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EXPLORING VIRTUAL CURRENCIES: HOW DO YOU TAX THE CLONES IN THE CLOUDS?

by

John Paul*

I. INTRODUCTION

The emergence of virtual currencies has posