "currency" determination.

51. Herzfeld et al., *supra* note 6 (suggesting virtual currency issued by central governments and stablecoins denominated in foreign currencies might be considered real currency).

I. DOMESTIC CURRENCY, NORMAL PROPERTY, AND FOREIGN CURRENCY

While U.S. taxpayers typically use U.S. dollars to transact, they may also use foreign currency or even normal property to purchase goods and services in the economy.[52] As explained in this section, the federal income tax result can vary significantly depending on which form of payment a taxpayer uses—domestic currency, normal property, or foreign currency. While the use of domestic currency (the U.S. dollar) as a medium of exchange presents no major tax issues, complications arise when either normal property or foreign currency is used to purchase goods and services.

A. Domestic (Functional) Currency

For U.S. taxpayers, when U.S. dollars are used to purchase goods or services, the purchaser does not realize any tax gain or tax loss in the transaction.[53] The only U.S. dollars that a taxpayer has to spend are after-tax dollars. Therefore, when a taxpayer buys property with U.S. dollars, she does so with money that has already been subject to tax.[54] For example, $10 in one's bank

52. *See, e.g.*, *Charitable Contribution Deductions*, IRS, https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions [https://perma.cc/LCM7-BZFM] (Aug. 20, 2024) (property used in charitable donations); Robert W. Wood, *What Is a 1031 Exchange? Know the Rules*, INVESTOPEDIA, https://www.investopedia.com/financial-edge/0110/10-things-to-know-about-1031-exchanges.aspx [https://perma.cc/4R66-AVSS] (Dec. 16, 2024) (real-estate swaps); Hung Tran, *Understanding the Growing Use of Local Currencies in Cross-Border Payments*, ATL. COUNCIL (Aug. 25, 2023), https://www.atlanticcouncil.org/blogs/econographics/understanding-the-growing-use-of-local-currencies-in-cross-border-payments/ [https://perma.cc/77TF-PB96] (cross-border transactions).

53. The seller of the goods or services, by contrast, will have tax consequences. *See* I.R.C. § 61(a)(1)–(3) (explaining that gross income includes compensation for services, income derived from business, and gains from dealings in property). *See* Treas. Reg. § 1.61-1(a) (1960) ("Gross income includes income realized in any form, whether in money, property, or services.").

54. I. RICHARD GERSHON & JEFFREY A. MAINE, A STUDENT'S GUIDE TO THE INTERNAL REVENUE CODE 56 (7th ed. 2019).

> This is true even if the government decides not to tax the dollars she uses, through the various exclusions found in the Code. After all, an exclusion simply means that the government has decided not to tax a particular type of income; the income itself was subject to the laws of taxation, although it was not ultimately taxed.

Id.

account represents dollars that have already been taxed at some point by the government. There is no unrealized economic gain or loss lurking in those $10; in tax jargon, we say that cash always has a "basis" equal to its face amount/value.[55] Thus, if a taxpayer exchanges those previously taxed dollars for goods worth $10, no gain or loss results—all that has happened is that she has changed her form of after-tax dollars from cash to property.[56]

The buying power of U.S. dollars may change over time as a result of inflation or other market forces, but that does not change the tax result. In other words, it does not matter tax-wise if a taxpayer is able to use $10 to buy three cups of coffee today or only one cup of coffee three years from now. Furthermore, the actual fair market value of the goods ultimately purchased with the $10 of real-world fiat money may be higher or lower than $10, but that too does not change the tax result. Paying less cash for an item than its fair market value does not generally create taxable gain,[57] and paying more cash for an item than its value does not create a deductible loss.[58]

55. Taxpayers are not taxed on the return of their investment in property. A taxpayer's investment, referred to in the Code as "basis," is determined by Part II of Subchapter O. *See* I.R.C. §§ 1011–1017, 1019, 1021, 1023.

56. Her basis in the property acquired is $10. *See id.* § 1012. If the taxpayer sells the property for $10, she should owe no tax, because all that has happened is that she changed the form of after-tax dollars from cash to property and back to cash. Even if she sells the property for $15, she will still be able to receive her original $10 investment, her basis, tax-free.

57. "The government generally does not require a buyer to report the benefit of a bargain (the true value of the item purchased minus the amount paid for it) at the time of purchase, regardless of whether the buyer knew the purchased item was more valuable than the seller knew." JOHN A. MILLER & JEFFREY A. MAINE, THE FUNDAMENTALS OF FEDERAL TAXATION 25–26 (6th ed. 2023) (summarizing some long-standing administrative practices where the I.R.S. chooses to exclude certain items from income even though such items represent clear accessions to wealth and no statutory exclusion applies to them). An important exception to this government practice exists when a bargain purchase occurs in an employment setting. *See* Treas. Reg. § 1.61-2(d)(2)(i) (as amended in 2003).

58. *See, e.g.*, Fla. Publ'g Co. v. Comm'r, 64 T.C. 269, 275–76 (1975); *see also* Grigsby v. Comm'r, 87 F.2d 96, 97 (7th Cir. 1937); Perkins v. United States, 701 F.2d 771, 775 (9th Cir. 1983).

B. Normal Property

When normal property, as opposed to U.S. dollars, is used to purchase goods or services, a vastly different tax result occurs. That is because the fair market value of the property does not always represent the taxpayer's investment of previously taxed dollars, or "basis," in the property.[59] While a taxpayer's investment, or basis, in property is constant, the value of property can fluctuate over time. In our tax system, those fluctuations in property value are not taxed as they occur but only when they are realized in an identifiable event—i.e., a "sale or other disposition" of the property.[60] The phrase "sale or other disposition" is broad and includes most transactions producing a quid pro quo for the taxpayer, including the exchange of property for other property differing materially either in kind or in extent.[61]

The U.S. government has long taken the position that barter exchanges are taxable.[62] Tax gain or tax loss is based on whether

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59. *See* I.R.C. § 1012.

60. *See id.* § 1001(a) (referring to the "sale or other disposition of property").

61. Treas. Reg. § 1.1001-1(a) (as amended in 2024) ("Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.").

62. *See* Rev. Rul. 79-24, 1979-1 C.B. 60 (ruling a lawyer and housepainter, who were members of a barter club, were both taxed when the lawyer provided legal services to the painter and, in return, the housepainter painted the lawyer's house); *see also* DAVID ELKINS, TAXATION OF BARTER TRANSACTIONS: THEORY, COMBINATION TRANSACTIONS, INTEREST-FREE LOANS 1 (2012) ("For thousands of years, humans have engaged in barter transactions . . . . However, barter transactions are not merely the province of history or fantasy. The twenty-first century is witness to clubs and internet sites dedicated to facilitating barter transactions."). The notion that barters should be subject to immediate taxation stems from the realization requirement in our income tax system. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (defining income as "undeniable accessions to wealth, *clearly realized*, and over which taxpayers have complete dominion" (emphasis added)). *Realization* is generally a prerequisite for income taxation and has important tax applications. *See* MILLER & MAINE, *supra* note 57, at 23. For the leading case on the realization doctrine, *see* Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 566–67 (1991) (holding an exchange of mortgage portfolio for similar mortgage portfolio was a realization event as the exchanged portfolios had different legal entitlements). *But see* Moore v. United States, No. 22-800, slip op. at 2, 4 (S. Ct. June 20, 2024) (upholding a shareholder tax on undistributed income realized by the entity, although not answering whether realization is constitutionally required). It essentially determines the proper timing of taxation by telling us when

the property used to buy the goods or services has appreciated or depreciated in the hands of the buyer. If a taxpayer uses Property A worth $10 to buy Property B worth $10, the taxpayer's gain or loss would depend on how much she paid for Property A. If she paid $10 for Property A, then no gain or loss would be realized on the exchange (the value of Property B received would equal the taxpayer's investment in Property A). But if she paid $6 for Property A, then $4 of previously untaxed economic gain or appreciation lurking in Property A would be taxed upon receipt of Property B.

As can be seen, when property is used to buy goods or services, the "buyer" also wears the hat of "seller" for tax purposes. In the example above, the taxpayer was, in effect, selling Property A to the owner of Property B with consideration received being a non-cash benefit (Property B). That disposition of Property A is a "realization" event that triggered a $4 gain. In the disposition, the taxpayer is permitted to receive back her original $6 investment, her basis in Property A, tax-free, and she is only required to pay tax on the $4 of previously untaxed appreciation in Property A. This is the same result that would occur if the taxpayer first sold Property A for $10 in cash and then used the $10 cash to buy Property B.[63]

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income and deductions should be recorded. For example, increases and decreases in the value of property are not taken into account for tax purposes when they accrue each year, but only when they are realized by a potentially taxable event (e.g., when the taxpayer actually sells, exchanges, or otherwise disposes of the property). *See* Eisner v. Macomber, 252 U.S. 189, 232–33 (1920). There are some statutory exceptions. *See, e.g.*, I.R.C. § 1256(a)(1) (annual mark-to-market requirements); *id.* § 475(f) (providing for a mark-to-market election for taxpayers engaged in a trade or business of trading securities under which gains and losses (including those that result from mere market fluctuations) are taxed as ordinary gains and ordinary losses). The realization requirement gives us consistency, objectivity, and certainty in tax. "The most common modern reasons offered for the realization requirement are (1) liquidity concerns; (2) administrative impossibility of annual valuation of assets; (3) political impossibility of repealing the realization rules; and (4) popular desire to tax capital gains, but not 'paper gains.'" Sergio Pareja, *It Takes a Village: The Problem with Routinely Taxing Barter Transactions*, 59 CATHOLIC U. L. REV. 785, 794 (2010) (citing Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 355–56 (2004)).

63. In either case, the taxpayer's new basis in Property B would be $10. *See* Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 190 (Ct. Cl. 1954) (holding that the taxpayer's basis in property received in a taxable exchange is equal to the fair market value of the property

The hypothetical above is quite simple. In reality, when property is used to purchase goods or services, numerous tax complications can arise. For starters, calculating the amount of gain or loss realized in a property exchange—the difference between the fair market value of the property acquired and the basis of the property exchanged—is not always easy. The valuation of property acquired in a purchase can be quite subjective. Determination of basis in property exchanged requires knowledge of a host of Code provisions that create, limit, or otherwise affect basis in property.

In addition, the taxpayer must determine whether the gain or loss is eligible for tax deferral or tax exemption.[64] As a general rule, the entire gain or loss realized on an exchange of property is recognized (i.e., reportable).[65] In some cases, however, a taxpayer may be eligible to postpone the reporting of gain or loss to a later year. Special deferral rules in the Code are usually based on the rationale that the taxpayer's economic position has not really changed (e.g., the property received in the transaction is simply a continuation of the taxpayer's investment in modified form), but they may also be justified for administrative convenience reasons (e.g., it may be administratively difficult to value property received in an exchange).[66] In addition to

received). This makes sense if we look at the tax consequences to the taxpayer of the exchange. The exchange is a "sale or other disposition of property" and the amount of the taxpayer's "gain realized" is $4, that is $10 "amount realized" (fair market value of Property B received) minus $6 "adjusted basis" (cost of Property A). I.R.C. §§ 1001(a)–(b), 1011, 1012. This $4 gain is part of the taxpayer's cost of Property B. The taxpayer's total cost in Property B is $10—she gave up Property A for which she paid $6, plus she reported gain of $4 in the exchange.

64. With respect to loss recognition, there is an important limitation for individuals established by section 165. This provision disallows the deduction of most losses from dispositions of personal use property. *Id.* § 165(c)(1)–(2). Put another way, section 165 only allows loss recognition, with one exception, for business losses and losses from "any transaction entered into for profit, though not connected with a trade or business." *Id.* There are other provisions, including section 1211 discussed below, that overlay section 165 to further limit loss deduction in a variety of circumstances. *See* discussion *infra* note 72 and accompanying text.

65. I.R.C. § 1001(c).

66. *See, e.g.*, *id.* §§ 351, 721 (providing nonrecognition of gain or loss on the exchange of property for an ownership interest in a corporation or partnership); *id.* § 1031 (providing nonrecogntion of gain or loss on the exchange of certain realty for "like-kind" realty). Nonrecognition provisions merely postpone the reporting of gain or loss to a later year when the property

deferral rules, there are also provisions in the Code that permanently exempt from taxation any gain or loss that is otherwise clearly realized.[67] These so-called "exclusion" rules, which are more favorable than "deferral" rules, usually address some particular congressional concern or achieve some particular goal.[68] It should be noted that both deferral and exclusion provisions are narrowly defined and constitute the exception rather than the general rule.

When property is used to purchase goods or services, the appropriate character of any reportable gain or loss must also be determined. Under general tax principles governing property transactions, a gain or loss is characterized as either *capital* or *ordinary*.[69] Individuals generally prefer gains to be characterized as capital gains as opposed to ordinary since certain capital gains are subject to reduced tax rates.[70] In contrast to gains, individuals tend to prefer that their losses be characterized as ordinary losses because of a statutory limitation on capital loss deductions.[71] Specifically, capital losses can only be used to offset capital gains (plus up to $3,000 of ordinary income) in any given year.[72] The Code contains many provisions governing the character of gains and losses for property transactions, which can be difficult for taxpayers to maneuver.[73] As one example,

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received in the transaction is sold or disposed of in a taxable transaction. Gain or loss is preserved by giving the taxpayer the same basis in the property received as he or she had in the property given up in the transaction. *See id.* §§ 358(a)(1), 1031(d).

67. *See id.* §§ 101–140.

68. *Id.*

69. For summary, see MILLER & MAINE, *supra* note 57, at 275–85.

70. I.R.C. § 1(h).

71. *Id.* § 165(f) ("Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212."). The main reason for the limitation on capital losses is to prevent taxpayers from using capital losses from property transactions to wipe out or shelter ordinary income from other sources. MILLER & MAINE, *supra* note 57, at 276.

72. I.R.C. § 1211(b).

73. For example, under a special rule, taxpayers engaged in a trade or business of trading securities or commodities may elect under section 475(f) to be treated as a "dealer." *Id.* § 475(f). This so-called "mark-to-market" election means that gains and losses (including those that result from mere market fluctuations) are characterized as ordinary gains and ordinary losses. *Id.* Ordinary losses are not subject to the $3,000 capital loss limitation discussed above. *Id.* § 1211(b).

the capital gain preference and the capital loss limitation only apply if the property used to buy goods or services was a so-called "capital asset" in the owner's hands.[74] This determination is not always easy, especially in connection with new versions of property that emerge.[75]

As can be seen, numerous tax complications arise when normal property, as opposed to domestic fiat currency, is used as a medium of exchange to purchase goods or services.

C. Foreign (Nonfunctional) Currency

As noted above, U.S. dollars always have a value that is equal to the basis. This is not necessarily the case with normal property. This is not necessarily the case with respect to foreign currency either. While a taxpayer's investment, or basis, in foreign currency remains constant, the value of foreign currency in relation to the U.S. dollar can fluctuate over time. Thus, when foreign currency is used as a medium of exchange to purchase goods or services, gain or loss realized (referred to as "exchange gain or loss") may arise from that value fluctuation.[76]

One may be tempted to apply the general tax principles governing normal property, discussed above, to foreign currency exchange gain or loss.[77] After all, "foreign currency is treated as personal property—and not as equivalent to the U.S. dollar—

This election is limited in that it applies only to those who engage in a trade or business of trading securities or commodities, which can be difficult to ascertain. *Id.* § 475(f)(A). For a discussion of whether virtual currency transactions qualify for section 475(f) treatment, see *Can Virtual Currency Traders Elect into Special Rules That Allow Current Deductions for Trading Losses?*, MCDERMOTT WILL & EMERY (June 24, 2020), https://www.mwe.com/insights/can-virtual-currency-traders-elect-into-special-rules-that-allow-current-deductions-for-trading-losses/ [https://perma.cc/3HD7-ZF3X].

74. I.R.C. § 1222.

75. The Tax Code defines the term capital asset as all property held by the taxpayer (whether or not connected with a trade or business), subject to certain exceptions. *Id.* § 1221(a). The exceptions cover many types of property, such as inventory and inventory-like property, depreciable or real property used in a trade or business, and self-created property. *Id.* § 1221(a)(1)–(3).

76. *See* Gillin v. United States, 423 F.2d 309, 311 (Ct. Cl. 1970).

77. *See* discussion *supra* Section I.B.

for federal tax purposes."[78] However, the amount, timing, and character of foreign currency exchange gain or loss are not determined under the tax rules governing normal property. Instead, the Code has a number of special rules devoted specifically to the tax treatment of foreign currency gains and losses that must be applied.[79] Under these rules, any foreign currency gain or loss attributable to a "section 988 transaction" must be computed separately and treated as ordinary income or loss.[80]

Specifically, section 988 of the Code states that a taxpayer recognizes foreign currency gain or loss when entering into a "section 988 transaction" denominated in a "nonfunctional currency."[81] A nonfunctional currency is defined for this purpose as currency other than the taxpayer's functional currency.[82] For a U.S. taxpayer, functional currency is the U.S. dollar. The disposition of nonfunctional currency (e.g., the use of foreign currency as a medium of exchange) is a section 988 transaction.[83]

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78. S. REP. NO. 313, at 433 (1985); *Gillin*, 423 F.2d at 311; KVP Sutherland Paper Co. v. United States, 344 F.2d 377, 379 (Ct. Cl. 1965); H.R. Rep. No. 99-426 (1985) (emphasis added) ("When a U.S. taxpayer uses foreign currency as a medium of exchange, gain or loss (referred to as 'exchange gain or loss') may arise from fluctuations in the value of the foreign currency in relation to the U.S. dollar. This result obtains because foreign currency is treated as personal property, and not as equivalent to the U.S. dollar, for federal tax purposes.").

79. I.R.C. §§ 985–989 (Subpart J - "Foreign Currency Transactions").

80. *Id.* § 988(a)(1)(A) ("Except as otherwise provided in this section, any foreign currency gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss (as the case may be)."). For definition of these transactions, see I.R.C. § 988(c)(1)(B)–(C).

81. *Id.* § 988(c)(1) (providing that a section 988 transaction includes one where a taxpayer accrues any income or expense in a nonfunctional currency or disposes of a nonfunctional currency). Foreign exchange gain or loss can arise in the course of a business or investment transaction. It can also arise where foreign currency is acquired for personal use. *See* Rev. Rul. 74-7, 1974-1 C.B. 198 (ruling that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency).

82. Treas. Reg. § 1.988-1(c) (as amended in 2024). Nonfunctional currency is defined to include, "with respect to a taxpayer or qualified business unit [("QBU")], a currency . . . other than the taxpayer's or [QBU's] functional currency as defined in section 985 and regulations thereunder." *Id.*; *see also* I.R.C. § 988(c)(1)(C)(ii). Functional currency means the U.S. dollar or the currency used in the economic environment of a "qualified business unit." I.R.C. § 985(b)(1).

83. *Id.* § 988(c)(1)(C); Treas. Reg. § 1.988-1(a)(1)(i) (as amended in 2024).

To give a simple example, assume that a taxpayer purchases €100 for $110 ($1.1: €1).[84] Shortly thereafter, the exchange rate changes from $1.1: €1 to $1.2: €1, and the taxpayer purchases an asset for €100.[85] It can be hard to see, but the taxpayer has a $10 currency gain when she purchases the asset.[86] The $10 gain is from a *hypothetical exchange* of Euros for dollars—she purchased the Euros for $110 (establishing a $110 basis in those Euros) and then exchanged them for $120, which she is deemed to have used to purchase the asset.[87]

The use of foreign currency (nonfunctional currency) to buy an asset is really treated as a two-step transaction involving (1) the hypothetical exchange of foreign currency for domestic currency at the spot rate on the exchange date, followed by (2) the purchase of the asset with domestic currency.[88] That approach quantifies the exchange gain or loss on the disposition of the foreign currency.[89] These tax results are seemingly similar to those tax results when normal property is used to buy an asset. When a taxpayer uses normal property to acquire a new asset, the taxpayer realizes gain or loss on the barter exchange, just as if the taxpayer sold the old asset first and then used the cash proceeds to buy the new asset.[90]

There are, however, some key tax differences between the two methods of payment—foreign currency and normal property. In short, the differences are in whether gain is exempt from taxation, how gain is computed, and how gain is characterized for tax rate purposes (ordinary gain or capital gain). Each of these is worthy of further treatment here.

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84. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 370.

85. *Id.*

86. Per Professor Chodorow, the initial purchase of foreign currency with USD establishes a USD basis for tax purposes. *Id.* This basis applies to both the original currency purchase and subsequent transactions involving the currency, such as buying assets. *Id.* For further explanation, see Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19.

87. *Id.* at 370 (explaining that this purchase is ordinary income).

88. Treas. Reg. § 1.988-2(a)(2)(ii)(B) (as amended in 2024).

89. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 370.

90. *See id.* at 370–71; *see supra* Section I.B.

Perhaps the most significant difference is that the foreign currency rules have a de minimis exception for taxpayers who spend foreign currency in a personal transaction.[91] Specifically, no gain is recognized by reason of changes in exchange rates if an individual spends foreign currency in a personal transaction unless the gain exceeds $200.[92] The personal-use exemption was enacted to avoid the administrative burdens associated with spending foreign currency on small personal items.[93] As seen earlier, there is no de minimis or personal-use exemption for when normal property, as opposed to foreign currency, is used to buy personal goods or services. Every transaction in which normal property is used to buy goods or services—no matter how small—is a taxable event.

A further tax distinction between foreign currency and normal property is that when foreign currency is used to purchase goods or services, the gain or loss (exceeding $200) is automatically characterized as "ordinary."[94] When normal property is used as a payment method, the gain or loss is characterized as either long-term capital, short-term capital, or ordinary depending on a number of factors, including the nature of the property used in the purchase and the taxpayer's holding period of the property.[95] Thus, if normal property held for investment has declined in value and is used to purchase an asset, the resulting loss on the exchange would be characterized as capital loss (long-term or short-term, depending on how long it was held). Capital losses, in contrast to ordinary losses, are subject

91. I.R.C. § 988(e). Personal transactions are those entered into by individuals for which no deductions under sections 162 or 212 are allocable. *Id.*

92. *Id.* § 988(e)(2)(B)(3) (providing that personal transaction is any transaction other than one where expenses would be deductible as business or investment related).

93. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 391 (citing H.R. REP. NO. 105-148, at 525–26 (1997), reporting on Pub. L. No. 105-34, which added the provision).

94. I.R.C. § 988(a)(1)(A) (noting foreign currency gain or loss from a section 988 transaction is generally treated as ordinary income or loss); *see also* Treas. Reg. § 1.988-3(a) (as amended in 2024).

95. *See supra* Section I.B.

to limitation; they can only be used to offset capital gains (plus up to $3,000 or ordinary income) in any given year.[96]

Another key distinction between foreign currency and normal property relates to how gain or loss is computed. When foreign currency is used to buy an asset, the basis of the foreign currency used must be compared to the value of the foreign currency in U.S. dollars on the purchase date.[97] Similarly, when normal property is used to buy an asset, the basis of the property used must be compared to the value of the asset received in the transaction.[98] In both cases, the basis of what is used in the exchange must be known. The basis of a specific item of property is its original cost.[99] The basis of foreign currency is also its original cost (the U.S. dollars used to buy the foreign currency)[100]; however, the key difference is that foreign currency is fungible and can be commingled in a single account. To determine which foreign currencies are withdrawn and used in the purchase, the regulations have special rules allowing taxpayers to elect any reasonable and consistently applied method so long as it does not lead to the highest-basis currency (leading to the lowest tax gain) being used first.[101] These basis rules applicable to foreign currency leave less room for tax maneuvering than that specific-item basis rule applicable to normal property. Under normal property basis rules, a taxpayer can pick

96. I.R.C. § 1211(b). While investment losses from exchanges of property are limited by the capital loss limitation rule, they are not then subject to further limitation under the deduction hierarchy rules—i.e., they are above-the-line deductions rather than the less favored below-the-line itemized deductions. *Id.* § 62(a)(3); Temp. Treas. Reg. § 1.62-1T(c)(4) (as amended in 1992) (providing investment losses are above-the-line deductions if they result from a "sale or exchange of property" (and certain other transactions)).

97. Recall from above that on the purchase date, there is a hypothetical exchange of the foreign currency for U.S. dollars at the spot rate on the exchange date, which establishes the foreign currency exchange gain or loss. *See* note 84 and accompanying text.

98. *See supra* Section I.B.

99. I.R.C. § 1012.

100. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 371.

101. Reasonable methods include FIFO, LIFO, and pooling. *See id.* (noting that "a method that ensures that the highest basis currency is used first, that is, one that ensures the lowest possible currency gains, will not be considered reasonable," but also acknowledging that "taxpayers can easily accomplish this banned result by depositing different batches of currency into separate accounts and then spending money from the account with the highest basis").

and choose which specific property to spend (most likely, property with the highest basis to minimize tax gain) in the acquisition of goods or services.[102] Under the formulaic basis rules for commingled foreign currency, taxpayers are limited in their ability to do so.[103]

II. TAXATION OF VIRTUAL CURRENCY WHEN USED TO PURCHASE GOODS AND SERVICES

The U.S. government had several options when deciding on an appropriate tax scheme for virtual currency transactions—immediate taxation, deferred taxation, and tax exemption. The government chose, through administrative decision, the immediate taxation method when it (1) took the position that virtual currency is property, not currency, for purposes of gain and loss recognition under the Code, and (2) failed to consider tax deferral or exemption options. This section explains the challenges with the immediate taxation method and explores policy alternatives—specifically, tax deferral and tax exemption.

A. Challenges with the Current Approach—Immediate Taxation

The IRS decided that virtual currency is not currency and, hence, cannot be subject to the special U.S. income tax regime governing foreign currency gains or losses discussed above.[104] Thus, the special rules in that regime do not govern the amount, timing, or character of gains and losses when virtual currency is used as a medium of exchange.

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102. *See, e g., id.* Basis of an asset is generally the specific cost of that particular asset. I.R.C. § 1012.

103. Allowing taxpayers to choose their own basis formula (LIFO v. FIFO) does give them some discretion. Taxpayers can also avoid these basis rules by keeping separate batches of foreign currency in separate accounts. *See, e.g., id.*

104. *See supra* Section I.C (reviewing tax rules governing foreign currency transactions). *See also* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 (Q&A-2) ("Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes."). The IRS described convertible virtual currency as "[v]irtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency . . . ." *Id.* at § 2. The IRS later clarified that virtual currency does not include a representation of the U.S. dollar or a foreign currency. Rev. Rul. 2019-24, 2019-44 I.R.B. 1004.

Instead, the IRS decided that general tax principles governing property should govern all virtual currency transactions. As a result, the use of any virtual currency to acquire goods or services gives rise to a taxable event for the buyer/owner—no matter whether the taxpayer is buying a cup of coffee, a nonfungible token, or a house.[105] The purchase of property with virtual currency is really viewed as a taxable barter transaction in which one property (virtual currency) is exchanged for another property.[106] The amount of taxable gain or deductible loss is based on whether the virtual currency used to buy the property has appreciated or depreciated in the hands of the buyer.[107]

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105. Christine Deveney, *Tax Treatment of Individual Owners of Bitcoin and Other Virtual Currencies Held for Personal Use or Investment*, TAX ADVISER (June 1, 2018), https://www.thetaxadviser.com/issues/2018/jun/tax-treatment-individual-owners-bitcoin-other-virtual-currencies-personal-use-investment.html [perma.cc/7ASK-7PJA]; Avi-Yonah & Salaimi, *supra* note 43, at 4 ("[E]very transaction in which crypto is exchanged for other crypto used to acquire goods, services, or fiat money becomes a taxable realization event."). For a proposal that income and wealth within the Metaverse should be subject to immediate taxation, see Young Ran (Christine) Kim, *Taxing the Metaverse*, 112 GEO. L.J. 787, 787 (2024).

106. As one commentator described,

> [p]urchases paid for with virtual currency are treated as two transactions: (1) disposing of the virtual currency and (2) spending the dollar equivalent amount. In effect, this requires virtual currency users to calculate a gain or loss every time they make a purchase—no de minimis exception applies (as for personal transactions of less than $200 under Sec. 988(e)).

Deveney, *supra* note 105. Another commentator explained:

> Think of it this way: if an individual invests $15,000 in a digital asset and it grows in value to be worth $200,000 a few months later, and if they want to purchase a home with that asset but the seller doesn't accept crypto directly, they will have to convert it in U.S. dollars and potentially pay capital gains tax on the conversion. If the seller accepts cryptocurrency, the same treatment applies, except the step of first converting the digital asset is eliminated.

K.M. Jennings, *A Virtual Currency Taxation in Individual Real Estate Transactions*, 177 TAX NOTES FED. 709, 710 (2022) (exploring the tax ramifications for individuals purchasing a home with cryptocurrencies).

107. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 (Q&A-6) (noting that upon an exchange of virtual currency for other property, the taxpayer will have gain if the value of the property received in the exchange exceeds the taxpayer's adjusted basis of the virtual currency, and the taxpayer will have loss if the value of the property received is less than the adjusted basis of the virtual currency); *see* Lee A. Sheppard, *Tax Treatment of Crypto Loans and Shorts*, 175 TAX NOTES FED. 335, 336 (2022) [hereinafter Sheppard, *Tax Treatment of Crypto Loans*] ("If you use virtual currency to pay for your latte, you have taxable gain."). NFTs are typically purchased using virtual currency, not cash. Because virtual currency is considered property by the IRS, the "purchase" of an NFT is considered to be a barter transaction in which loss may result (if the crypto used to buy the NFT depreciated in the hands of the taxpayer/buyer). *Id.*

Other tax issues, such as those related to timing and character, are governed, as well, under general tax principles applicable to normal property.[108]

The application of general tax principles to virtual currency—when used as a convenient, alternative payment method for personal goods and services—raises a number of tax policy questions.

1. Equity and Efficiency Concerns

Under the current approach—immediate taxation—virtual currency that has *increased in value* and is used to buy goods or services is at a disadvantage relative to foreign currency (i.e., currency that has risen relative to the U.S. dollar because of fluctuating currency exchange rates) used for similar purposes. That is because individuals are required to recognize gain in *personal virtual currency* transactions in all cases. In contrast, they are not required to recognize exchange gain in *personal foreign currency* transactions (unless the gain exceeds $200).[109] In other words, the de minimis exclusion provided for personal gains from foreign currency transactions does not apply to exchanges of virtual currency.[110]

In addition, virtual currency that has *declined in value* is not treated similarly to foreign currency, the value of which has declined relative to the U.S. dollar.[111] That is because virtual currency losses are often classified as capital losses rather than ordinary losses and, thus, are subject to statutory limitation (i.e., they are allowed in a given year only to offset capital gains, if any, plus $3,000 or ordinary income).[112] Foreign currency exchange losses, in contrast, are classified as more favorable ordinary losses, which are not so limited. As noted by one commentator, virtual currency traders, unlike foreign currency traders,

108. *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 (Q&A-6).

109. I.R.C. § 988(e); *see* discussion *supra* Section I.C.

110. *See* ROB MASSEY & CONNOR O'BRIEN, BNA PORTFOLIO 190-2ND: TAXATION OF CRYPTOCURRENCIES AND OTHER DIGITAL ASSETS § IV(A)(3)(c) (2024).

111. *See* Nguyen & Maine, *supra* note 26, at 1148 & n.217.

112. *See id.* at 1156.

"can lose twice—once in the decline in value and again at tax time."[113]

In short, those who use virtual currency as a form of payment are at a disadvantage relative to those who use real foreign currency as a form of payment, regardless of whether the virtual currency has *appreciated* or *depreciated* in value. This raises potential equity concerns.[114] In an ideal tax system, if owners of virtual currency and foreign currency were viewed as similarly situated or engaged in economically equivalent activities, then they should be taxed in the same manner.[115] This begs the question of whether the two forms of payment are different enough to justify different tax treatment, or whether they are similar enough to suggest potential problems with the tax system.[116] Is there really a difference between an individual who chooses to use Bitcoin tokens as a convenient, trendy, preferred payment method for a cup of coffee and an individual who, on vacation in France, goes to the ATM machine and gets some Euros to conveniently buy a latte? Current tax law treats these

113. McCullum, *supra* note 40, at 867–68 ("Tax law allows for taxation of the full amount of any capital gain, but capital losses are limited to capital gains plus $3,000. As a result, large losses are carried forward, often for years." (citation omitted)).

114. *See* Schwartz, *supra* note 38, at 769 (describing the de minimis exception for personal foreign currency transactions and concluding "[i]t seems inequitable . . . to require individuals to recognize capital gain or loss when they use virtual currency to buy a cup of coffee").

115. Tax fairness is usually described in terms of "horizontal equity." *See* Jeffrey H. Kahn, *The Mirage of Equivalence and the Ethereal Principles of Parallelism and Horizontal Equity*, 57 HASTINGS L.J. 645, 647–48 (2006). Horizontal equity requires that persons who are similarly situated should be taxed in a similar fashion. *Id.* A related concept of equity is that economically equivalent activities should be taxed in the same manner even if they differ in form. *Id.* at 645, 647–48 (using the term "parallelism" for the proposition that "the same or equivalent receipts, expenditures or losses should be treated the same by the tax law"; non-parallelism "results in disparate tax treatment of taxpayers who occupy similar positions"); Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, 16 VA. TAX REV. 39, 49 (1996) (using the term "uniform taxation,'' which rests on the concept of horizontal equity, "to refer to tax treatment in accordance with some general approach . . . without any differentiation as to type of income or type of taxpayer,'' and using the term "nonuniform taxation" to refer "to tax rules that vary by type of income or type of taxpayer").

116. "It is important to emphasize that horizontal equity is concerned with individuals who are 'similarly situated,' not with those who are 'identically situated.'" David Elkins, *Horizontal Equity as a Principal of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 44 (2006) ("Tautologically, any conceivable tax arrangement will treat identically situated taxpayers equally. . . . Taxpayers are similarly situated when their situations are considered equivalent.").

individuals differently.[117] The tax distinction arguably lacks theoretical justification, suggesting legislative or administrative changes may be warranted. At a minimum, the government should establish a sound basis for making the tax distinction as horizontal equity remains an important principle of tax theory.[118]

Efficiency concerns, in addition to equity concerns, might also be raised.[119] The immediate taxation method, which stems

117. This Article focuses on taxpayers who own and use virtual currency as a medium of exchange (and not for pure investment reasons). There are also differences in the tax treatment of those who own virtual currency for investment and those who own foreign currency for investment. Gains and losses from the sale of virtual currency held for investment must be reported as capital gain or loss, whereas gains and losses from foreign currency investments are reported as ordinary gains or losses. There are similarities, however, in the tax treatment of virtual currency investors and foreign currency investors. For example, regulated futures contracts—including both Bitcoin futures and option contracts, as well as foreign currency contracts—are subject to the tax rules in section 1256. I.R.C. § 1256 (providing specific rules for "section 1256 contracts," which are investment options (e.g., futures contracts and options on futures)). These traders are required to use so-called mark-to-market accounting, and they are required to report 60% of gain as long-term capital gain and 40% as short-term capital gain. *See* Nicholas C. Mowbray, *Are Positions in Virtual Currency Subject to the Timing and Character Rules of Section 1256? If so, When and What is the Impact?*, LUKKA, https://lukka.tech/are-positions-in-virtual-currency-subject-to-the-timing-and-character-rules-of-section-1256-if-so-when-and-what-is-the-impact/ [https://perma.cc/P792-ZMRC] (last visited Apr. 15, 2025) (stating "only Bitcoin futures and options contracts constitute Section 1256 Contracts" but "other virtual currencies (in particular Ehtereum) may constitute commodities"; noting further that "the CFTC [("Commodities Futures Trading Commission")] anticipates that additional virtual currency derivatives will be traded on the U.S. markets in the near future"). Forex traders (foreign exchange traders) are generally taxed under section 1256 of the Code, meaning 60% of forex gains and losses are treated as long-term capital gains or losses and 40% are treated as short-term capital gains or losses, regardless of how long the trade was pending. I.R.C. § 1256(a)(3)(A)–(B). So-called spot forex traders can opt, however, to be taxed according to section 988 of the Code, meaning gains or losses are treated as ordinary. *Id.* § 988(a)(1)(A). Before beginning trading, forex traders must decide which tax path they prefer and cannot later change their election. Treas. Reg. § 1.988-1(a)(7)(iv)(A) (as amended in 2024). In contrast to forex gains and losses, virtual currency gains and losses are treated as capital gains or losses. Virtual currency owners do not get to choose their preferred taxation method. *Id.* It should also be noted that traders in virtual currency may be able to elect into the special tax rules found in section 475(f) of the Code to receive ordinary income and loss if virtual currency transactions qualify as "securities" or as "commodities" (the more likely scenario) and trading activities rise to the level of trading. *Can Virtual Currency Traders Elect into Special Rules that Allow Current Deductions for Trading Losses?*, *supra* note 73.

118. Kahn, *supra* note 115, at 645.

119. Efficiency is an important feature of tax policy. *See* Zolt, *supra* note 115, at 63. The tax system should generate enough money for the government to do its job without distorting economic behavior. *Id.* ("Efficient taxes should distort as little [as] possible."); MICHAEL J. GRAETZ

from the IRS's classification of virtual currency as property, potentially distorts economic behavior by encouraging the use of traditional fiat currency and discouraging the use of innovative payment methods such as virtual currency.[120] Indeed, consumer advocates have argued that declaring and taxing virtual currency as property "could dissuade people from using the currency" in light of the burden of tracking gain or loss on every transaction, and they argue that treating virtual currency as a currency could increase its use as a medium of exchange.[121] The IRS, however, stands by its position that the virtual currency-as-property approach will not hinder virtual currency's use on a daily basis for purchases.[122] This disagreement likely stems from the differing views of virtual currency's principal function—a medium of transaction or an investment asset held for appreciation.[123] Without agreement over the function of virtual currency, any governing tax regime adopting one view over the other will inevitably lack neutrality—i.e., unnecessarily shape economic behavior.[124] Faced with taxation every time a purchase is made with virtual currency, taxpayers will likely opt instead to transact with real fiat currency (domestic or foreign) to achieve more favorable tax results.

& DEBORAH H. SCHENK, FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES 29 (6th ed. 2009) (stating that efficiency requires that a tax interfere as little as possible with people's economic behavior); Elkins, *supra* note 116, at 47 (stating that efficient taxes minimize deadweight losses caused by taxpayer actions to reduce tax burden by choosing courses of action that minimize tax).

120. *See* McCullum, *supra* note 40, at 867–68.

> Arbitrarily declaring that bitcoin is property—as the IRS has done—ignores several significant issues that can hurt taxpayers, the government, or both . . . . In fact, the current IRS position *will* inhibit the use of Bitcoin as a medium of transaction . . . . [T]he IRS will likely take the position that *any* Bitcoin kept in a virtual wallet is an investment and therefore a capital asset. Consequently, every time a purchase is made from a bitcoin wallet, the taxpayer will have to determine whether it results in capital gain or loss, which will serve to deter bitcoin transactions and hinder its use as a medium of transaction.

Id.

121. *See id.* at 869.

122. *Id.* at 868 (quoting Keith Aqui, one of the IRS Notice's principal drafters).

123. *Id.* at 869. For usage as a medium of exchange, it is argued, current tax treatment is inappropriate. *Id.*

124. *See, e.g.*, MILLER & MAINE, *supra* note 57, at 25.

In addition to potentially distorting economic behavior, the current tax rules governing virtual currency arguably hamper innovation and stifle beneficial economic activity. Some commentators, however, ultimately question the need for a government subsidy.[125] Omri Marian fails to see any "serious normative argument" that would justify government subsidy to help the virtual currency space.[126] According to Marian, taxation hasn't been shown to impede blockchain innovation: "To argue for government subsidy for an investment that is designed to deny government control of monetary policy and that may facilitate crime, one has to point to a significant benefit for society that outweighs these major detriments."[127] Adam Chodorow has argued: "the government has little interest in promoting Bitcoin's adoption as an alternate currency. While Bitcoin offers many benefits to users, including enhanced security and eliminating the need for costly third-party intermediaries, such as banks, it also opens the door to potential tax evasion and may facilitate other illegal activities."[128]

Proponents of the crypto space view the crypto economy as an ideal, innovative system for the internet age—one that is fair, assessable, efficient, and transparent.[129] The crypto economy is accessible, not just to the sophisticated, but to millions of people who may not have access to traditional financial services. Indeed, recent studies have shown that populations historically

125. *See* Omri Marian, *Law, Policy, and the Taxation of Block Awards*, 175 TAX NOTES FED. 1493, 1494 (2022).

126. *Id.* at 1504.

127. *Id.* (evaluating current taxation of block rewards).

128. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 389 (arguing that another reason the government may not want to facilitate virtual currency is that it is quite volatile; questioning "whether the government should facilitate the use of something so volatile, especially among a population lacking the resources to hedge its risks to absorb losses that might arise").

129. *Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States: Hybrid Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. app. at 145 (2021) (testimony of Alesia Haas, Chief Executive Officer, Coinbase, Inc.) (providing ten key benefits of virtual currency, including access, individual ownership, enhanced transparency, increased resiliency, efficiency, lower transaction costs, continuous operation, creator control, new ways to interact with assets, and micro-transactions).

underrepresented in the traditional finance system are turning to the crypto economy to find avenues that put them on even ground with other investors.[130] Further, when virtual currency, instead of fiat currency, is used as a payment method, users may "pay lower transaction fees and achieve faster transfer of funds."[131] There are benefits for merchants and retailers as well. Many retailers who accept virtual currency as a payment instrument have seen a positive impact on their business's customer metrics (such as customer-based growth and brand perception).[132] Accepting virtual currency as payment is not just a marketing technique. Many merchants see real economic benefits such as speed of payments and cost efficiencies.[133]

While virtual currency offers many benefits to both consumers and merchants, there are some drawbacks. As noted above, some commentary focuses on how the use of virtual currency

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130. *Id*. (citing Perrin, *supra* note 21). "This stands in stark contrast to the traditional financial system where Black and Hispanic communities are underrepresented." *Id.* (citing Stan Choe, *Stocks Are Soaring, and Most Black People Are Missing Out*, YAHOO FIN., https://finance.yahoo.com/news/stocks-soaring-most-black-people-163013743.html [https://perma.cc/J5LF-HD3S] (Oct. 12, 2020, 12:30 PM)).

131. *Closing the Tax Gap: Lost Revenue from Non-Compliance and the Role of Offshore Tax Evasion: Hearing Before the Comm. on Fin. Subcomm. on Taxation and IRS Oversight*, 117th Cong. 7 (2021) [hereinafter *Closing the Tax Gap Hearing*].

> A Cryptocurrency transfer might have a "gas fee," which is basically the cost to use the digital asset . . . . These are lower than a traditional wire transfer fee. This is enticing to some looking to save in that area by using cryptocurrency. The major factor that makes this possible is the conversion speed that can take an individual's digital assets and convert them into fiat currency such as the U.S. dollar or the euro.

Jennings, *supra* note 106, at 711 (describing benefits of using virtual currency to buy a home). These fees vary based on network load and infrastructure, but outside of extreme peaks, they are normally "rounding errors" for expensive mainstream coins like Bitcoin. Anders Bylund, *How Much Are Cryptocurrency Transaction Fees*, MOTLEY FOOL, https://www.fool.com/investing/stock-market/market-sectors/financials/cryptocurrency-stocks/transaction-fees/ [https://perma.cc/3SZT-MMUV] (Jan. 16, 2025); Spencer Tierney, *Wire Transfer Fees: What Banks Charge*, NERDWALLET, https://www.nerdwallet.com/article/banking/wire-transfers-what-banks-charge [https://perma.cc/6THC-9FX8] (Jul. 11, 2024) (finding that outgoing international wires can exceed $50 in fees).

132. *See* CASTRO TANCO, DELOITTE DIGITAL CURRENCY PAYMENTS SURVEY, *supra* note 23, at 6 ("[Merchants] expect to derive value from their digital currency adoption in three distinct ways: improved customer experience, increased customer base, and perception of brand as cutting edge.").

133. *See id*. at 7 ("86% [of merchants] see a significant benefit to their finance and cash management for accepting digital currency payments.").

may allow anonymity in transactions and the possibility of avoiding tax reporting obligations—through willful or non-willful conduct.[134] Another drawback is virtual currency's recent price volatility, which can be a problem for taxpayers "lacking the resources to hedge its risks or absorb losses that might arise."[135] But these legitimate concerns are being addressed by the government and industry. The government is moving forward with new regulations and reporting tools to capture tax avoidance and evasion.[136] New forms of virtual currency are being introduced to address price volatility concerns.[137]

Whatever one's view, it could be argued that domestic economic growth will likely suffer if the government does not consider an "intuitive taxation scheme" to facilitate the inevitable worldwide adoption of virtual currency as a form of payment.[138] As noted earlier in this paper, foreign governments are

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134. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 387 (arguing that "the lack of regulation and ability to conduct anonymous transactions without third-party intermediaries opens the door to possible criminal behavior secrecy, and tax evasion"); *see also Closing the Tax Gap Hearing*, *supra* note 131, at 38 ("Taxation compliance risks can arise from willful conduct by a taxpayer (*e.g.*, using virtual currency to evade taxes) or nonwillful conduct (*e.g.*, lacking an understanding of the taxability of virtual currency transactions, calculation of gain/loss from virtual currency transactions, characterization of income, third-party reporting responsibilities)."). With all that said, as crypto becomes more and more of a known commodity, some groups have claimed the uniquely open nature of block chains actually presents an opportunity for more transparency. *See, e.g.*, *Is Bitcoin Traceable?*, CHAINANALYSIS (Apr. 11, 2022), https://www.chainalysis.com/blog/is-bitcoin-traceable/ [https://perma.cc/P2XK-NFZN] (arguing that, while the transactions are all pseudo-anonymized, all movements and recipients' wallet addresses are publicly available if you have the background to read blockchain data).

135. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 388–89 ("Another reason that the government may not want to facilitate Bitcoin is that it is quite volatile.").

136. *See, e.g.*, Press Release, IRS, Non-Payment of Federal Income Tax on Cryptocurrency Earnings Leads to Conviction for South Florida Resident (Oct. 3, 2022), https://www.irs.gov/compliance/criminal-investigation/non-payment-of-federal-income-tax-on-cryptocurrency-earnings-leads-to-conviction-for-south-florida-resident [https://perma.cc/E7NQ-E4UB]; Sophia Kielar & Samidh Guha, *The Future of Crypto Regulation: What Is FIT 21?*, REUTERS (Sept. 20, 2024), https://www.thomsonreuters.com/en-us/posts/government/crypto-regulation-fit-21/ [https://perma.cc/VL3L-HNTB] (discussing the current legislative plan to address crypto jurisdiction and regulation); *Is Bitcoin Traceable?*, *supra* note 134 (reflecting the industry's effort to regulate itself in an attempt to gain mainstream acceptance).

137. *See supra* notes 26–32 and accompanying text.

138. Johnson, *supra* note 14, at 1597.

beginning to recognize virtual currency as real currency.[139] While U.S. businesses are beginning to embrace virtual currencies as a form of payment, many have yet to invest in the systems and infrastructure to do so.[140] And, as long as individuals are subject to a cumbersome tax regime every time a purchase is made using virtual currency, U.S. businesses are unlikely to make the necessary investment. Unfortunately, if businesses "are ill-equipped to accept cryptocurrencies as a form of payment—especially in international business . . . domestic economic growth will likely suffer."[141]

2. Administration and Compliance Problems

While it is debatable whether immediate taxation raises sufficient equity and efficiency concerns to warrant tax law change, there is likely greater consensus that the immediate taxation method is not administratively practical.

a. Taxpayer Compliance Challenges

Taxpayers who use virtual currency as a transactional currency face significant compliance challenges. With little guidance from the IRS, taxpayers must perform burdensome computations to account for the change in the value of virtual currency from the time acquired to the time spent—more specifically; they must determine the basis of the specific virtual currency exchanged and the value of the property acquired, both of which can be difficult to ascertain.[142] They must also

139. *See supra* notes 10–15 and accompanying text.

140. *See supra* notes 16–23 and accompanying text.

141. Johnson, *supra* note 14, at 1597.

142. McCullum, *supra* note 40, at 867 (arguing current classification requires taxpayers "to keep a record of every purchase made and to perform burdensome calculations to account for the changing value of a bitcoin"); D. Larry Crumbley, Joseph Wall, Lewis B. Kilbourne & Caleb Blair, *Cryptocurrencies Are Taxable and Not Free From Fraud*, 158 TAX NOTES 225, 227 (2018) (imagining "the difficulty of taxpayers keeping track of every gain or loss on each transaction if they use digital money the same way they use cash, credit cards, or checks"); Avi-Yonah & Salaimi, *supra* note 43, at 74 ("[T]he [IRS's] view that cryptocurrency should always be taxed as an asset is wrong because it is unadministrable. Under the agency's view, every time a taxpayer uses crypto to buy a cup of coffee, she must calculate her basis in that particular token and pay tax on the gain.").

determine the character of any gain or loss, which can also be a difficult determination. They then need to figure out how to self-report the gain or loss on their tax returns,[143] maneuvering through "complex and unclear tax reporting requirements."[144] After all of that, they may have trouble finding funds to pay tax on the "paper" gains since cash was not received in the purchase. Each of these practical difficulties for taxpayers warrants further treatment here.

To calculate gain or loss when virtual currency is exchanged for goods or services, one must determine and use the value of the goods or services received (and not the value of the virtual currency exchanged).[145] In third-party transactions, one might presume that the value of goods or services received would equal the value of the virtual currency used in the exchange. That is not always the case. Virtual currency prices can fluctuate quickly and significantly, making valuation complex on any given transaction date.[146] Even "exchange platforms may have different prices for the same virtual currency."[147] And those

143. *See* IRS, *Digital Assets*, *supra* note 1.

144. McCullum, *supra* note 40, at 867 (arguing current classification "requires consumers, businesses, and service providers to maneuver through complex and unclear tax reporting requirements").

145. I.R.C. § 1001 (determining gain or loss by reference to the "amount realized" in the exchange, which is the fair market value of the property received in the exchange); *see Frequently Asked Questions on Virtual Currency Transactions*, IRS [hereinafter IRS, *Frequently Asked Questions*], https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions [https://perma.cc/A67N-FBJH] (Jan. 7, 2025) ("How do I calculate my gain or loss when I exchange my virtual currency for other property?").

146. *See* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 41. Stablecoins, which are virtual currencies claimed to be backed by fiat currencies, present less valuation problems. Tether ("USDT") is an example of a stablecoin pegged to the U.S. dollar. The Libra stablecoin, introduced by Facebook, is presented "as a global currency 'designed and governed as a public good,' and backed by a reserve of 'high quality liquid assets' including fiat currencies and short-term government securities. Such a reserve of assets should preserve its intrinsic value and ensure the stability of its price over time." *Id.* at 46.

147. *Id.* at 41 (describing common challenges in taxing virtual currencies).

prices can fluctuate even over a short time frame.[148] The IRS has provided limited guidance on valuing virtual currency.[149]

The value of the item received must be compared against the basis of the virtual currency used.[150] The basis of virtual currency used to buy goods or services is not always easily determinable. Keeping track of basis requires records of purchase, a difficult task if a taxpayer's wallet includes different types of virtual currencies or includes the same types purchased for different prices at different times. The IRS states that a taxpayer may choose which units of virtual currency are deemed to be used for the purchase of goods if a taxpayer "can specifically identify which unit or units of virtual currency are involved in the transaction and substantiate [their] basis in those units."[151]

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148. *Id.*

149. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 ("If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars . . . at the exchange rate, in a reasonable manner that is consistently applied."). Recent guidance on the IRS website provides that convertible virtual currency ("CVC") received through an exchange has a fair market value equal to the amount recorded on the ledger in U.S. dollars or the amount the virtual currency was trading for on the exchange at the time the transaction would have been recorded on the ledger. *See* IRS, *Frequently Asked Questions*, *supra* note 145. If the virtual currency was received in a peer-to-peer transaction, the IRS will accept as evidence of fair market value the value determined by a blockchain explorer that analyzes worldwide indexes of convertible virtual currency and calculates the value at an exact date and time *Id.* If an explorer value is not used, the taxpayer must establish that the fair market value of the virtual currency is accurately represented. *Id.* If the virtual currency is not traded on any exchange and does not have a published value, then the fair market value of the virtual currency received is equal to the fair market value of the property or services exchanged. *Id.*

150. *See supra* Section I.B.

151. *See* IRS, *Frequently Asked Questions*, *supra* note 145. According to the IRS:

> [A taxpayer] may identify a specific unit of virtual currency either by documenting the specific unit's unique digital identifier such as a private key, public key, and address, or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet, or address. This information must show (1) the date and time each unit was acquired, (2) [the] basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged or otherwise disposed of, and (4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.

Id. The government's identification rules for virtual currency follow those applicable to stocks or bonds. *See* Treas. Reg. § 1.1012-1(c)(2) (as amended in 2024) (allowing taxpayers to specify which lots of stocks or bonds they are deemed to sell in a written

If a taxpayer cannot identify specific units of virtual currency used to acquire goods or services, then the units are deemed to have been used in chronological order, based on the "first in, first out" ("FIFO") accounting principle.[152] Because of these obvious challenges in determining basis, the IRS is apparently "looking to external vendors for the tools that will help not only trace but establish basis" on digital asset transactions.[153] Until such tools are in place, taxpayers may struggle to compute proper gain and loss amounts.

Even if a taxpayer can maneuver through these hurdles to compute a gain or loss figure, he or she must then determine whether that gain or loss is eligible for tax deferral or exemption.[154] While immediate taxation is the norm,[155] the Code provides some exceptions of which taxpayers may not be aware. To give an example, if a taxpayer transferred Bitcoin (with a basis of $10,000) to a corporation or partnership in exchange for an ownership interest in such entity (with a fair market value of $15,000), none of the taxpayer's $5,000 gain realized would have to be recognized currently.[156] As another example, if a taxpayer transferred Bitcoin to a spouse or former spouse incident to divorce, no gain or loss is required to be recognized currently,

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notation made at the time of sale or under an acknowledged standing order given to a broker); Treas. Reg. § 1.1012-1(c)(1)(i) (as amended in 2024) (first in, first out).

152. IRS, *Frequently Asked Questions*, *supra* note 145. For inventory accounting, accountants use one of two conventions known as FIFO and LIFO. FIFO (first in, first out) assumes that the first items purchased are the first ones sold. LIFO (last in, last out) assumes that the most recently purchased items are the first ones sold. The choice of inventory accounting methods will affect the amount of gain or loss in any given year. However, over time, differences will even out as items with different bases are sold. *See* MILLER & MAINE, *supr*a note 57, at 234–36.

153. David van den Berg, *IRS Crafting Digital Asset Payment Reporting Form*, LAW360 (June 24, 2022, 6:05 PM), https://www.law360.com/tax-authority/articles/1505456/irs-crafting-digital-asset-payment-reporting-form [https://perma.cc/4JWG-WSDY].

154. With respect to loss recognition, there is an important limitation for individuals established by section 165. This provision disallows the deduction of most losses from dispositions of personal use property. Put another way, section 165 only allows loss recognition, with one exception, for losses from dispositions of business or investment property. I.R.C. § 165(c)(1)–(2). There are other provisions, including section 1211 discussed below, that overlay section 165 to further limit loss deduction in a variety of circumstances.

155. *See id.* § 1001(c).

156. *See id.* §§ 351, 721.

regardless of whether the taxpayer is using the Bitcoin to buy something from the spouse or settle their respective property rights.[157] In each of these particular examples, the reporting of gain would not be permanently excluded but would be postponed until a later year, such as when the taxpayer sold the company stock or the transferee spouse sold the Bitcoin.[158]

If tax deferral or tax exemption is not available, the tax analysis is not over. The appropriate "character" of that gain or loss must be determined.[159] In contrast to foreign currency transactions, which generally produce ordinary gains and ordinary losses,[160] virtual currency transactions can produce either ordinary gains and losses or capital gains and losses depending on a number of factors, including the nature of the property.[161] For most taxpayers, virtual currency is a capital asset.[162] This means that their gains are taxed at preferential rates (if the virtual currency was held for over a year), and their losses are subject to the capital loss limitation rule—both of which require a special IRS Form.[163]

In sum, taxpayers who use virtual currency as a transactional currency face significant compliance challenges—the burden of recordkeeping, calculating tax liabilities correctly,

157. *See id.* § 1041(a).

158. Gain is preserved by giving the taxpayer the same basis in the stock received as he had in the Bitcoin given up in the transaction and by giving the transferee spouse the same basis the transferor spouse had in the Bitcoin. *See id.* §§ 358(a)(1), 1041(b)(2).

159. *See supra* Section I.B. For general treatment of the requirement, see MILLER & MAINE, *supra* note 57, at 25.

160. I.R.C. § 988(a)(1).

161. *See* IRS, *Digital Assets*, *supra* note 1.

162. I.R.C. § 1221 (defining "capital asset" as all property except for a few limited categories).

163. *Topic No. 409, Capital Gains and Losses*, IRS, https://www.irs.gov/taxtopics/tc409 [https://perma.cc/7CC4-5TH9] (Jan. 2, 2025). While investment losses from exchanges of virtual currency for goods or services are limited by the capital loss limitation rule, they are not then subject to further limitation under the deduction hierarchy rules—i.e., they are above-the-line deductions rather than the less favored below-the-line itemized deductions. *See* I.R.C. § 62(a)(3); Temp. Treas. Reg. § 1.62-1T(c)(4) (as amended in 1992) (providing investment losses are above-the-line deductions if they result from a "sale or exchange of property" (and certain other transactions)).

and declaring or reporting information via tax returns on time without adequate guidance on these matters.[164]

b. IRS Enforcement Challenges

The IRS faces significant tax enforcement challenges as well.[165] Historically, there has been a lack of robust third-party information reporting in place in which exchange platforms would be responsible for both recordkeeping and transmitting information to virtual currency owners (to help them with compliance) and to the IRS (to help with enforcement).[166] In 2020, the Treasury Inspector General for Tax Administration issued a report acknowledging that "[t]he IRS cannot easily identify taxpayers with virtual currency transactions because of the lack of third-party information reporting that specifically identifies virtual currency transactions."[167] The use of virtual currency allows anonymity in transactions and the possibility of avoiding tax reporting obligations.[168] This can contribute substantially to the annual gross tax gap (the amount of tax liability not paid voluntarily and timely).[169] The IRS recognizes this; indeed, the

164. *See* IRS, *Digital Assets*, *supra* note 1.

165. TREASURY INSPECTOR GEN. FOR TAX ADMIN., VIRTUAL CURRENCY TAX COMPLIANCE ENFORCEMENT CAN BE IMPROVED 1 (2024).

166. *Id.* at 5.

167. IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 10. *See* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 42 ("[T]o promote both simplicity for taxpayers and improved compliance, a framework by which exchange platforms are also responsible for both recordkeeping and for transmitting information to the domestic tax authorities, may be advantageous.").

168. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 387.

169. *IRS: The Tax Gap*, IRS, https://www.irs.gov/statistics/irs-the-tax-gap [https://perma.cc/UWR5-JN8G] (Mar. 21, 2025). "Thanks to the burden of compliance and lack of taxpayer education, there is a monumental tax gap (the difference between taxes paid and taxes owed) attributable to [convertible virtual currency]." Jesse C. Hubers, *Everything We Know—and Don't—About Taxing Cryptocurrency*, 178 TAX NOTES FED. 1699, 1709 (2023). A rough estimate in 2019 placed the tax gap at about $11.5 billion. IRS, INFORMATION REPORTING ADVISORY COMMITTEE PUBLIC REPORT 31, 65 (2018). "In early 2021, IRS Commissioner Charles Rettig said the total tax gap might be as high as $1 trillion and attributed much of it to [convertible virtual currency.]" *See* Hubers, *supra*, at 1709 (citing *The 2021 Filing Season and 21st Century IRS: Hearing Before the S. Comm. on Fin.*, 117th Cong. (2021) (statement of Charles Rettig, Commissioner of the IRS)); Alexander Rifaat, *Digital Assets Could Imperil Government Budgets, Says Watchdog*, 177 TAX NOTES 279, 280 (2022) (discussing $1 trillion revenue loss from digital asset

IRS Commissioner has emphasized that "unreported cryptocurrency gains are an IRS enforcement priority for the agency."[170]

Without a broad and substantial third-party information reporting system in place, the government has taken other necessary enforcement steps.[171] The IRS, for example, has increased its enforcement efforts by seeking to serve John Doe summonses on several cryptocurrency exchanges to discover noncompliant taxpayers.[172] Federal prosecutors recently made the first public indictment of an individual who underreported gains from a $4 million legitimate sale of Bitcoin.[173] The IRS has also invested in artificial intelligence and data-analysis-based tools to trace and track virtual currency transactions.[174]

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tax avoidance and noting "insufficient resources to address problems related to cryptocurrencies and similar technologies"); *see also* IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 1.

170. Joshua Rosenberg, *Easement Abuse an IRS Enforcement Priority, Rettig Says*, LAW360 (Nov. 14, 2019), https://www.law360.com/tax-authority/articles/1219874/easement-abuse-an-irs-enforcement-priority-rettig-says [https://perma.cc/W2DV-WPCW].

171. The government could impose tax penalties for those who do not properly report the income tax consequences of virtual currency transactions. Taxpayers could even be subject to criminal prosecutions. *See, e.g.*, IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 3.

172. *See, e.g.*, *In re* John Does, No. 3:16-cv-06658 (N.D. Cal. Nov. 17, 2016) (granting the IRS's application to serve a John Doe summons on Coinbase, Inc. under section 7609(f)).

173. Indictment at 3–4, United States v. Ahlgren, No. 24-cr-00031 (W.D. Tex. Feb. 6, 2024); *see* Kat Lucero, *First Purely Tax Crypto Indictment Signals More on Tap*, LAW360 (Feb. 14, 2024) https://www.law360.com/articles/1796503/first-purely-tax-crypto-indictment-signals-more-on-tap [https://perma.cc/5NH8-SLR8]; *see also* Treasury Inspector Gen. for Tax Admin., *Virtual Currency Enforcement Needs Improvement, TIGTA Says*, TAX NOTES (July 10, 2024) [hereinafter Treasury Inspector Gen. for Tax Admin., *Virtual Currency Enforcement Needs Improvement*], https://www.taxnotes.com/research/federal/other-documents/treasury-reports/virtual-currency-enforcement-needs-improvement-tigta-says/7kh1d [https://perma.cc/TA5G-B3ZD] (noting the IRS Criminal Investigation division, in years 2018-2023, investigated 390 cases involving virtual currency; 224 cases were completed with a prosecution recommendation).

174. *See* Jonathan Curry, *Info Reporting Regime Sets Up IRS Crypto Crackdown*, TAX NOTES (Sept. 26, 2022), https://www.taxnotes.com/featured-news/info-reporting-regime-sets-irs-crypto-crackdown/2022/09/23/7f61d [https://perma.cc/6SCL-T85X] (noting AI and data-analysis-based tools provided by companies like Palantir and blockchain-scanning platforms like Chainalysis); *see also* Garrett L. Brodeur, *New Crypto Tax Question Foreshadows IRS Enforcement Priorities*, 176 TAX NOTES FED. 1571, 1571–73 (2022) (noting the amended 2022 crypto question is conveniently structured to facilitate an enforcement shift and noting: "The IRS Criminal Investigation division has already invested in multiple technologies necessary to trace and track cryptocurrencies, and it has thus far successfully participated in the prosecution of many large-

Moreover, to get taxpayers to self-report, a virtual currency question was added at the top of Form 1040, asking whether taxpayers have engaged in digital asset transactions.[175] The question now focuses not only on the acquisition and ownership of virtual currency but also the taxable disposition of virtual currency (which includes "exchanges" of virtual currency for goods or services), "underscor[ing] the IRS's increasing focus on taxable events."[176] However, the question does not reach into the specific nature and extent of the transactions, which would help the IRS better understand the tax compliance risks associated with digital asset transactions.[177]

Despite these enforcement efforts, third-party information reporting is needed to close the information gap with respect to virtual currencies.[178] Because virtual currency is classified as property, a payment made using virtual currency is already subject to withholding requirements and information reporting to the same extent as any other payment made in property.[179] Still, without additional clear reporting obligations imposed on all third-party virtual currency exchanges, the IRS will not be

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scale money laundering cases involving digital assets") (citing IRS Pub. 3583, IRS-CI Ann. Rep. 2021, at 8 (Rev. 11-2021)).

175. *See IRS Form 1040, U.S. Individual Income Tax Return*, IRS, https://www.irs.gov/forms-pubs/about-form-1040 [https://perma.cc/JZB3-YNHZ] (Jan. 30, 2025). The question replaces the term "virtual currency" with "digital asset," a term that was recently added to the Code, but surprisingly has not once appeared in the IRS's formal guidance on the taxation of virtual currency. Brodeur, *supra* note 174, at 1572 (noting the change is "likely intended to encompass various innovations, such as non-fungible tokens (NFTs) and synthetic assets that do not fall neatly with the IRS's traditional definition of virtual currency"); *see* Lauren Loricchio, *IRS Data Shows Sharp Rise in Reporting of Crypto Transactions*, 177 TAX NOTES FED. 1290, 1290 (2022) ("The number of individual tax returns that were checked 'yes' in response . . . jumped by roughly 150 percent in tax year 2020 over the previous year . . . .").

176. Brodeur, *supra* note 174, at 1572.

177. IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 3.

178. *See, e.g.*, OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 43.

179. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 (Q&A-12). Thus, Form 1099-MISC is required when virtual currency of $600 or more is paid in settlement of services provided by a business (i.e., if the value of virtual currency paid to an independent contractor exceeds $600, it must be reported to the IRS and the payee on Form 1099). *Id.* (Q&A-13). "Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee." *Id.* (Q&A-14). Form W-2 and payroll withholding are required when virtual currency is paid as wages. *See* Deveney, *supra* note 105.

able to "easily identify taxpayers with virtual currency transactions."[180]

As a general proposition, third-party information reporting does yield results—tax compliance is much higher when third-party information reporting is provided to the IRS.[181] There has been some movement toward enhanced information reporting for virtual currency transactions, including a newly released Form 1099-DA ("Digital Asset Proceeds From Broker Transactions").[182] But still, there has been much confusion over information reporting forms required of virtual currency exchanges.[183]

Historically, traditional "brokers" have been required to file Form 1099-B ("Proceeds from Broker and Barter Exchange Transactions") to report transactions on behalf of customers.[184] Interestingly, the reporting requirement was enacted in the 1970s to target barter exchanging companies; they must report exchanges informing their clients that bartering is taxable.[185] Some virtual currency exchanges have issued Form 1099-B.[186]

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180. IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 10. The OECD has also pushed for third-party reporting by exchange platforms. *See* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 43 ("[T]o promote both simplicity for taxpayers and improved compliance, a framework by which exchange platforms are also responsible for both record-keeping and for transmitting information to the domestic tax authorities, may be advantageous.").

181. IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 2 (finding that non-compliance rates have increased, to as high as 55%, as third-party reporting requirements have lessened across property types).

182. *See* I.R.C. § 6045(a); *id.* § 6050W(a); I.R.S. News Release IR-2024-204 (Aug. 9, 2024).

183. Christopher Burks, *Bitcoin: Breaking Bad or Breaking Barriers?*, 18 N.C. J.L. & TECH. 244, 255–56 (2017); *see also* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938, § 4 (Q&A-12).

184. I.R.C. § 6045(a) (setting the basic requirements of broker reports); *id.* § 6045A(a)–(b) (extending those requirements to broker-to-broker transactions); *see* Nicole Mirjanich, *Digital Money: Bitcoin's Financial and Tax Future Despite Regulatory Uncertainty*, 64 DEPAUL L. REV. 213, 242 (2014); *see also* Burks, *supra* note 183, at 255–56 ("[T]he Coinbase CEO suggested in a public press release that rather than regulating by asking Coinbase to turn over all customer records, the IRS should simply require virtual currency exchanges to issue customers a Form 1099-B like brokers do . . . .").

185. *See* Pareja, *supra* note 62, at 805 (citing I.R.C. § 6045).

186. Michelle Legge, *Crypto 1099 Form: 1099-K vs. 1099-B vs. 1099-MISC*, KOINLY, https://koinly.io/blog/crypto-1099-k-1099-b-1099-misc/ [https://perma.cc/3DUL-ESXK] (Mar. 10, 2025) (noting companies, such as Uphold and Bittrex and Robinhood, who have indicated they will issue 1099-B forms).

The form, however, requires brokers to report gains from a capital asset on behalf of a client, which is impossible for virtual currency exchanges if they do not have the cost basis of a given crypto asset (i.e., if the virtual currency used to transact was acquired from a different account).[187] If a taxpayer transferred virtual currency into her crypto exchange wallet to trade it on that platform, the exchange does not know the price she paid for the virtual currency as she bought it elsewhere.[188] That is information needed for the form.[189]

In 2021, Congress passed legislation that amends the definition of "broker" to potentially include virtual currency exchanges.[190] It clarified and expanded how digital assets should be reported by brokers under these provisions in order to improve tax administration and compliance with respect to digital asset transactions—i.e., requiring cryptocurrency brokers to begin tracking and reporting their customers' crypto transactions in order to report those transactions to the IRS.[191] While the law's tax reporting requirements stated that taxpayers should begin receiving 1099s, the Treasury Department announced in late 2022 that such brokers would not have to track customers' transactions until final regulations were issued.[192] In

187. *Id.*

188. *Id.*

189. *Id.*

190. *See* Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, § 80603, 135 Stat. 429, 1339–40 (2021).

191. *Id.* at 1339–40. The legislation did a number of things. It clarified the definition of "broker" in section 6045(c)(1) to include any person who, for consideration, "is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." *Id.* at 1340. It modified the definition of "specified services" subject to basis reporting under section 6045(g) to include digital assets. *Id.* And it clarified that transfer statement reporting under section 6045A(a) applies to transfers between brokers of covered securities that are digital assets and added a new information reporting provision for certain transfers under section 6045A(d). *Id.* In response to the legislation, the IRS created a new information form, Form 1099-DA, which is designed to be used by brokers now that regulations under section 6045 have been finalized. I.R.S. News Release IR-2024-204 (Aug. 9, 2024).

192. I.R.S. Announcement 2023-2 (Jan. 17, 2023) ("Brokers will not be required to report or furnish additional information with respect to dispositions of digital assets under section 6045, or issue additional statements under section 6045A, or file any returns with the IRS on transfers of digital assets under section 6045A(d) until those new final regulations under sections 6045 and 6045A are issued.").

July 2024 final regulations were released regarding the reporting by brokers on dispositions of digital assets in certain transactions.[193] An updated version of the new form, Form 1099-DA ("Digital Asset Proceeds from Broker Transactions"), reflects final regulation changes for broker reporting for certain digital asset transactions that take place in 2025.[194]

Another information reporting regime the government has attempted to utilize in the past is the one applicable to credit card companies and third-party settlement organizations ("TPSOs").[195] Historically, TPSOs have been required to file Form 1099-K ("Payment Card and Third Party Network Transactions") to report certain payments made in settlement of third-party network transactions.[196] Specifically, payment processors must provide information to the IRS about customers who receive payments (paid via a third-party network) for the sale of goods and services above the reporting threshold in a calendar year.[197] The IRS advised crypto exchanges that certain third parties who settle payments made in virtual currency on behalf of merchants that accept virtual currency from their customers should report payments to those merchants on Form 1099-K.[198] Coinbase and other large exchanges began issuing 1099-K forms in 2018.[199]

There are limitations, however, with the TPSO reporting regime. First, there are certain thresholds for issuing a Form 1099-K. The Form 1099-K historically was required to be filed only for customers with more than 200 transactions in a year that

193. *See generally* T.D. 10000, Treas. Dec. Int. Rev. (applying to transactions after January 1, 2025); 89 Fed. Reg. 56480 (July 9, 2024); I.R.S. News Release IR-2024-204 (Aug. 9, 2024).

194. I.R.S. News Release IR-2024-204 (Aug. 9, 2024).

195. *See* I.R.C. § 6050W.

196. *See id.* (requiring payment settlement entities to issue Form 1099-K statements to payees who meet the criteria of I.R.C. § 6050W(e); specifically, requiring any "payor," or payment settlement entity, making one or more payments to a participating payee in settlement of "reportable payment transactions," to annually file Form 1099-K with the IRS reporting the gross amount of reportable payment transactions for the year as well as the name, address, and taxpayer identification number of the participating payees).

197. *Id.*

198. I.R.S News Release FS-2024-12 (Apr. 2024); Legge, *supra* note 186.

199. Legge, *supra* note 186.

total in excess of $20,000.[200] Due to tax law changes in 2021, however, the reporting threshold was to be dropped dramatically to $600 or more in gross sales from goods or services in the year.[201] But that change has been delayed more than once.[202] In addition, Form 1099-K shows gross proceeds but not the actual taxable amount of gains and losses.[203] As a result, the Form 1099-K issued by virtual exchanges may be inaccurate or contain incomplete information.[204] Many virtual currency exchanges, like Coinbase and Binance, started using the Form 1099-MISC instead of 1099-K.[205]

Subjecting businesses that provide for the exchange of virtual currencies to information transaction reporting is generally accepted as a good thing by both the crypto industry and the government.[206] According to one blockchain analyst, new third-party information reporting would be "an important step toward maturity for the market," which would benefit the industry and the government.[207] According to another commentator,

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200. *See id.*; I.R.C. § 6050W(e)(1) (setting the threshold to 200 or more transactions of at least $20,000 in prior version of statute). These apply to payments made through online intermediaries. I.R.C. § 6050W(a), (b)(3); *see* IRS CAN IMPROVE TAXPAYER COMPLIANCE, *supra* note 17, at 5–7 (citing the new section 6050W and noting that TPSOs are required to file Form 1099-K when exceeding $600 or more in gross sales from goods or services in the year—a stark departure from the 2018 law).

201. *See* American Rescue Plan Act of 2021, Pub. L. No. 117-2, § 9674, 135 Stat. 4, 9 (2021). The threshold change, introduced in the American Rescue Plan Act of 2021, set the threshold for section 6050W at the lower $600 amount. *Id.* at 185.

202. *See* I.R.S. News Release FS-2023-27 (Nov. 2023); Kate Dore, *IRS Delays Tax Reporting Rule Change for Business Payments on Apps Such as Venmo and PayPal*, CNBC (Nov. 21, 2023, 4:07 PM), https://www.cnbc.com/2023/11/21/irs-delays-rule-change-for-1099-k-on-venmo-paypal-business-payments.html [https://perma.cc/HJ58-FWNE]. The IRS announced it was phasing in the new threshold, and that taxpayers would not receive the form until at least 2026. *Id.*

203. Miles Brooks, *1099-K for Crypto Taxes: Investor's Guide 2024*, COINLEDGER https://coinledger.io/blog/what-to-do-with-your-1099-k-from-coinbase-gemini-or-gdax-for-crypto-taxes [https://perma.cc/M637-J79E] (last visited Apr. 16, 2025).

204. *Id.*

205. *Id.* (noting some exchanges have switched from the 1099-K form to the 1099-MISC form).

206. *Introduction to Cryptocurrency Exchange Compliance*, CHAINALYSIS (Nov. 21, 2024), https://www.chainalysis.com/blog/introduction-to-cryptocurrency-exchange-compliance-crypto-businesses-2024/ [https://perma.cc/7YWU-SSXE].

207. Roger Brown works for Chainalysis, a block chain tracing company supporting investigative efforts. *See id.*; Curry, *supra* note 174, at 105 (quoting Roger M. Brown).

"The third-party reporting of cryptocurrency transactions . . . could revolutionize the IRS's efforts to combat tax evasion of digital assets" and "introduce accountability to a system of transacting that is otherwise largely self-reported."[208]

However, third-party information reporting requirements for exchanges, including guidance on which 1099 forms exchange companies should be issuing to their customers, will not solve all problems. Forms designed to report capital gains and losses will be plagued with inaccuracies due to basis determination concerns.[209] Indeed, even the new draft Form 1099-DA, which is set to replace some of the 1099 forms currently used by virtual currency exchanges, will not require basis reporting in all cases (i.e., basis reporting will be limited to dispositions of virtual currency from the same account in which it was acquired).[210] Further, the forms will not catch all transactions on the exchange market as there are a myriad of secondary markets; these secondary markets may lack systems for tracking value and cost basis, "leading to problems with tax reporting (for the seller or purchaser)."[211] How does the IRS find out about a taxpayer who holds virtual currency somewhere off the platforms, like in cold storage? Putting virtual currency in cold storage "is much like when people used to burry money in their backyard."[212] Every virtual currency transaction is electronically recorded on a public ledger.[213] However, because of the public/private key feature, virtual currency can be transferred anonymously.[214] It is also worth repeating that even with third-

208. Curry, *supra* note 174, at 105–06.

209. Brooks, *supra* note 203.

210. *Draft Tax Forms*, IRS, https://www.irs.gov/draft-tax-forms [https://perma.cc/Q3ZE-H2NU] (Oct. 8, 2024) (listing instructions for 1099-DA).

211. McCullum, *supra* note 40, at 868.

212. Curry, *supra* note 174, at 107.

213. Avi-Yonah & Salaimi, *supra* note 43, at 13–14.

214. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 388 ("While many will use third-party intermediaries and those intermediaries can collect information on their clients, those seeking anonymity can achieve it by interacting directly with others. In such cases, the only way the government will learn about [virtual currency] income is if taxpayers self-report, something unlikely from those seeking anonymity.").

party information reporting, taxpayers may simply not have the liquidity to pay tax on their paper gains when using virtual currency to buy goods and services.[215]

In sum, there are numerous administration and compliance problems with the current immediate taxation approach. The apt question in the present context is "where the line of administrative practicality should be drawn lest the [IRS] concern itself with costly and almost insoluble problems of measurement and enforcement."[216] Administrative practicality concerns are a legitimate and valid reason to deviate from the norm that all virtual currency exchanges should be taxable. When viewed pragmatically, an exception rooted in practical concerns, including basis and valuation difficulties and liquidity issues (as opposed to theoretical concerns), is worthy of consideration. The following considers two possible exceptions: tax deferral and tax exemption.

B. Policy Alternatives—Tax Deferral and Tax Exemption

1. Tax Deferral

An alternate method of taxing virtual currency is a method that would defer taxation until a later time. In other words, even though the use of virtual currency as currency is treated as a taxable barter exchange of property, Congress could choose to defer tax until a later time (e.g., the disposition of the asset acquired with the virtual currency). The deferral method would likely have to be explicitly adopted by Congress and not come through some IRS administrative exception to immediate taxation.[217]

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215. Bryan T. Camp, *The Play's the Thing: A Theory of Taxing Virtual Worlds*, 59 HASTINGS L.J. 1, 32–33 (2007) ("[I]n the absence of cash, taxpayers may not understand they have reportable income and, if they do understand, may have difficulty in setting aside cash from other transactions to pay the resulting tax. Thus, when bartering is done informally and directly between taxpayers, there may be a high level of noncompliance in reporting the income received.").

216. *See* Mark A. Haskell & Joel Kauffman, *Taxation of Imputed Income: The Bargain Purchase Problem*, 17 NAT'L TAX J. 232, 232 (1964) (addressing the taxation of imputed income).

217. Although, a current administrative tax exemption for bargain purchases would have the same effect as tax deferral. *See* discussion *infra* Section II.B.2.

Congress has enacted a number of tax exceptions that defer the reporting of gain or loss realized in a transaction to a later date.[218] These so-called non-recognition provisions, which are often narrowly defined, usually address valuation or liquidity concerns but are also based on the rationale that the taxpayer's economic position has not really changed (i.e., the taxpayer has not cashed in her chips).[219] It should be emphasized that non-recognition provisions do not permanently exclude gain but merely postpone the reporting of gain or loss to a later year when the property received in the transaction is sold or disposed of in a taxable transaction. Gain or loss is preserved by giving the taxpayer the same basis in the property received as he or she had in the property given up in the transaction.[220]

One of the most prominent of these nonrecognition provisions is section 1031, which grants non-recognition to so-called "like-kind" exchanges of certain property.[221] Due to a 2017 law change, section 1031 applies only when a taxpayer exchanges business or investment real property for like-kind business or investment real property.[222] Virtual currency is not eligible for deferral under section 1031 since like-kind exchanges are now restricted to real estate.[223] Prior to 2017, when the rule was not restricted to realty, some taxpayers took the position that an exchange of virtual currency for some other form of virtual currency could be treated as a tax-deferred, like-kind exchange under section 1031.[224] The IRS concluded, however, that none of the presented virtual currencies were eligible for like-kind exchanges—noting that Bitcoin and Ethereum were

218. *See, e.g.*, I.R.C. §§ 1031, 1045.

219. *See, e.g.*, *id.* § 1031 (applying only to exchanges of real property held for business or investment).

220. *See, e.g.*, *id.* § 1031(d) (providing the basis of property received in a section 1031 like-kind exchange is determined by reference to the basis of property given up in the exchange).

221. *Id.* § 1031(a).

222. *Id*. (incorporating the law change in Pub. L. 115-97, 131 Stat. 2054 (2017)).

223. *Id.*

224. Memorandum No. 202124008 from Ronald J. Goldstein, Off. of Chief Couns. IRS, to Michael Fiore (June 18, 2021) (rejecting taxpayers' question if cryptocurrencies qualify for deferral under previous regulations).

fundamentally different "because of the difference in overall design, intended use, and actual use."[225]

While current tax deferral regimes do not apply, tax deferral for virtual currency used as a transactional currency could be justified on several grounds, many of which parallel the reasons for the exemption of bargain purchases from taxation.[226] Tax deferral would allow taxpayers to use their virtual currency as currency without immediate complex tax computations (e.g., determining the value of property acquired, the amount of gain or loss realized, the character of that gain or loss, etc.). Tax deferral would avoid taxpayers having to pay tax on "paper gains" that produced no means of payment. Deferral would put compliant and noncompliant taxpayers on equal footing—neither would be subject to current taxation; current taxation of barter transactions, in contrast, is unfavorable to compliant taxpayers but favorable to noncompliant taxpayers since private barter transactions are virtually undetectable by law enforcement.[227] Deferral could be justified as creating economic efficiency since the current taxation of barter exchanges severely impacts taxpayers' willingness to use their virtual currencies to buy goods or services.[228]

To minimize the impact on the public fisc, tax deferral could be limited. For example, it could be applied only if virtual currency was held by the taxpayer for less than a year (or a shorter period), which makes it look more like real currency rather than an investment asset held for appreciation in value. Moreover, deferral could be available only if that virtual currency was

225. *Id.*; *see also* Sheppard, *Tax Treatment of Crypto Loans*, *supra* note 107 (summarizing Rev. Rul. 82-166, 1982-2 C.B. 190 as "[w]hy would anyone argue otherwise? Gold bullion isn't the same as silver bullion"). *But see* Reuven S. Avi-Yonah, *Now You Have It, Now You Don't: Taxing Crypto, Part 1*, 183 TAX NOTES 1795, 1798 (2024) (arguing for tax-free treatment of crypto-to-crypto transactions, specifically amending section 1031 to include cryptocurrencies).

226. *See* discussion *infra* Section II.B.2.

227. *See* Pareja, *supra* note 62, at 801.

228. *See* ELKINS, *supra* note 62, at 3 (giving the example of corporate mergers, which benefit from tax-deferred, non-recognition rules: "Were the appreciation of property exchanged in a merger be subject to tax, it is reasonable to assume that mergers would rarely be undertaken. The resultant economic inefficiency would not be balanced by any benefit to the public fisc.").

used to acquire goods or services for personal consumption (under the theory that section 1031 already addresses business and investment property exchanges).[229] If the acquisition of property using virtual currency qualified for nonrecognition, any gain or loss would be deferred until the sale of that property (e.g., for real fiat currency).[230]

A tax deferral rule limited to *personal* property barter exchanges is not a novel idea.[231] With that said, policymakers would have to weigh the benefits of a formal deferral method against its cost and consider whether a formal deferral method is preferable to formal exemption or even less formal administrative approaches like those considered below.[232] A significant obstacle of the deferral method is that the basis of the item purchased with virtual currency would be the same basis of the virtual currency exchanged in order to preserve inherent gain or loss until the item is sold or otherwise disposed of. As noted earlier, determining the basis of virtual currency can be challenging. This would not be a problem if virtual currency was exchanged for a personal item to be consumed by a taxpayer and not for something to be later sold. But then, this begins looking more like a tax exemption method of dealing with virtual currency.

2. Tax Exemption

Another possible method of dealing with virtual currency used for transactions is a partial or full exemption from taxation. The government, administratively or through congressional acts, has on numerous occasions chosen to exempt or partially exempt certain items from taxation despite such items

229. *See supra* text accompanying notes 218–25.

230. *See id.* (discussing section 1031 deferrals, which actualize only once the property is converted to a currency).

231. *See* Pareja, *supra* note 62, at 815 (proposing that personal property exchanged for other property should receive nonrecognition treatment).

232. *See generally* Leigh Osofsky & Kathleen DeLaney Thomas, *The Surprising Significance of De Minimis Tax Rules*, 78 WASH. & LEE L. REV. 773 (2021) (providing a framework for making these evaluations and suggesting particular considerations that should apply in specific contexts).

representing clear accessions to wealth with no statutory exclusions.[233] Tax exemption is often justified based on based on valuation, timing, liquidity, and administrative problems—the same problems plaguing virtual currency used to transact.[234]

The tax exemption method for virtual currency transactions could be achieved through formal congressional approval or through less formalized administrative means. Tax exemption could mean full exemption or partial exemption, and it could be permanent or temporary—i.e., temporarily halting full taxation when virtual currency is used as a transactional currency. Temporary tax exemption is not a new concept. A prime example is the tax exemption that is afforded to the internet—specifically the Internet Tax Freedom Act, which placed a moratorium on any new federal, state, or local taxes on the internet.[235] A similar moratorium could be placed when virtual currency is used as real currency to support it as innovative technology until alternative tax policy choices have been fully considered.[236]

a. Administrative Discretion

i. Nontaxable Imputed Income Theory

The IRS could exercise its administrative discretion and not tax virtual currency transactions. One justification for administrative exemption, albeit weak, might be that the use of virtual currency to acquire a benefit (goods or services) resembles a form of nontaxable *imputed income*.[237] For as long as we have had an income tax, the IRS has never attempted to tax imputed income, which is generally thought of as economic savings

233. *See id*.

234. *See* discussion *infra* Section II.A.2.

235. Internet Tax Freedom Act, Pub. L. No. 105-277, §1101(a), 112 Stat. 2681, 2723 (1998).

236. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 368 (citing as an example, the Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681 (1998)).

237. *See* Donald B. Marsh, *The Taxation of Imputed Income*, 58 POL. SCI. Q. 514, 514 (1943) (examining the basis for taxation of imputed income, either non-cash or income in kind).

attributed to the value of labor or property taxpayers perform or produce for themselves.[238]

One might attempt to argue that we should treat the exchange of virtual currency for real-world property or services as a form of imputed income.[239] Everyone agrees that a homeowner who spends $50 on seedlings, compost, and fertilizer in May to grow her own tomatoes in her backyard will have nontaxable imputed income when she eats the fully grown tomatoes in October then worth $75. Could the same nontaxable imputed income theory be used for a homeowner who buys $50 worth of Bitcoin in May and spends the Bitcoin on $75 worth of tomatoes at a local farmer's market in October? In both cases, the homeowner made a $50 investment with the hopes of receiving $75 in tomatoes at some point; in both cases, the homeowner derived a $25 benefit from her own property. And an argument could be made that both activities are merely substitutes for leisure and it would be unfair to tax them even if it were possible to do so.[240]

There are several problems with the nontaxable imputed income theory. For starters, the use of virtual currency as currency doesn't meet the generally accepted definition of imputed income.[241] Imputed income generally arises from property that taxpayers "create for their own use or consumption."[242]

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238. RICHARD SCHMALBECK, LAWRENCE ZELENAK & SARAH B. LAWSKY, FEDERAL INCOME TAXATION 117 (5th ed. 2018) ("The language of [section 61] seems broad enough to encompass imputed income, and no other code provision expressly excludes impute income from gross income. Nevertheless, the de facto exclusion is as old as federal income tax.").

239. *See* Adam S. Chodorow, *Ability to Pay and the Taxation of Virtual Income*, 75 TENN. L. REV. 695, 728 (2008).

240. *See* Haskell & Kauffman, *supra* note 216, at 234 (discussing imputed income and noting "since it is obviously impossible to tax the estimated value of leisure time and since many of these activities are merely substitutes for leisure, it might well be inequitable to tax them, even if it were possible to do so").

241. *See, e.g.*, Marsh, *supra* note 237, at 514 (defining imputed income as "a flow of satisfactions from durable goods owned and used by the taxpayer, or from goods or services arising out of the personal exertions of the taxpayer on his own behalf").

242. Marian, *supra* note 125, at 1499 (explaining why block rewards are correctly taxable upon receipt as a matter of law). *But see* Abraham Sutherland, *Phantom Income and the Taxation of New Cryptocurrency Tokens*, 178 TAX NOTES FED. 669, 675 & n.34 (2023) ("[P]roperty need not

Property does not, however, have to be created to give rise to untaxed imputed income, the classic example being the fair rental value of an owner-occupied home, however acquired.[243]

An argument could be made that the *use value* of virtual currency is a form of imputed income—the *imputed interest income from investing in a substitute for consumer durable goods*. Still, it would be hard to argue that exchanging virtual currency for a different asset meets the traditional understanding of imputed income excluded from taxation.

Further, there is clearly a difference between nontaxable imputed income (satisfaction from property owned and used by a taxpayer) on the one hand and taxable barter exchange transactions (exchange of property for property differing materially in kind) on the other. It is widely accepted that if a taxpayer grows and consumes her own tomatoes, she has untaxed imputed income. But, if she trades those tomatoes for her neighbor's squash, she will have taxable gain (a clear realization event producing taxable gain equal to the value of her neighbor's squash less the cost of harvesting the tomatoes). Simply exchanging imputed income in one's hands for imputed income in another's hands does not convert the gain into imputed income. In our example, the taxpayer, "by engaging in barter, entered the market, received real income, and under current tax law must be subject to taxation."[244]

The exchange of virtual currency, viewed as property, for fiat currency, different virtual currency, or goods and services is a realization event—a prerequisite for taxation under *Glenshaw Glass*.[245] The IRS has ruled that some virtual currency

be created by the taxpayer to give rise to untaxed imputed income. The textbook example of imputed income is the rental value of an owner-occupied home. If you build a house yourself, finishing the construction isn't a taxable event, and regardless of how you acquired the home, the imputed income from living in it rent-free wouldn't accrue until you actually live in it rent-free.").

243. *See* Steve R. Johnson, *Don't Tax Imputed Income from Owner-Occupied Houses*, A.B.A SECTION OF TAX'N NEWSQ., Winter 2013, at 17, 17.

244. *Id. See generally* Pareja, *supra* note 62, at 798 (arguing that "true barter transactions, whether formal or informal, generally are taxable under current law").

245. *See supra* note 62 and accompanying text.

transactions are *not* realization events. For example, an airdrop is not a taxable realization event that results in taxable income—it is an accession to wealth, but it does not meet the realization prong of *Glenshaw Glass*.[246] Similarly, a cryptocurrency blockchain upgrade (the conversion of the Ethereum blockchain from a proof-of-work consensus mechanism to a proof-of-stake consensus mechanism) is not a taxable realization event (i.e., a realization event does not occur for existing cryptocurrency in a blockchain when the blockchain undergoes changes to its consensus mechanism for adding new transactions).[247] However, if and when the benefits and burdens of ownership of these new tokens are transferred, a realization event occurs. The IRS suggests an actual exchange of units would be a realization event.[248]

When virtual currency is used as currency, the transaction results in the receipt of property that is materially different from the virtual currency being transferred. The exchanged properties—virtual currency on the one hand, and a cup of coffee, a magazine subscription, or a new car on the other—are not mere economic substitutes but are legally distinct. Under general tax

246. Rev. Rul. 2019-24, 2019-44 I.R.B. 1004. In contrast, the IRS has concluded that cryptocurrency staking rewards are realized accessions to wealth "in the taxable year in which the taxpayer gains control and dominion over the rewards." Rev. Rul. 2023-14, 2023-33 I.R.B. 1. *But see* David L. Forst & Sean P. McElroy, *The Creation of Property Through Staking*, 175 TAX NOTES FED. 2033, 2034 (2022); Sutherland, *supra* note 242, at 669 (arguing that cryptocurrency staking rewards should not be taxable when they are created). For the argument that entering into a liquidated staking arrangement should not constitute a realization event, see David L. Forst, Sean P. McElroy & Matthew L. Dimon, *Blockchain Tax Principles and New Guidance*, 179 TAX NOTES 1165, 1169 (2023) (arguing "the act of staking a token and receiving a corresponding liquidity token should not constitute a realization event").

247. Memorandum No. 202316008 from Alexa T. Dubert, Off. of Chief Couns. IRS, to Michael Fiore 3–4 (Apr. 21, 2023) [hereinafter Alexa Dubert Mem.] (concluding the existing crypto units "remain unchanged by the protocol change and there is not an exchange of the units . . . under section 1001"). For commentary, see Forst et al., *supra* note 246, at 1165 (arguing that the IRS's conclusions "are consistent with basic and long-standing tax principles"); Mary Katherine Browne, *No Tax Consequences from Crypto Protocol Changes, IRS Says*, 179 TAX NOTES FED. 872 (2023).

248. Alexa Dubert Mem., *supra* note 247, at 4 (noting that with a blockchain upgrade, "there is not an exchange of units . . . under section 1001 . . . . and the protocol upgrade does not result in a realization event from which [taxpayer] realizes gain or loss on [taxpayer's] existing . . . units").

principles, the exchange is a barter realization event.[249] A recent Tax Court case involving a non-virtual currency matter supports this notion. In *Shankar v. Commissioner*, the Tax Court held that a taxpayer's redemption of bank reward points (issued as a reward for opening a bank account) for a noncash benefit (airline ticket) constituted a realization event.[250] And it is likely the IRS and courts will continue to find that digital assets used to acquire goods will be treated the same. For example, "Starbucks Odyssey, a soon-to-launch blockchain-based customer rewards program . . . [invites participants] to complete games, challenges, and learning exercises (journeys) to acquire digital journey stamps, which are non-fungible tokens (NFTs) that unlock exclusive rewards."[251] It has been suggested that if a taxpayer redeems a journey stamp for a noncash Starbucks reward (e.g., a virtual espresso martini-making class), a realization event would be deemed to happen in the year of redemption.[252]

Treating virtual currency exchanges as barter realization events, however, will continue to haunt taxpayers with problems of valuation and liquidity. When virtual currency is used to purchase goods or services, it may be difficult to estimate the value of the property or service acquired.[253] Regarding

249. Avi-Yonah and Salaimi question the soundness of taxing exchanges of crypto for crypto; they propose waiting until crypto is exchanged for real-world items (fiat currency, goods, or services), like in the prior example, before saying a realization has occurred. *See* Avi-Yonah & Salaimi, *supra* note 43, at 39–40 (proposing crypto be taxed only when exchanged for real-world fiat money or goods and services because of the volatility of crypto and administrative difficulty in measuring gain or loss). "Because it is so volatile, it is hard to measure gain or loss when crypto is exchanged for other crypto. Basis is hard to determine, and any gain may be illusory and disappear the next minute because the token's value plummets." *Id.*

250. In *Shankar v. Commissoner*, 143 T.C. 140, 141, 148 (2014), a taxpayer purchased an airline ticket by redeeming Citibank's "thank you points" they got for opening an account with them. The Tax Court determined that the ticket's fair market value was included in gross income.

251. Garrett L. Brodeur & Mahima Chaudhary, *Coffee, NFTs, and Noncompliance?*, 177 TAX NOTES FED. 1241, 1241 (2022) (examining Odyssey, a new blockchain-based rewards program from Starbucks, and its potential tax pitfalls for unwary customers).

252. *Id.*

253. *See generally* William Kastin, Faith H. Liveoak & Peter L. Krehbiel, T*axation of Cryptocurrency and Similar Transactions*, SNELL & WILMER (April 19, 2022) https://www.swlaw.com/publication/taxation-of-cryptocurrency-and-similar-transactions/ [https://perma.cc/XE5W-74QP].

liquidity, the buyer may not have the cash to pay tax on the exchange. The realization requirement in our income tax was designed to solve these problems (i.e., provide an event that would provide the information necessary to quantify the accession to wealth inherent in an asset and to provide cash with which to pay tax).[254] Ironically, treating virtual currency exchanges as realization events actually creates these problems. Speaking to barter transactions more generally, David Elkins has aptly questioned: "Why then does the tax system consider a barter transaction to be a realization of the appreciation inherent in the property that was sold? In other words, why does the tax system consider this event an appropriate time for the settling of accounts with the taxpayer?"[255]

In addition to valuation and liquidity problems, it is very difficult for the government to enforce barter-exchange rules in general. As Sergio Pareja has argued, "other than barter through barter-exchange companies, the current rules regarding taxation of barter transactions 'can rarely be enforced' and they have the potential to be 'enforced at the whim of [government] officials.'"[256]

ii. Nontaxable Bargain Purchase Theory

To solve problems of valuation, liquidity, and enforcement, virtual currency, when used as a transactional currency, should not be viewed as part of a barter system but instead, as a medium of exchange to actually avoid the inconveniences of a barter system and facilitate trade in the economy. That is the essence of real currency in the economy.[257] As noted by the European Central Bank, a core feature of legal tender is that it "can be used as a medium of *exchange to avoid the inconveniences*

254. *See* Cornell L. Sch., *Realization of Gain*, LEGAL INFO. INST., https://www.law.cornell.edu/wex/realization_of_gain [https://perma.cc/EXU5-E59] (Sept. 2021).

255. *See* ELKINS, *supra* note 62, at 2.

256. Pareja, *supra* note 62, at 800.

257. Skatteverket v. Hedqvist, C-264/14 (CJEU 2015), ¶ 24 (noting the key characteristic of money is to use it as a means of payment in the real economy).

of a barter system"[258] By referring to the function of money, which is *to facilitate trade in the economy*, the Court of Justice of the European Union has said the key characteristic of money is to use it as "a means of payment in the real economy."[259]

When virtual currency is viewed from this perspective (as a medium of exchange rather than normal property), the exchange of virtual currency for different property more closely resembles a bargain purchase, the purchase of property for less than its fair market value. The IRS could take an informal position that virtual currency transactions are untaxed bargain purchases, with the bargain element being the difference between the value of the item purchased and the basis (original cost) of the virtual currency used in the transaction.

The IRS generally does not require a buyer to report the benefit of a bargain (the true value of the item purchased minus the amount paid for it) at the time of purchase, regardless of whether the buyer knew the purchased item was more valuable than the seller knew.[260] The reason is one of administrative convenience, namely difficulty in measuring the bargain element

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258. Jasmin Kollmann, Liu Qichaeo & Wu Fangbei, *Income Taxation of Cryptocurrency—A Country Comparison*, 173 TAX NOTES FED. 935, 937 (2021) (citing EUR. CENT. BANK, VIRTUAL CURRENCY SCHEMES 10 (Oct. 2012), https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf).

> The EU's Electronic Money Directive (2009/110/EC) defines the term: "Electronic money" means electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions . . . and which is accepted by a natural or legal person other than the electronic money issuer. By referring to the function of money, which is to facilitate trade in the economy, the Court of Justice of the European Union has said the key characteristic of money is to use it as a means of payment in the real economy.

Id. (citing Skatteverket v. Hedqvist, C-264/14 (CJEU 2015),¶ 24).

259. *Id.* (citing Skatteverket v. Hedqvist, C-264/14 (CJEU 2015), ¶ 24).

260. Treas. Reg. § 1.61-2(d)(1) (as amended in 2003). An important exception to this government practice exists when a bargain purchase occurs in an employment setting. *See id.* § 1.61-2(d)(2)(i). If, for example, an employee purchased property from his employer at a discount because the employer owed the employee money, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and taxable. *Id.* (providing an example). Other exceptions can be found when there is a special relationship between the buyer and seller. For example, if a shareholder purchased property from a corporation at a discount, the discount, or bargain element, may be viewed as a taxable disguised dividend.

in every purchase.[261] Tax enforcement would be impossible lest the IRS was able to scrutinize every acquisition in order to determine if a bargain had occurred. Further, "since taxes are payable in money it would seem to be logical to defer taxation to such time as the taxpayer had resold the commodity and received money income."[262]

If the nontaxable bargain purchase theory were accepted, it would essentially result in tax deferral unless the item purchased was consumed by the purchaser or never disposed of. The buyer's investment, or basis, in the item purchased would be its cost (and not the item's fair market value), which would be determined by reference to the cost basis of the virtual currency used in the acquisition. If the buyer later sold the purchased item for its higher value, then the gain that accrued from the time of acquisition to the time spent would be reported at that time. Thus, a deferred taxation approach, while solving current valuation and liquidity problems, still requires difficult basis determinations. This is true, however, only if items purchased are later resold. Often, "items purchased as bargains are never resold; rather they are consumed by the purchaser. Here, the bargain would never be taxed."[263]

iii. Non-enforcement

In lieu of taking an administrative position that virtual currency transactions are forms of untaxed imputed income or untaxed bargain purchases, the IRS could reach a similar result through non-enforcement of the law in circumstances it deems appropriate (such as de minimis purchases). The IRS often exercises its prosecutorial discretion in certain cases, effectively announcing an informal policy that exempts transactions from taxation.[264]

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261. Haskell & Kauffman, *supra* note 216, at 233–34.

262. *Id.* at 236 (explaining reasons for the bargain purchase exception).

263. *Id.*

264. *See infra* notes 282–86 and accompanying text (discussing administrative discretion for crypto-taxes).

A highly relevant example of non-enforcement is the IRS's treatment of *purchased* credit card points and frequent flyer miles. Many airline companies have plans in which members can purchase points to be used toward future travel, and they often offer significant bonus points as an incentive to do so.[265] When a member uses those points to purchase a flight, the IRS does not tax the member even though the value of the flight greatly exceeds the cost of the points used.[266] Purchased virtual currency that is used to later acquire more valuable goods or services is akin to the purchased points later used to acquire flights.

Other examples of non-enforcement can be found, especially in the case of employer-provided fringe benefits for which there is no clear right of tax exclusion. For example, in Announcement 2002-18, the IRS said that it will not attempt to tax personal benefits received through the use of frequent flyer miles or other in-kind promotion benefits attributable to a taxpayer's business travel unless the benefits are converted to cash.[267] If a free airline ticket was received as a result of prior business travel paid for by an employer, there is arguably compensation income to the employee. But the IRS does not attempt to tax this benefit, which is clearly additional compensation income for taxpayers, because of practical difficulties with

265. *See, e.g.*, Kyle Olsen, Gabrielle Bernardini & Rachel Craft, *Buy Bonus Points and Miles with These March Promotions*, THE POINTS GUY (Mar. 13, 2025), https://thepointsguy.com/news/current-buy-points-miles-promotions/ [https://perma.cc/W3M3-77VD].

266. Elizabeth Gravier, *Are Credit Card Points Taxable? Here's When You May Have To Pay Taxes on Your Rewards*, CNBC, https://www.cnbc.com/select/are-credit-card-rewards-taxable/ [https://perma.cc/3V5N-P6NC] (Jan. 3, 2025). Consider the following example: Air Canada's "Aeroplan" offered members up to 125% bonus points on purchases of 100,000 points or more. Taxpayer purchased 100,000 points (which came with 100,000 bonus points) for a cost of $2,500. For 199,500 points, the taxpayer was able to buy a round-trip business-class ticket from Boston to Paris. The same flight costs over $4,000 if paid for in cash. Under *Glenshaw Glass*, the taxpayer realized $2,000 gain in the transaction. However, the IRS does not tax it. Lucy Weaver, Houston, We Have a Problem: Navigating the Tax Implications for Transactions Involving Credit Card Points and Frequent Flyer Miles 13 (Dec. 18, 2023) (unpublished note) (on file with the University of Maine School of Law).

267. I.R.S. Announcement 2002-18, 2002-1 C.B. 621.

valuation and burdensome recordkeeping, as well as taxpayer liquidity concerns and IRS enforcement problems.[268]

Non-enforcement of virtual currency reporting might be viewed by some as different from non-enforcement of airline point redemption reporting, especially considering the magnitude of virtual currency exchanges. Some might question the fairness of enforcing the taxation of normal property exchanges but not enforcing the taxation of virtual currency exchanges.[269] Some might worry that non-enforcement could lead to an explosion of other untaxed benefits.[270] Some might argue that non-enforcement could result in "a wholesale waiver of taxation"—i.e., there will be no opportunity to impose tax in the future if the taxpayer consumes what he received in the virtual currency exchange.[271]

But many of these concerns could be addressed by setting parameters on non-enforcement. Equity concerns could be mitigated, for example, by limiting non-enforcement to virtual currencies pegged to a fiat currency (such as stablecoins), which take on the appearance of a medium of exchange rather than

268. *Id.* ("There are numerous technical and administrative issues relating to these benefits . . . including issues relating to the timing and valuation of income . . . . Because of these unresolved issues, the IRS has not pursued a tax enforcement program with respect to promotional benefits such as frequent flyer miles.").

269. *See* ELKINS, *supra* note 62, at 2 (claiming there is no difference between the timing or source of cash and non-cash property and service taxation).

270. Indeed, the IRS's passive approach toward frequent flyer miles may have contributed to an explosion of other untaxed benefits for which there is no clear right of exclusion. *See* Jay A. Soled & Kathleen DeLaney Thomas, *Revisiting the Taxation of Fringe Benefits*, 91 WASH. L. REV. 761, 773–74, 788 (2016) (crediting airlines rewards programs with the growth of loyalty programs, which, despite "sound statutory footing" to the contrary, are exempted as fringe benefits). Currently, the most notable examples are the many freebies accorded to employees of Silicon Valley companies, like meals, fitness classes, concierge services, and massages; the non-taxation of these benefits has been widely chronicled and roundly criticized. *See, e.g.*, *id.* at 778–79; Austin L. Lomax, *Five-Star Exclusion: Modern Silicon Valley Companies Are Pushing the Limits of Section 119 by Providing Tax-Free Meals to Employees*, 71 WASH. & LEE L. REV. 2077, 2079–82 (2014); Yehonatan Givati, *Googling a Free Lunch: The Taxation of Fringe Benefits*, 69 TAX L. REV. 275, 276–77 (2016).

271. ELKINS, *supra* note 62, at 3.

traditional investment property.[272] To prevent complete waiver of taxation, the IRS could limit administrative discretion to circumstances involving small amounts of income—e.g., specifically adopt an informal policy exemption for relatively small purchases, or, more narrowly, small purchases for personal consumption.[273] Or the non-enforcement policy could be limited to situations where no special relationship exists between buyer and seller—where a special relationship exists, as between employers and employees, tax exemption many not be justified.[274] There are likely other possible parameters for administrative discretion to address tax avoidance concerns.

b. Formal Exemption

Apparently, however, the IRS does not believe it has the authority to use administrative discretion to exempt even de minimis virtual currency gains in light of section 988(e) of the Code in which Congress has specifically exempted de minimis foreign currency gains.[275] Ironically, it was the IRS, not Congress, that decided virtual currency does not meet the definition of foreign currency for purposes of that exemption.[276] This underscores the preference for some formal exemption over some less formal administrative discretion to address policy concerns raised earlier.[277]

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272. *Cf.* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 46 (claiming that although many stablecoins are less volatile because of their innate relation to fiat currency, governments are still unlikely to treat them as anything but investment property).

273. *See* Osofsky & Thomas, *supra* note 232, at 838–39. Virtual currency to be used as a medium of exchange for personal goods or services would have to be distinguished from virtual currency to be held for business or investment purposes. *See* Pareja, *supra* note 62, at 814–15.

274. *See generally* discussion *supra* Section II.B.2.a.ii. An example would be where an employee uses virtual currency to buy property from her employer and the "bargain" element is a substitute for wages owed to the employee. The difference between the fair market value of the property and the employee's cost in the virtual currency would be included in income. *Id.*

275. *See* 26 U.S.C. § 998(e); T.D. 8400, 57 Fed. Reg. 9175 (Mar. 17, 1992) (notably, the IRS, responding to a request to exclude de minimis gains of individuals, stated: "Commentators have recommended adoption of a rule that would exempt a de minimis amount of exchange gain or loss realized by individuals during a taxable year. The Service does not have authority to adopt such a rule in light of section 988(e).").

276. I.R.S. Notice 2014-21, 2014-1C.B. 938.

277. *See supra* Sections II.A.1, II.A.2.

Formal tax exemption is not a new concept. There are numerous examples in which Congress has decided to exclude (or partially exclude) certain types of receipts or benefits from the income tax base.[278] Each statutory exclusion addresses some particular congressional concern or achieves some particular goal. An exclusion might reflect, for example, congressional compassion[279] or congressional concern about administrative convenience.[280] An exclusion might exist to eliminate tax considerations from the decision on whether to engage in certain transactions.[281] For some exclusions, perhaps the only justification is a political one.

Congress could choose to exempt personal transactions made with virtual currency. While other countries generally treat purchases using crypto as taxable, some do have de minimis exemptions.[282] Even the OECD has suggested countries consider providing simplified tax treatment for occasional or small traders—a de minimis exemption for personal use (e.g., by volume, trade, or gain value)—so such traders can avoid income tax consequences every time they complete a transaction.[283]

Virtual currency advocates have advocated for a de minimis exception (a threshold in the amount of gain below which no

278. *See generally* I.R.C. §§ 101–40.

279. *See, e.g.*, *id.* § 104 (excluding from gross income damages received in certain tort actions, perhaps reflecting congressional compassion for those who suffer personal physical injury or sickness).

280. *See, e.g.*, *id.* § 132 (excluding from gross income certain fringe benefits received from an employer, in part reflecting congressional concern about administrative convenience); *see also id.* § 102 (excluding gifts and bequests from gross income). The section 102 exclusion for gifts and bequests is a matter of administrative convenience. Life is full of gifting activities, especially within families, and it would be administratively burdensome both for taxpayers, who would have to keep track of all gifts received during the year, and for the IRS, which would have to enforce tax liability. *See* David Joulfaian, *The Distribution and Division of Bequests: Evidence from the Collation Study*, *in* COMPENDIUM OF FEDERAL ESTATE TAX AND PERSONAL WEALTH STUDIES 429, 431 (1994) (claiming there was "over one hundred billion dollars in annual transfers" even in 1994).

281. *See, e.g.*, I.R.C. § 121 (excluding gain from the sale of a taxpayer's principal residence, promoting the goal of eliminating tax considerations from the decision to move from one home to another).

282. *See* Kollmann et al., *supra* note 258, at 939 (explaining that Brazil has a de minimis tax exemption for the sale of assets that includes cryptocurrency).

283. *See* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 55–56.

tax is due).[284] Without such a de minimis exemption, the argument goes, "a cryptocurrency user could trigger a taxable event every time she pays for a good or service rendering cryptocurrencies too complicated for micropayments or other simple payments use."[285]

There is already a de minimis exemption from taxation for foreign currencies used to transact.[286] But this exemption does not apply to virtual currency, which is classified as property and not currency. A bipartisan group of lawmakers has introduced legislation to apply a similar standard to virtual currencies as property.[287] The Virtual Currency Tax Fairness Act seeks to create a workable structure for taxing purchases made with virtual currency and to exempt personal transactions made with virtual currency when the gains are $200 or less.[288] The

284. *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 § 4; *see, e.g.*, Nikhilesh De, *Crypto Wants a De Minimis Tax Exemption in the U.S.*, COINDESK (Sept. 19, 2023, 1:30 PM), https://www.coindesk.com/policy/2023/09/19/crypto-wants-a-de-minimis-tax-exemption-in-the-us/ [https://perma.cc/ME8T-NZV6]; Herzfeld et al., *supra* note 6 (explaining de minimis tax exemptions for foreign currency use).

285. *Cryptocurrencies: What Are They Good For?: Testimony Before the S. Comm. on Banking, Hous., & Urb. Affs.*, 117th Cong. 12 (2021) [hereinafter *Cryptocurrencies: What Are They Good For? Hearing*] (statement of Jerry Brito, Executive Director, Coin Center).

286. *See supra* Section I.C.

287. Mary Katherine Browne, *Senators Look to Exclude Small Crypto Transactions from Taxation*, 176 TAX NOTES FED. 765, 765 (2022) (discussing Virtual Currency Tax Fairness Act, S. 4608, 117th Cong. (2022), which was introduced with bipartisan support by Senate Finance Committee members Patrick J. Toomey, R-Pa., and Kyrsten Sinema, D-Ariz.).

288. Hubers, *supra* note 169, at 1702 n.23 (discussing the Act's goal of excluding from gross income de minimis gains from certain sales or exchanges of virtual currency). Under the proposal, gross income would not include gain from the sale or exchange of virtual currency, unless the sale or exchange was "for cash or cash equivalents," or business or investment property. Virtual Currency Tax Fairness Act, S. 4608, 117th Cong. (2022). The gain exclusion would not apply in a sale or exchange for which the total value of such transaction exceeded a certain dollar amount, or the total gain which would otherwise be recognized with respect to such transaction exceeded a certain dollar amount. *See* Browne, *supra* note 287, at 765. Similar provisions have been introduced in other proposed legislation. *See, e.g.*, Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022) (introduced by Senators Cynthia Lummis, R-Wyo., and Kirsten E. Gillibrand, D-N.Y.) (providing a de minimis exclusion of up to $200 per virtual currency transaction); *see also* Virtual Currency Tax Fairness Act of 2022, H.R. 6582, 117th Cong. (2022) (introduced by Suzan K. DelBene, D-Wash.) (excluding from gross income personal currency transaction gains below $200). DelBene and Schweikert previously introduced their bill in 2020 as H.R. 5635. Virtual Currency Tax Fairness Act of 2020, H.R. 5635 116th Cong. (2020).

proposed legislation would allow taxpayers to use virtual currency as an everyday method of payment by exempting small personal transactions from taxes.[289] The Virtual Currency Fairness Act is broadly supported throughout the cryptocurrency industry.[290]

Some have argued against adopting any form of tax exemption for virtual currency.[291] However, formal exemption could be justified on several grounds. It could be argued that compliance costs are extremely high when taxpayers use virtual currency to buy small goods and services, and the tax revenue at stake is not worth those compliance costs.[292] More and more Americans regularly transact with virtual currency as a currency, and it is administratively burdensome for them to keep track of numerous small purchases and for the IRS to enforce tax liability.[293] It could also be argued that the property tax regime governing property exchanges is quite complex and targets more sophisticated business owners and investors, and, therefore, individuals (less sophisticated parties) with little income making everyday personal purchases with virtual currency should not be subject to that complex tax regime.[294] As a final point, formal tax exemption would also promote the goal

289. *See* H.R. 6582.

290. *See Toomey and Sinema Introduce Bipartisan Legislation to Simplify Use of Digital Assets for Everyday Purchases*, U.S. S. COMM. ON BANKING, HOUS., & URB. AFFS. (July 26, 2022), https://www.banking.senate.gov/newsroom/minority/toomey-and-sinema-introduce-bipartisan-legislation-to-simplify-use-of-digital-assets-for-everyday-purchases [https://perma.cc/N9CG-F5FK]. Virtual currency "needs the same exemption for small, personal transactions that we have for foreign currency." *Id.* (quoting Jerry Brito, Executive Director of Coin Center).

291. *See, e.g.*, Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 369. Chodorow argues against extending the personal-use exemption to Bitcoin because "(1) the rationale underlying the personal-use exemption does not apply to Bitcoin and (2) extending the exemption would create the same administrative and line-drawing problems." *Id.*

292. *See generally* Osofsky & Thomas, *supra* note 232, at 777–78 ("[M]ost de minimis tax rules are intended to reduce administrative and compliance costs for both taxpayers and the government when those costs are not justified by the revenue at stake.").

293. *See* Hubers, *supra* note 169, at 1702 ("[T]he burden of compliance is heavy for taxpayers who regularly transact with [convertible virtual currency] as a currency.").

294. *See generally* Osofsky & Thomas, *supra* note 232 (providing I.R.C. § 199A and § 7872 as examples of allowing taxpayers below a certain income threshold and who make gift loans less than $10,000 to avoid some of its most complicated provisions and interest calculations).

of eliminating tax considerations from the decision of whether to use cryptocurrency for everyday purchases. Tax law is currently standing in the way of virtual currency's use as a payment method.

In designing formal tax exemption for virtual currency used as a medium of exchange, several considerations would be warranted: What should the exemption amount be? Should an exemption be available for any use of virtual currency or be limited to personal use? Should an exemption be measured by volume, trade, or gain value? Should the exemption be available on a per-transaction basis or on an aggregate annual basis?[295] Should the exemption be substantive or procedural?

Perhaps the most important design consideration is the exemption amount applicable to virtual currency barter transactions. The $200 per-transaction exemption that has been proposed in recent bipartisan legislation parallels the present exclusion found in the foreign currency rules.[296] That exclusion helps "spare vacationers" from the burden of managing gains on their exchanged currencies.[297] The $200 amount may be rational for foreign currency transactions that occur overseas over a relatively short vacation period of time (since foreign currency price fluctuations are typically insignificant and foreign exchange gain will be small).[298] It is debatable, however, whether

295. An exemption available on a per-transaction basis would be similar to the current $200 exclusion available for personal foreign currency transactions. An exemption available on an aggregate basis would be similar to the Form 1099-K reporting requirements for third party network transactions (where the focus is on transactions that exceed a minimum threshold in aggregate payments, regardless of the number of transactions). However, there are potential tax avoidance problems with a per-transaction approach. *See, e.g.*, Chason, *supra* note 39, at 803–04 (providing an example in which someone would negotiate a $6,000 monthly rent payable in Bitcoin at $200 per day so no gain would be recognized).

296. *Compare* Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022) (proposing $200 de minimis exception for virtual currency), *with* I.R.C. § 988(e) (setting $200 de minimis exception to gains for foreign currency).

297. Chason, *supra* note 39, at 802–03.

298. *Id.*; *Managing Projects Involving Foreign Currency*, UNIV. CAL. S.F., https://irso.ucsf.edu/resources/intl-project/foreigncurrency [https://perma.cc/UYH9-2E6R] (last visited Apr. 16, 2025) (stating, "[m]ost of the time, currency fluctuations are relatively moderate," outside of extreme international events). *But see* Chodorow, *Bitcoin and the Definition of*

the $200 amount is appropriate for virtual currency used regularly for everyday purchases throughout the year (when price fluctuations may be significant).[299] The application of general property tax principles to virtual currency barters is complex, and many virtual currency owners are unsophisticated, suggesting a larger exemption may be warranted. Whatever dollar amount is adopted, it should be large enough to prevent most taxpayers from having to keep detailed records of valuation of goods acquired and basis of virtual currency used throughout the year.[300] Designing the appropriate exemption amount should involve the careful weighing of costs and benefits—specifically, the appropriate exemption would yield a greater reduction in taxpayer compliance and government enforcement costs than reduction in tax revenue.[301]

Another important design consideration is whether to formally exempt certain virtual currency transactions from taxation or merely exempt reporting obligations.[302] De minimis tax rules can exempt taxpayers from substantive tax obligations (e.g. if a transaction is below a certain dollar threshold), or they can relieve taxpayers only of the procedural, but not substantive, burdens of the tax law.[303] As noted by Leigh Osofsky and

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Foreign Currency, *supra* note 19, at 389 ("Admittedly, foreign currencies can be quite volatile, too.").

299. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 391–93 (noting people typically use foreign currency while on vacation during which currency fluctuates (and, hence, currency gain or loss is likely to be small)). Chodorow argues Bitcoin differs from foreign currency in several ways that suggest a similar exemption is not appropriate. *Id.*

300. *See id.* at 391. Of course, taxpayers would have to keep detailed records if the exemption might not apply and gain or loss is to be reported. *See id.* at 393.

301. Osofsky & Thomas, *supra* note 232, at 831 (providing a framework for making these evaluations and suggesting particular considerations that should apply in specific contexts). Osofsky and Thomas suggest that the reduction in taxpayer compliance costs and government enforcement costs from de minimis tax rules should outweigh the reduction in tax revenue. Where possible, an exemption should be designed to minimize behavioral distortions. *Id.* at 831–34 ("If taxpayers alter their behavior to avoid application of a tax rule and qualify for a de minis exception, this distortion imposes further costs on the tax system.").

302. *See, e.g.*, I.R.C. § 6041(a) (exempting payments from the Form 1099 requirements if the aggregate amount paid to a contractor is less than $600).

303. Osofsky & Thomas, *supra* note 232, at 787–88 (citing as an example section 2503, which provides that gifts to an individual under $15,000 are not subject to gift tax or the accompanying gift tax return obligation).

Kathleen DeLaney Thomas, "since procedural de minis tax rules . . . do not purport to change the substantive tax law, they seem like a can't lose proposition: they reduce administrative costs, without reducing revenue owed."[304]

The obvious problem with procedural de minimis rules is that they may alter substantive tax obligations.[305] For example, a Form 1099-K third-party reporting exemption of $20,000 or 200 transactions per year (or, under recent changes, $600 or more in gross sales from goods or services in the year) risks becoming perceived as a substantive tax obligation exemption.[306] Even if substantive tax obligations are understood, some might keep inadequate records or forget to report their transactions. Because taxpayers often confuse reporting exemptions with substantive tax exemptions, a change in underlying tax law may be warranted here.[307]

III. AN ALTERNATIVE CLASSIFICATION FRAMEWORK

> [W]hat we view as money has changed over time. Cowrie shells once were such a medium but no longer are . . . our currency originally included gold coins and bullion, but, after 1934, gold could not be used as a medium of exchange . . . perhaps one day employees will be paid in Bitcoin or some other type of cryptocurrency.[308]

The immediate taxation method—the current tax scheme governing virtual currency when used as transactional currency—causes a number of problems that currently stand in the way of broader adoption of virtual currency as an everyday purchasing tool. An argument could be made that tax policy should facilitate, not hinder, the broader adoption of virtual

304. *Id.* at 789.

305. *Id.* at 805 (citations omitted).

306. *See id.* at 805–06.

307. *Id.*

308. Wis. Cent. Ltd. v. United States, 585 U.S. 274, 286–87 (2018) (Breyer, J., dissenting) (arguing that stock options were "a form of money renumeration") (citations omitted)).

currency for retail payments and the further development of decentralized blockchain infrastructure.[309] For years, the government has used tax policy to actively support the Internet as an innovative technology. The Internet Tax Freedom Act ("ITFA"), signed into law in 1998, bars federal, state, and local governments from taxing internet access and imposing internet-only taxes or multiple taxes on e-commerce transactions.[310] The ITFA, which Congress has extended many times, is an effort by the government to promote and preserve the internet's potential.[311] To further promote the commercial potential of the internet, an argument can be made that virtual currency, which is a fair, accessible, efficient, and transparent financial system for the internet age, should likewise be supported.[312]

But controversy over the appropriate tax system governing virtual currency doesn't have to revolve around the resolution of theoretical questions (i.e., is virtual currency's use as real currency a positive development that should be supported by the government or is a negative development that should be discouraged). Indeed, it is unlikely there will ever be consensus on whether virtual currency is worthy of government support and, hence, whether tax policy should facilitate or hinder adoption.[313] Indeed, many of the benefits of virtual currency

309. *See, e.g.*, *Cryptocurrencies: What Are They Good For? Hearing*, *supra* note 285, at 12 (statement of Jerry Brito, Executive Director, Coin Center).

310. Internet Tax Freedom Act, Pub. L. No. 105-277, 112 Stat. 2681-719 (1998) (codified at 47 U.S.C. § 151, note).

311. *See* MILAN N. BALL, CONG. RSCH. SERV., IF11947, THE INTERNET TAX FREEDOM ACT AND FEDERAL PREEMPTION 1 (2021); *see also* Erik Cederwall, *The Internet Tax Freedom Act and the Internet Economy*, TAX FOUND. (Oct. 27, 2014), https://taxfoundation.org/blog/internet-tax-freedom-act-and-internet-economy/ [https://perma.cc/89PX-R8CN].

312. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 368 (exploring whether "tax authorities should actively support Bitcoin as an innovative technology . . . in a manner similar to that afforded the internet"); *see also* Marian, *supra* note 125, at 1502–03 (identifying "equity, efficiency, and administrability" as three indicators of what is good tax policy).

313. *See* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 384–90 (concluding that, in light of the United States's history, the government's attitude toward alternate currencies "has been ambivalent," at best).

espoused by proponents are likely viewed as negative by the government.[314]

Instead, debate/controversy should center on practical questions. Won't the current tax system break down if it continues to demand that taxpayers pay tax on "phantom" income every time they use virtual currency to purchase a cup of coffee (which produces no means of tax payment)?[315] Isn't it difficult, if not impossible, for taxpayers to ascertain tax gain or loss on each transaction and for the government to detect and enforce? Doesn't the current approach "make[] suckers out of compliant taxpayers by imposing requirements that are practically unenforceable against noncompliant taxpayers"?[316]

To address these practical concerns, partial tax exemption (a de minimis exemption for personal transactions) is often recommended.[317] Partial exemption could be adopted in a couple of ways. It could be adopted through administrative discretion or formal exemption while continuing to classify virtual currency as property. This approach would allow the government to continue to view virtual currency as an investment asset (subject to general tax principles governing normal property), but carve out a tailored exemption for virtual currency when used as a medium of exchange for de minimis purchases. Starting from scratch in crafting a de minimis exemption would be painful and likely require lengthy consideration of numerous design questions and would likely end up stalled in lengthy policy debates.

Alternatively, partial tax exemption could be achieved by giving certain, not all, virtual currencies foreign currency status. As described in Part I.C. of this paper, the foreign currency rules in the Code apply to transactions denominated in a

314. *Id.* at 384–86 (outlining some Bitcoin benefits but noting the "government likely views many of the benefits as . . . negatives").

315. Pareja, *supra* note 62, at 801 (examining the current taxation of barter transactions, more generally, and arguing "income from barter transactions is difficult, if not impossible, to ascertain and because private barter transactions are virtually undetectable by law enforcement").

316. *Id.*

317. *See supra* notes 300–01 and accompanying text.

currency other than a taxpayer's function currency.[318] For taxpayers using the U.S. dollar as a functional currency, the disposition of foreign currency results in the recognition of gain or loss.[319] However, giving virtual currency foreign currency status would automatically permit virtual currency users to take advantage of the de minimis personal-use exemption and formulaic basis accounting rules in the foreign currency rules.[320]

This Article proposes the latter alternative, which would require the government to stop adhering to ancient concepts of currency and adopt a flexible property-versus-currency classification test that was principle-based and applied based on the unique characteristics of each virtual currency.

A. Problems with FinCEN's Rigid Currency Definition

The U.S. government has refused to treat virtual currency as foreign currency because it does not accept that it is currency.[321] Some forms of virtual currency, perhaps even Bitcoin (either now or in the future), might satisfy dictionary meanings, which focus more on usage. *Merriam-Webster* defines "currency" by reference to "something . . . that is in circulation as a medium of

318. *See supra* Section I.C; *see also* MASSEY & O'BRIEN, *supra* note 110. A nonfunctional currency is any currency other than the U.S. dollar unless there's a qualified business unit ("QBU") that conducts a significant part of its activities in an economic environment in a non-dollar currency. I.R.C. § 985(b)(1)(A)–(B). If there is a QBU, the currency of the economic environment may be used as the QBU's functional currency. *Id.* § 985(b)(3)(A)–(B).

319. MASSEY & O'BRIEN, *supra* note 110, at III.D. Generally, any disposition of a nonfunctional currency is treated as ordinary gain or loss. I.R.C. § 988(a)(1)(A), (c)(1)(C)(i)(II).

320. *See supra* Section I.C. For the reader's convenience: I.R.C. § 988(e)(2)(B) provides that if nonfunctional currency is disposed of by an individual in any personal transaction, "no gain shall be recognized . . . by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition." *But see id.* (setting a $200 limit on such exemption). *See also id.* § 988(e)(3) (defining "personal transaction"). The formulaic basis accounting rules applicable to foreign currency would also apply. Treas. Reg. § 1.988-2(a)(2)(iii)(B). "[T]ax authorities should require Bitcoin users to adopt a formulaic approach to basis. Doing so would eliminate unnecessary complexity for Bitcoin users and ensure that they were not able to manipulate the basis rules to minimize their tax burdens." Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 369.

321. *See* Paul Carman, *A Systematic Approach to the Classification of Cryptocurrency*, 172 TAX NOTES FED. 2131, 2131–32 (2021).

exchange," or "a common article for bartering."[322] Virtual currency, however, does not meet the rigid legal definition adopted by the IRS.[323] In Notice 2014-21, the IRS defined currency as "the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance."[324]

By limiting currency to *coin and paper money*, the IRS has excluded all virtual currencies entirely. This is true even for virtual currencies issued or adopted by other countries.[325] The requirement that currency be *issued by a jurisdiction and accepted as legal tender* also excludes virtual currencies (other than those issued by a government's central bank).[326] An interesting question that has arisen is whether El Salvador's recognition of Bitcoin as legal tender converts that virtual currency into foreign currency for U.S. tax purposes.[327] Some commentators say

322. *Currency*, MERIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/currency [https://perma.cc/T29W-SBH5] (last visited Apr. 16, 2025).

323. *See* Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (citing 31 C.F.R. § 1010.100(m)).

324. *See* I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (modified by Notice 2023-14); Rev. Rul. 2019-24, 2019-44 I.R.B. 1004 (citing 31 C.F.R. § 1010.100(m)); *see also supra* note 2 and accompanying text (discussing the IRS's identification of Bitcoin in Notice 2014-21 as "one example of a convertible virtual currency"); *see* Wis. Cent. Ltd. v. United States, 585 U.S. 274, 277 (2018) (noting that "'money' was ordinarily understood to mean currency 'issued by [a] recognized authority as a medium of exchange'"); *see also* Rev. Rul. 76-214, 1976-1 C.B. 218 ("[M]oney in its usual and ordinary acceptation is synonymous with currency."); Rev. Rul. 74-218, 1974-1 C.B. 202 ("Currency in its usual and ordinary acceptation means gold, silver, other metals or paper used as a circulating medium of exchange, and does not embrace bonds, evidences of debt, or other personal property or real estate.").

325. Carman, *supra* note 321, at 2142 ("For now, however, the IRS appears to have made a decision that no cryptocurrencies are foreign currencies.").

326. *See Wis. Cent. Ltd.*, 585 U.S. at 277 (recognizing the authority requirement behind currency).

327. *See* Paez, *supra* note 11.

yes.[328] Some say no.[329] Some interpret the IRS's definition as requiring currency to be issued by the jurisdiction and not merely accepted as legal tender there.[330] Bitcoin is legal tender at least in El Salvador, but it is not issued by a government's central bank.[331] In contrast to virtual currencies like Bitcoin, central bank digital currencies ("CBDCs") "issued by a central bank would by definition be legal tender."[332] They still, however, are in digital form and not coin or paper money.

Another requirement for currency is that it must be *customarily used and accepted as a medium of exchange* in a country. Just because coin or paper money is issued by a government does not make it currency under the IRS's definition. This was illustrated in Revenue Ruling 76-214, wherein bullion gold coins issued by Mexico were exchanged for bullion gold coins issued by Australia.[333] The IRS ruled that the gold coins were not currency; thus, the exchange qualified for nonrecognition of gain under the provision of section 1031.[334] According to the IRS, the value of such coins was determined on the basis of their gold content; they did not derive value from being used as a medium of exchange.[335] They were no longer circulating as a medium of

328. Chason, *supra* note 39, at 804 ("[T]his move has not prompted the IRS to reclassify Bitcoin as 'currency' rather than 'property.' At some point, the IRS may need to do so, particularly if individuals and businesses use Bitcoin for day-to-day transactions more commonly in El Salvador."); *see* Billy Abbott, *The Anything Asset: The Tax Classification of Cryptocurrency, NFTs, DAOs and Other Digital Assets*, 26 CHAPMAN L. REV. 459, 463 n.22 (2023) ("The designation of Bitcoin as the legal tender of certain foreign jurisdictions could call into question whether it will still fall outside the definition of foreign currency.").

329. *See, e.g.*, Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 381–84 (arguing that, unlike all other foreign currencies, Bitcoin is not issued by a foreign government).

330. *See* Hubers, *supra* note 169, at 1701.

331. *See* Lee A. Sheppard, *IRS and Regulators Struggle with Crypto Questions*, 179 TAX NOTES FED. 757, 759 (2023) (arguing the IRS "should have said that [B]itcoin is not foreign currency because it is not issued by a central bank").

332. U.S. DEP'T OF THE TREAS., CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, *supra* note 9, at 5 nn.4–5 (noting that although a virtual currency like Bitcoin, commonly referred to by the public as "cryptocurrency," does not have legal tender status, a Central Bank Digital Currency "would by definition be legal tender" provided it is issued by a central bank).

333. Rev. Rul. 76-214, 1976-1 C.B. 218.

334. *Id.* (citing 26 U.S.C. § 1031(a)).

335. *Id.*

exchange, and they were no longer currency in their respective countries.[336] Currency, "in its usual and ordinary acceptation, means gold, silver, other metals or paper used as a circulating medium of exchange."[337] While Bitcoin may have legal tender status in a jurisdiction (El Salvador) and may be circulating there, it is not clear whether it is "customarily used and accepted as a medium of exchange" in that country (yet).[338]

The IRS followed the definition of currency provided by the Department of the Treasury Financial Crimes Enforcement Network ("FinCEN"). While something can be said for consistent legal classifications of currency among regulatory authorities, the one adopted by the IRS—the FinCEN classification—really is irrelevant. Indeed, other U.S. regulators have taken inconsistent approaches such that we have a fragmented regulatory approach with different regulators adopting different classifications.[339] So, why did the IRS adopt FinCEN's rigid classification? As suggested by Eric Chason, "FinCEN's mission differs from the IRS's, its classification should not be dispositive (or even relevant) under the [tax] Code."[340]

The FinCEN classification is overly restrictive—specifically, the requirement that something can be currency only if it is coin or paper money and only if it is issued by a central bank or public authority. The definition ignores other key characteristics of

336. Rev. Rul. 76-214, 1976-1 C.B. 218 (citing Rev. Rul. 74-218, 1974-1 C.B. 202).

337. Rev. Rul. 74-218, 1974-1 C.B. 202.

338. Hubers, *supra* note 169, at 1701. A month into El Salvador's adoption of Bitcoin as an official currency, 12% of El Salvadorans reported using Bitcoin, and 7% of companies there received payment in Bitcoin. Reuters, *Bitcoin Use in El Salvador Grows*, *supra* note 11.

339. While this Article focuses on tax classification, other U.S. regulators have also taken inconsistent approaches. *See* Michail Risvas, *The Legal Classification of Cryptocurrencies in US, EU, UK and WTO Law: Fragmentation or Towards a Common, Transnational* Lex Cryptographica?, STAN. L. SCH., https://law.stanford.edu/transatlantic-technology-law-forum/projects/the-legal-classification-of-cryptocurrencies-in-us-eu-uk-and-wto-law-fragmentation-or-towards-a-common-transnational-lex-cryptographica/ [https://perma.cc/5N7D-ZQTL] (last visited Apr. 16, 2025). For example, the Treasury's Financial Crimes Enforcement Network has classified virtual currency as currency when applied to money transmitters under the Bank Secrecy Act of 1970 ("BSA"). U.S. GOV'T ACCOUNTABILITY OFF., GAO-20-188, VIRTUAL CURRENCIES: ADDITIONAL INFORMATION REPORTING AND CLARIFIED GUIDANCE COULD IMPROVE TAX COMPLIANCE 7 (2020) (citing Bank Secrecy Act of 1970, 31 U.S.C. § 5311).

340. Chason, *supra* note 39, at 800.

currency, such as durability, divisibility, portability, fungibility, limited supply, store of value, and difficulty of counterfeiting, to name a few.[341] No justification has been offered as to why these and other key characteristics of money are not part of the classification calculus for tax purposes.

It is unlikely the IRS can continue to adhere to FinCEN's rigid definition of currency. Indeed, the current evolution of virtual currencies and their use as real transactional currencies provides an opportunity for the government to reconsider its classification approach.[342] Stablecoins are not considered currency under FinCEN's definition "since they are not issued by a central bank or a public authority, and are not legal tender . . . ."[343] But stablecoins have many characteristics of real currency, especially fiat-backed, or dollar-referent stablecoins (as opposed to crypto-backed, algorithmic stablecoins or others).[344] CBDCs also may not meet FinCEN's definition since they are not coin or paper money. But shouldn't they be reasonably considered to be currency if they have legal tender status in their jurisdiction of issuance, are accepted as a medium of exchange in their jurisdiction of issuance, and even possess other key characteristics of currency?[345]

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341. John P. Keller, *Why Do Bitcoins Have Value?*, INVESTOPEDIA, https://www.investopedia.com/ask/answers/100314/why-do-bitcoins-have-value.asp [https://perma.cc/4Z6K-BLEJ] (Apr. 10, 2024).

342. *See* Herzfeld et al., *supra* note 6. According to Herzfeld, "at least two types of cryptocurrencies might be considered 'real currency' in which case they could be considered foreign currency covered under section 988: [(1)] cryptocurrency issued by central governments and [(2)] stablecoins denominated in foreign currencies." *Id.*

343. OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 47.

344. *But see* Schwartz, *supra* note 38, at 771 ("Sound tax policy ought to tax similar assets similarly.").

345. *See* Stotzer, *supra* note 50, at 224. If CBDCs are used as mediums of exchange in the areas where they are recognized as legal tender, it follows that such central bank cryptocurrencies may meet the definition of "currency," including for federal tax purposes. In that case, the rules of section 988 could apply to govern recognition of foreign currency gain or loss. *See id.*

B. Toward a New Classification: Rethinking Currency Characteristics

As Justice Breyer suggested, our view of currency has changed over time, and our definitions should be tested and reset over time as new commonly accepted mediums arise.[346] Virtual currencies are not a homogenous group, and a one-size-fits-all tax classification regime lacks justification. There exist public blockchain native tokens, fiat-backed stablecoins, asset-backed stablecoins, DAO governance tokens, liquidity pool (LP) tokens, and on and on. The IRS's arbitrary decision to treat them all as property and none as currency is irrational. A better tax regime would be "principle-based" and applied based on the characteristics of each particular virtual currency.[347] Under such a regime, some might appropriately continue to be classified as property subject to general tax principles related to investment assets. Others might more appropriately be classified as currency subject to the rules of section 988 governing recognition of foreign currency gains and losses.

Thinking of normal property and currency as two distinct categories, one could imagine a continuum with normal property at one end and currency at the other. Many virtual currencies do not fall neatly within one category or the other; they appear in many different forms, some with both investment property and real currency characteristics. An alternate framework could look at the characteristics of a particular virtual currency (or category of currency for ease of administration) to determine whether it is closer on the spectrum to investment property and, therefore, should be classified as property or

346. See Wis. Cent. Ltd. v. United States, 585 U.S. 274, 286–87 (2018) (Breyer, J., dissenting).

347. Carman, *supra* note 321, at 2139–41 (examining terms, such as "money" and "foreign currency" in relation to the tax treatment of virtual currency); *see also* Herzfeld et al., *supra* note 6 (claiming that blanket treatment of all cryptocurrencies is not feasible); OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 55 (suggesting that policymakers take the more nuanced approach).

whether, instead, it is closer to real currency and therefore should be classified as currency for tax purposes.[348]

At one end of the spectrum, there is investment property. Investment property has a number of key characteristics. For example, property held for investment is generally held long-term, for appreciation in value, and does not change hands rapidly in transactions.[349] Investment property is subject to potential price/valuation volatility due to various market forces.[350] It generally relies on market evaluations rather than government regulation.[351] Investment property is not easily divisible into small units or increments to be used in exchange for goods or services.[352]

At the other end of the spectrum is real fiat currency. Currency has a number of key characteristics.[353] For example, real fiat currency is often government-created and recorded on

348. This is the same problem the tax system has in classifying hybrid corporate instruments as either "debt" or "equity" for tax purposes. For an excellent summary, see CHERYL D. BLOCK, ARI GLOGOWER & JOSHUA D. BLANK, *The Corporate Capital Structure*, *in* CORPORATE TAXATION: EXAMPLES & EXPLANATIONS 49–50 (5th ed. 2022).

349. For example, the average holding period for commercial real estate investments is between five and ten years. *See Why Commercial Real Estate Investments Require a 5-10 Year Holding Period*, FIRST NAT'L REALTY PARTNERS (Apr. 22, 2021), https://fnrpusa.com/blog/holding-period-in-cre/ [https://perma.cc/X5PS-5BES]; *Real Estate Holding Periods: What You Need To Know*, SCH. OF COM. REAL EST. INVESTING (Oct. 14, 2022), https://www.schoolofcrei.com/holding-period/ [https://perma.cc/9MJ5-HE54].

350. Market volatility refers to the degree to which the price of an investment (e.g., stock) changes over time and can occur for a variety of reasons, including economic news, actions of central banks, unexpected events, etc. James Royal, *What Is Market Volatility?*, BANKRATE (Aug. 5, 2024), https://www.bankrate.com/investing/what-is-market-volatility/ [https://perma.cc/4PU5-FTZ7]; *see also* Kate Ashford, *What Is Market Volatility—and How Should You Manage It?*, FORBES (Feb. 13, 2023), https://www.forbes.com/advisor/investing/what-is-volatility/ [https://perma.cc/A8A8-DRH2] ("Market volatility is the frequency and magnitude of price movements . . . . [It] is a 'normal part of investing . . . .'").

351. *See* Peter Gratton, *Intrinsic Value of a Stock: What It Is and How to Calculate It*, INVESTOPEDIA, https://www.investopedia.com/articles/basics/12/intrinsic-value.asp [https://perma.cc/RBT3-DEBJ] (Dec. 12, 2024).

352. Historically, pure investment properties could not be divided into smaller units of value as easily as money could. *See Divisibility*, RIVER, https://river.com/learn/terms/d/divisibility/ [https://perma.cc/C9A3-VWHM] (last visited Apr. 16, 2025) ("Divisibility is one of the primary failings of gold as a currency . . . .").

353. *See Medium of Exchange*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/economics/medium-of-exchange/ [https://perma.cc/D9A3-H55U] (last visited Apr. 16, 2025) (noting characteristics of a medium of exchange).

centralized ledgers (i.e., issued by a central bank or public authority, such as the Federal Reserve System).[354] Because of legal tender status in its jurisdiction of issuance, currency holds intrinsic value due to government support.[355] And that value is generally stable and not subject to the same volatility we see with normal property, and thus has the stability of purchasing power.[356] Currency circulates (and can be exchanged rapidly) and possesses durability to withstand repeated usage. It is accepted and used as a medium of exchange to facilitate trade in the economy to avoid the inconveniences of a barter system.[357] As a result, it is usually held in accounts short-term, not long-term.[358]

Many virtual currencies have features common to both investment property and traditional fiat currency.[359] The new classification regime proposed here would require the application of a facts-and-circumstances balancing act to decide whether these digital assets falling in the middle of the spectrum are closer to one end or the other. This begs the question: What are the defining characteristics of any given virtual currency, and where does it fall on the spectrum?

Some policymakers might prefer to elevate one of the above features/factors as a super factor for ease of administration and

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354. *See* Troy Segal, *What Is a Central Bank, and Does the U.S. Have One?*, INVESTOPEDIA, https://www.investopedia.com/terms/c/centralbank.asp [https://perma.cc/B583-TLYZ] (Apr. 6, 2022) (stating that central banks are those with non-market-based powers to create currency and monetary policy).

355. *See Medium of Exchange*, *supra* note 353 (stating money, the most common and general accepted medium of exchange in the modern economy, "should have a consistent intrinsic value, be interchangeable, transportable, and reliable").

356. *See Managing Projects Involving Foreign Currency*, *supra* note 298.

357. *See* Allan H. Meltzer & Milton Friedman, *Money*, BRITANNICA, https://www.britannica.com/money/money [https://perma.cc/HK88-HH9X] (Mar. 13, 2025) ("The basic function of money is to enable buying to be separated from selling, thus permitting trade to take place without the so-called double coincidence of barter.").

358. *See What Is the Money Supply? Is it Important?*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/faqs/money_12845.htm [https://perma.cc/7QE5-3NHM] (July 19, 2024) (describing the money supply as the source of payments and short-term investments).

359. *See, e.g.*, *supra* note 35 and accompanying text (discussing U.S. acknowledgment of both aspects of virtual currency).

stability.[360] In other words, they might favor having a certain classification criterion provide a conclusive answer on whether a particular virtual currency should be taxed as real currency as opposed to normal property. However, settling on one defining characteristic that would dictate classification results would be difficult, and may not produce satisfactory results—i.e., eliminate inequities, inefficiencies, and administrative burdens caused by the government's current rigid approach.

Some, for example, might prefer the defining characteristic of currency to be that it is both *government-created and accepted as legal tender*.[361] Thus, even if a virtual currency is accepted as legal tender in a country, if a central bank does not issue it, then it would not be treated as foreign currency for tax purposes.[362] This approach, which would exclude Bitcoin (accepted as legal tender in El Salvador) and even stablecoins, is questionable. As suggested by McCullum, "the argument that a currency must be supported by government regulation to be a 'real' currency is dubious at best. For centuries, currencies were not supported by government relation but by the value of a commodity, typically gold."[363] The approach, however, would capture central bank digital currencies ("CBDCs")—a relatively new digital form of currency that is issued by a central public authority. CBDCs differ from stablecoins as CBDCs are guaranteed by central banks, similar to national currencies with the status of legal tender.[364] But whether the criterion should be controlling

360. *See, e.g.*, Joulfaian, *supra* note 280, at 431 (referring to the significant administrability concerns animating tax policy).

361. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 381–82 (arguing for a definition of foreign currency limited to money that is government-created and accepted as legal tender, necessarily excluding Bitcoin).

362. Sheppard, *supra* note 331, at 759. This would circumvent the issue of whether Bitcoin can be recognized as a foreign currency after El Salvador's adoption. *Compare id.* (claiming that the central bank requirement would keep Bitcoin from attaining foreign currency status), *with* Nadia Batey, *A Brief History of Bitcoin*, JAMESMOORE, https://www.jmco.com/articles/tax/brief-history-bitcoin/ [https://perma.cc/KN98-2ALM] (Nov. 14, 2024) (describing Bitcoin as a "decentralized currency" that does not rely on any singular country of issuance).

363. McCullum, *supra* note 40, at 870.

364. OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 48.

in the classification debate is questionable, especially in the case of rising stablecoins backed by fiat currencies.

Some might prefer the defining characteristic of currency to be its price *stability or lack of volatility*. If the defining characteristic of currency is its stability, many virtual currencies would be properly classified as property (similar to investment products like precious gems or collectibles, which widely fluctuate in value).[365] Many, however, such as stablecoins pegged to a stable asset like gold, the U.S. dollar, or the underlying fiat paper or coin currency of the jurisdiction,[366] would be properly classified as currency as they do not fluctuate widely.[367] But elevating volatility as a super factor in the classification analysis is also questionable. While we generally think of currency as less volatile than investment property, the value of foreign currency can fluctuate dramatically. A clear example of this phenomenon can be seen in the Swiss franc, which increased in value by 30% in only a few moments in January 2015.[368] In another case, the Russian ruble decreased in value by 40%, as compared to the

365. Henry Ordower, *Block Rewards, Carried Interests, and Other Valuation Quandaries*, 175 TAX NOTES FED. 1551, 1561 (2022); *see also* Avi-Yonah & Salaimi, *supra* note 43, at 39–40 ("[T]he defining characteristics of crypto is its volatility.").

366. Sherman Lee, *Explaining Stable Coins, the Holy Grail of Cryptocurrency*, FORBES, https://www.forbes.com/sites/shermanlee/2018/03/12/explaining-stable-coins-the-holy-grail-of-cryptocurrency/ [https://perma.cc/VYW6-G7L5] (Mar. 13, 2018, 11:14 PM). "Those stablecoins are issued in exchange for fiat currencies and do not bring a new asset into existence—in other words, it represents the underlying fiat currency . . . . [Therefore, it should be viewed as an] exchange at par." Noopur Trivedi & Jitesh Golani, *Tax Policy for Stablecoins and DAOs: A Peek into the Future*, 172 TAX NOTES INT'L 311, 314–15 (2021).

367. "Stablecoin 'is the oil to the machine of cryptocurrency. Everything else is a highly speculative and volatile asset, whether it's [B]itcoin, ethereum, whatever. But stablecoins are supposed to be the opposite of that.'" Sheppard, *supra* note 331, at 757 (quoting Orson Newstat) (noting troubles for Tether Holdings Ltd, the issuer of the USDT stablecoin that accounts for 90% of dollar liquidity in crypto transactions. *But see* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 48 (noting stablecoins "might still be too volatile to perform the functions of money or currency"). "The IRS should be open to classifying stablecoins as 'money.'" Chason, *supra* note 39, at 802 (noting that doing so involves two delicate issues and concluding that "[a]bsent a thorough evaluation of stablecoins and their role in non-tax policy, they should not be treated as 'money' for tax purposes").

368. McCullum, *supra* note 40, at 871 (providing examples of volatility in fiat currencies like the Swiss franc, the Russian ruble, the Canadian and Australian dollar, the Brazilian real, the Mexican peso, and the Turkish lira).

U.S. dollar, over the span of a year.[369] As a more historical example, Brazil's currency was very unstable throughout the late 1980s as the country endured a period of hyperinflation.[370] This calls into question how much weight to place on volatility if adopted merely as a factor in classifying virtual currency.[371] A normal level of price volatility, however defined (e.g., looking to see if price fluctuations in relation to an average price over a period of time were low, or looking to see if at a level that is consistent with average foreign exchange variability), could be used as an indicator that a given virtual currency might be viewed closer on the spectrum to currency.[372]

Acceptability and usage have long been key features of currency. Indeed, acceptability and usage as a means of payment are key reasons that in most of the world, virtual currency is treated as currency for purposes of value-added tax ("VAT") systems—"virtual currencies were comparable to fiat currencies in that their sole purpose was to provide a means of exchange."[373] According to the European Central Bank, a key feature of currency is that it is "used as a medium of exchange to

369. *Id.*

370. *Id.*

371. Another point to make is that volatility is tied to use and acceptance as a medium of exchange. As virtual currency gains mainstream acceptance and more individuals hold virtual currency, traders will have less of an impact on price. *See* Lee, *supra* note 366.

372. *See* OECD, TAXING VIRTUAL CURRENCIES, *supra* note 16, at 45–46 (citing G7 WORKING GROUP ON STABLECOINS, INVESTIGATING THE IMPACT OF GLOBAL STABLECOINS 11 (Oct. 2019)) (noting the policy implications and regulatory risks of stablecoins). Governments and regulators are concerned "over its functioning and the possible threat it represents to the global monetary system." *Id.* at 45. A French study concluded that "stablecoins . . . could reach a global scale, pose serious challenges for financial stability and monetary policy." *Id.* at 44.

373. *Id.* at 33. (citing Skatteverket v. Hedqvist, 2015 E.C.R. C-264/14). A similar VAT treatment approach is followed in most non-EU jurisdictions. *Id.* at 36 ("[I]n other jurisdictions the reasons are not always clearly articulated. Often no reasons for this approach are given, although it is likely that in many cases, the approach has been adopted for pragmatic reasons."). In Norway, for example, "the use of virtual currencies as a means of payment, as well as the exchange of virtual currencies, are typically exempt from VAT under the exemption for financial services, provided that the virtual currency is being used as an alternative means of payment." *Id.* In Switzerland, exchanges of virtual currency "for other goods and services are subject to VAT only on the supply of the good or service, but are not a barter transaction." *Id.* Elsewhere, "[o]utside Europe, almost all countries follow a similar approach . . . in not treating the purchase of goods and services with virtual currencies as a barter event . . . ." *Id.*

avoid the inconveniences of a barter system."[374] The European Union's Court of Justice has singled out usage as payment in the "real economy" as the "key characteristic of money."[375] But some prefer emphasis on objective factors that are easily measurable. Adam Chodorow has suggested emphasis should be on features that are more objectively measurable, cautioning against a difficult-to-manage functional approach that would emphasize acceptance and usage.[376]

Reuven Avi-Yonah and Mohanad Salaimi have proposed making the *holding period* of virtual currency a determining factor.[377] Specifically, if virtual currency is held for less than a year, it should be treated as foreign currency; hence, personal transaction gains of $200 or less would be exempt, and a reasonable method basis, rather than an item-by-item basis, would be used in calculating gain or loss.[378] However, if virtual currency is held for more than a year, it is investment property and should be taxed under capital gain and loss rules governing investment property (i.e., the current immediate taxation method).[379] This Article eschews any formulaic approach based solely on objective criteria. Indeed, attempting to adopt a precise standard could yield unsatisfactory results, considering the variations in the types of virtual currency that exist. Emphasizing only digital currency issued by a central bank or public authority, for example, would ignore other types of digital currency, such as

374. Kollmann et al., *supra* note 258, at 936–37 (citing European Central Bank, "Virtual Currency Schemes," at 10 (Oct. 2012)).

375. *Id.* at 937 (citing Skatteverket v. Hedqvist, 2015 E.C.R. C-264/14 ¶ 24).

376. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 383–84. It requires authorities to develop standards for deciding when the use of virtual currency as a method of exchange (versus use as an investment vehicle) would be sufficient enough to yield foreign currency tax status. One objectively measurable feature is "divisibility," which would most assuredly place virtual currency in the "currency" category. Bitcoin, for example, is capable of division into 0.00000001 of a single Bitcoin, dwarfing the dollar's smallest unit of 0.01. Paul Opoku, *There's Enough Bitcoin for Everyone*, NASDAQ (May 19, 2021, 5:38 PM), https://www.nasdaq.com/articles/theres-enough-bitcoin-for-everyone-2021-05-19 [https://perma.cc/A8ZZ-PQRY].

377. Avi-Yonah & Salaimi, *supra* note 43, at 46.

378. *Id.* at 46–47.

379. *Id.* at 75 (noting the method would preserve neutrality between virtual currency and fiat currency when used as real currency).

fiat-backed stablecoins, which may have many of the traditional characteristics of currency.

Under Avi-Yonah and Salaimi's "hybrid" proposal, characterization of a particular virtual currency would not depend on its overall design features but would be dictated by how long each individual owner held the virtual currency.[380] This could potentially double administrative burdens for an owner if, for example, Bitcoin used to transact was held for less than a year (taxed under the foreign currency rules), but Ethereum used to transact was held for more than a year (taxed under the property barter rules); under this scenario, the taxpayer must now comply with two different tax regimes, each with their own amount, timing, and character rules, which could also increase IRS enforcement challenges. And that approach would not preserve neutrality between Bitcoin held for less than a year (taxed under the foreign currency rules) and a fiat-backed stablecoin held for more than a year (taxed under the property barter rules even though the stablecoin possesses truer characteristics of currency than does Bitcoin). Instead of emphasizing only objectively measurable features, which won't always yield rational results, the currency test could be partly subjective.[381]

This Article suggests that the absence of a precise standard in characterizing virtual currency, while not satisfying a desire for tidiness, may be justified, especially considering the recent developments in the virtual currency space. This is the perfect moment to consider alternate tax classification frameworks for virtual currency functioning as transactional currency. One fresh approach would be a flexible facts-and-circumstances classification regime. Some virtual currencies would be considered property, subjecting transactions in such virtual currency to the capital gain and loss rules governing investment

380. *Id.* at 5, 46.

381. Stotzer, *supra* note 50 (suggesting the currency test really is "partly objective and partly subjective: [to] constitute money or currency, the property must be a medium of exchange (the objective test), and it must also be understood as a medium of exchange in its 'common meaning' or 'ordinary usage' (the subjective test)").

property.[382] Others would be considered fiat currency, subjecting transactions in such virtual currency to the tax rules applicable to foreign currency.[383] So, virtual currency issued by a central bank could be classified as foreign currency under section 988 if it also possessed other currency characteristics. Virtual currency not issued by a central government, such as Bitcoin, could also be considered foreign currency if it possessed other characteristics of currency. The government could keep track of each virtual currency's classification, just as it keeps track of which charities are tax-exempt organizations, which tracts of land are opportunity zones, which vehicles qualify for energy credits, and so forth.

Tax law is replete with classification challenges. For example, the classification of a particular corporate financial instrument as debt or equity is critical in determining the tax consequences of transactions.[384] Despite the tax stakes in debt/equity issues, the Code does not define debt or equity. And the IRS did not make some ad hoc decision that all hybrid corporate instruments are one or the other. Instead, courts employ an interesting process to determine whether a particular corporate instrument is debt or equity—often describing a spectrum with equity on one end and debt on the other and then deciding whether hybrid instruments falling in the middle of the spectrum are closer to one end or the other. Classification of a corporate instrument as debt or equity is a question of fact resolved by

382. *See supra* Section I.B.

383. *See supra* Section I.C.; *see also* Herzfeld et al., *supra* note 6 (suggesting virtual currency issued by central governments and stablecoins denominated in foreign currencies might be considered real currency).

384. *See generally In re* Live Primary, LLC, 626 B.R. 171 (S.D.N.Y. 2021); Submicron Sys., Inc., v. KB Mezzanine Fund, 432 F.3d 448 (3d Cir. 2006); Optim Energy, LLC, v. Cascade Inv., LLC, 527 B.R. 169 (D. Del. 2015). Many tax rules cannot be applied until an instrument has first been identified, for tax purposes, as debt or equity. *See, e.g.*, I.R.C. § 162 (allowing deduction of interest paid on debt, but not dividends paid with respect to equity); *id.* § 351 (allowing nonrecognition treatment on receipt of stock (not debt) in exchange for property); *id.* § 243 (allowing a deduction with respect to dividends received from domestic corporations, but not on interest receipts with respect to debt instruments).

weighing many factors.[385] As noted by courts, "neither any single criterion nor any series of criteria can provide a conclusive answer in the kaleidoscopic circumstances which individual cases present."[386]

> The various factors which have been identified in the cases are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture [equity] or represents a strict debtor-creditor relationship [debt].[387]

Consistent with this approach, the government could isolate a number of criteria by which to judge the true nature of a virtual currency as either investment property or currency—for all owners of that virtual currency.[388]

A different but related classification approach could be one that is applied at the individual owner level, i.e., identified factors could be aids in answering the question *with respect to individual owners* whether their particular virtual currency investment constitutes risk investment subject to general tax principles governing property transactions or represents a medium of exchange subject to the tax rules applicable to foreign currency. Under Avi-Yonah and Salaimi's proposal, for example, Bitcoin held by Individual A might be treated as "property" in his hands (because it was held for more than one year), but Bitcoin held by Individual B might be treated as currency in her hands (because it was held for less than a year).[389] The classification scheme could draw on the factors described above

385. Principal factors enunciated by the courts include the intent of the parties, the form of the obligation, the ratio of the company's liabilities to shareholders' equity, the proportionality of debt held by shareholders, subordination, etc. *See* Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) (listing and applying "a number of criteria by which to judge the true nature of an investment which is in form a debt").

386. *Id.* at 697 (citing John Kelley Co. v. Comm'r, 326 U.S. 521, 530 (1946)).

387. *Id.*

388. *See id.* at 696.

389. Avi-Yonah & Salaimi, *supra* note 43, at 22–23.

(hallmarks of currency), but other factors could be considered as well. For example, the nature and purpose of the acquisition by the particular virtual currency owner could be considered. The number and extent of previous exchanges by the owner could also be considered in determining how a taxpayer should self-report virtual currency activity. The analysis would require the weighing of many factors, some bright-line and some vague. As with many tax classification regimes in the Code, the IRS would not have to accept labels (adopted by taxpayers or exchange intermediaries) as controlling.

A classification regime that is individually specific is similar to one used in determining whether a real estate developer held property for investment (a capital asset) or for development (not a capital asset).[390] The Code and regulations fail to definitively resolve the question. As a result, courts have developed a number of factors, which are often mentioned as judicial tests, used to determine whether a seller of real estate is an investor (entitled to capital gain or loss treatment) or a dealer (subject to ordinary income and loss treatment).[391] Although no single factor or circumstance is controlling, certain factors have often been deemed preeminent. For example, the frequency and substantiality of sales is often preeminent.[392] But how the taxpayer self-reports land activity in years prior to sale can also be important.[393] What is clear in the case law, as with the case law in debt/equity determinations, is that the analysis is fact-specific:

390. *See* I.R.C. § 1221(a)(1).

391. *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 909–10 (5th Cir. 1969).

392. *See, e.g.*, *id.* ("[The factors used] most often are: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.").

393. *See, e.g.*, Musselwhite v. Comm'r, 123 T.C.M. (CCH) 1308 (2022) (holding loss was a capital loss because taxpayer consistently reported for years holding the lots for investment and not development); *cf.* Sugar Land Ranch Dev., LLC v. Comm'r, 115 T.C.M. (CCH) 1078 (2018) (holding taxpayers successfully transformed from developers into investors and were, thus, entitled to capital gains treatment on sales of property).

> Without any notable exceptions the many, many cases in this particular field have noted that each individual case must be considered and evaluated on its peculiar and particular facts . . . . "Perhaps the only guiding principle of general application that can be gleaned from the judicial decisions dealing with the problem . . . is that every case of the type mentioned must be decided on the basis of its own fact, there being no single test that can be applied to all such cases with decisive results."[394]

Over time, courts or authorities may choose to provide further guidance for analyzing property-versus-currency issues, and even go as far as elevating a factor or providing some mechanical tests.[395] Attempting to insert too much rigidity or formality in the calculus should be cautioned against. In resolving whether an instrument in a corporation is to be treated as stock or indebtedness, the Treasury Department attempted in 1980 to provide some mechanical tests to make things easy.[396] Under proposed regulations, straight debt instruments held non-proportionately were treated as debt, but straight debt instruments held proportionately were treated as stock unless the outside debt to equity ratio was less than 10:1 and the inside debt to equity ratio was less than 3:1.[397] A separate convoluted analysis was necessary for hybrid instruments.[398] Needless to say, the proposed regulations were widely criticized and eventually

394. Bynum v. Comm'r, 46 T.C. 295, 299 (1966) (quoting Lazarus v. United States, 172 F. Supp. 421, 424 (Ct. Cl. 1959)) (addressing whether the taxpayers were in the real estate business and selling property held by them primarily for sale to customers in the ordinary course of business).

395. Courts have held that certain factors, such as the frequency and substantiality of sales, are preeminent in determining whether subdivided land is a capital asset or non-capital asset. *See* Biedenharn Realty Co. v. United States, 526 F.2d 409, 423 (1976).

396. *See* T.D. 7920, 1983-2 C.B. 69, § 1.1371-1.

397. Christopher R. Hoyt, *New Debt-Equity Regulations Under the Internal Revenue Code,* 46 MO. L. REV. 764, 772 (1981).

398. *Id.*

withdrawn.[399] This is an important lesson if and when a new classification regime is considered for virtual currency.

C. Weighing Benefits and Costs

If a particular virtual currency were to be classified as currency under a new classification regime, neutrality would be achieved between that currency and fiat foreign currency.[400] One might argue, however, that such classification could create new economic distortions by favoring the use of that virtual currency over other virtual currencies classified as property. Such distortion could be justified. A classification system that treated stablecoins or CBDCs as foreign currency, for example, might distort behavior; but it would do so in a good way by encouraging taxpayers to invest in the more stable virtual currency and avoid the riskier ones.[401] The government must often pick winners and losers on purpose:[402] "When a societal interest is compelling enough, a government may subsidize an activity through the tax system to encourage that activity."[403]

Of course, there is always opportunity for tax avoidance. Any new classification framework for virtual currency would need to address government concerns over tax evaders and

399. T.D. 7920, 1983-2 C.B. 69; T.D. 9790, 2016-45 I.R.B. 540 (promulgating final regulations that generally provide "whether an interest in a corporation is treated for purposes of the Internal Revenue Code as stock or indebtedness . . . is determined based on common law, including the factors prescribed under such common law"); Treas. Reg. § 1.385-1(b) (as amended in 2020).

400. Avi-Yonah & Salaimi, *supra* note 43, at 45–46.

401. Under the tax rules governing foreign currency transactions, gains and losses of purchasing power resulting from a change in value from when the virtual currency was acquired to when it was spent are generally treated as ordinary gains or losses. This treatment would be favorable to most taxpayers who have recently seen a decline in the purchasing power of their virtual currency. But, if we begin to see an increase in the virtual currency market, virtual currency transactions would result in ordinary gain treatment, and investors—who seek tax-favored long-term capital gain treatment—"would tend to leave the market." McCullum, *supra* note 40, at 869.

402. Marian, *supra* note 125, at 1503 (raising equity considerations if the government taxed income in the form of block rewards differently from any other income).

403. *Id.* (giving as examples credits for research and development activities to encourage that activity or particular incentives for the production of renewable energies in order to steer taxpayers away from polluting activities).

virtual currency exchange intermediaries willing to aid them.[404] A classification framework applied at the individual owner level would invariably produce more tax avoidance opportunities. Thus, under that classification approach, the IRS should be able to recast an individual's purported currency as property, or vice versa. And measures should be taken to restrict an individual's classification changes as the government has done in other tax contexts.[405] In addition to clarifying the character of virtual currency (investment asset or currency) in a particular individual's hands when its actual classification is clear, additional safe harbors could be used for administrative reasons. In determining whether an owner holds virtual currency as property or real currency, a safe harbor could apply, rendering such determination unnecessary (e.g., the first "x" number of purchases with virtual currency by that owner could be deemed used with real currency to qualify for tax exemption under section 988).[406]

To minimize tax avoidance opportunities, this Article favors a classification system that treats any given virtual currency as either property or currency for all taxpayers. Regardless, it is worth noting that tax avoidance concerns may be a bit

404. Samantha Handler, *Warren Urges Swift Action on Delayed Crypto Tax Reporting Rules*, BLOOMBERG TAX (Aug. 2, 2023, 10:52 AM), https://news.bloombergtax.com/daily-tax-report/warren-urges-swift-action-on-delayed-crypto-tax-reporting-rules [https://perma.cc/KGG6-TETS] (quoting Senator Elizabeth Warren (D-Mass.) and other Senate Democrats).

405. For example, a dealer in securities might be tempted to shift securities from "investment" status to "inventory" status, or vice versa, to say that ordinary income was really capital gain income or that capital loss should be ordinary loss. Section 1236 restricts such classification changes that would be convenient by requiring a taxpayer to identify the status of the security at the time of its acquisition. *See* I.R.C. § 1236(a)(1), (b) (providing that if a dealer is to treat securities as capital assets, he or she must clearly indicate on his records before the close of the day on which the securities are acquired that they are held for "investment" purposes, and he or she cannot later change the classification (e.g., argue anytime thereafter that they were held for sale to customers)). *But see id.* § 1236(d) (providing an exception for securities floor specialists who have seven days in which to make a decision).

406. Real estate developers are eligible for a safe harbor providing capital asset treatment for the first five parcels sold in a given year provided certain requirements are met. *See* I.R.C. § 1237(b)(1); *see also* Treas. Reg. § 1.1237-1(a)(4) (1960) (noting section 1237 is not exclusive; even if a taxpayer does not qualify, he or she may still argue that he or she is an investor to classify all gains as capital gains).

overstated.[407] For starters, the classification of a particular virtual currency as a real currency would require the basic rules applicable to foreign currency to be used in gain or loss computations. Under these rules, taxpayers must use a reasonable method basis (such as averaging); thus, taxpayers would be unable to improperly reduce their tax obligations by picking and choosing which virtual currencies are deemed used in the purchase of goods or services as they can under the property tax regime. The foreign currency basis rules are designed to limit a taxpayers' ability to minimize taxation in cases where funds are commingled.[408] Their application to virtual currency seems an important safeguard considering the fungible nature of virtual currency.

Moreover, virtual currencies that have increased in value and are used as a payment method for personal goods would be eligible for tax exclusion but only on up to $200 in gain.[409] Excess gains of purchasing power resulting from a change in value from when the virtual currency was acquired to when it was spent would be treated as ordinary income tax at higher rates than applicable to capital gains.[410]

Treating certain virtual currency as real currency for tax purposes would also avoid arbitrage opportunities that currently exist. Assume a taxpayer wishes to invest in a foreign currency (e.g., Singapore dollars). Under current law, if she invested in the underlying currency, she would have ordinary gain upon disposition of that currency (under section 988(c) of the foreign currency rules). Under current law, if she invested

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407. *Cf.* Katherine Baer, Ruud de Mooij, Shafik Hebous & Michael Keen, *Crypto Poses Significant Tax Problems—and They Could Get Worse*, IMF (July 5, 2023) https://www.imf.org/en/Blogs/Articles/2023/07/05/crypto-poses-significant-tax-problems-and-they-could-get-worse [https://perma.cc/JE7H-AQLV].

408. *Compare* Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 371 (discussing the ways tax policy attempts to intentionally limit forex manipulation), *with* Claudio Borio, Robert McCauley, Patrick McGuire & Vladyslav Sushko, *Covered Interest Parity Lost: Understanding the Cross-Currency Basis*, BANK INT'L SETTLEMENTS Q. REV., Sept. 2016, at 45, 45 (claiming those attempts have largely failed since 2007).

409. Virtual Currency Tax Fairness Act, H.R. 6582, 117th Cong. (2022).

410. I.R.C. § 988(a)(1).

in a foreign-currency-referent stablecoin (e.g., Liquid's XSGD, which is backed by Singapore dollars), she would have capital gain upon disposition of the stablecoin (under general tax principles applicable to property). Treating the stablecoin as currency, and not property, would prevent that arbitrage opportunity.[411]

Any classification regime would need to balance benefits and costs.[412] Investment by firms would be needed in enabling infrastructure (e.g., easy ways for merchants to convert virtual currency into fiat currency).[413] Integration complexity is a legitimate concern.[414] Potential risks to U.S. financial stability is also a legitimate concern.[415] But risks should be weighed against the many benefits of any alternate classification regime (e.g., opportunities to expand access to financial services, reduction in transactions costs, etc.).

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411. Schwartz, *supra* note 38, at 770.

412. Chodorow, *Bitcoin and the Definition of Foreign Currency*, *supra* note 19, at 384–86 (outlining some Bitcoin benefits).

413. CASTRO TANCO, DELOITTE DIGITAL CURRENCY PAYMENTS SURVEY, *supra* note 23, at 10. Investment will be needed to enable infrastructure. Firms do not necessarily have to build infrastructure internally, but can partner "with third-party payment processors to enable digital currency payment." *Id*. More than half of respondents surveyed plan to have payment processors convert digital currency into fiat so they never actually take custody of the digital currency. *Id.*

414. *Id.* at 11 (noting integration complexity is a barrier, with customer security of the payment platforms at the top of the list).

415. Press Release, U.S. Dep't of the Treasury, Remarks by Secretary of the Treasury Janet L. Yellen at Financial Stability Oversight Council Meeting (Oct. 3, 2022), home.treasury.gov/news/press-releases/jy0990 [https://perma.cc/DK9F-H8LR]; Rifaat, *supra* note 169, at 279–80 (quoting Treasury Secretary Janet Yellen, noting risk to U.S. financial stability if overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure); *see* DEP'T OF TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, *supra* note 9, at 26, 33, 37 (dividing risks into several categories—(1) conduct risks, including product, and investor, consumer, and business protection risks, (2) operational risks, including the technology-specific risks of crypt-assets and systems, and (3) risks arising from crypto-asset intermediation).

CONCLUSION

Virtual currency is increasingly equated with the notion of real currency.[416] Non-tax legal and regulatory schemes are beginning to grapple with this recent phenomenon.[417] The tax system, however, continues to classify all forms of virtual currency as "property," and not "currency," subject to general tax principles governing investment assets. This arbitrarily adopted tax treatment raises a number of equity, efficiency, and administrative concerns, and should be reassessed, especially in light of the emergence of new forms of virtual currency. Visioning a new tax classification framework is no easy task due to competing goals and perspectives. But exploring fresh approaches to the tax treatment of virtual currency when used as currency is a worthy endeavor.

416. *See* Ken Martin, *A Primer on Virtual Currency*, PROB. & TR. L. SECTION NEWSL., July 2020, at 1, 1.

417. Adam Hayes, *How SEC Regs Will Change Cryptocurrency Markets*, INVESTOPEDIA https://www.investopedia.com/news/how-sec-regs-will-change-cryptocurrency-markets/ [https://perma.cc/G43E-6SLQ] (July 24, 2024).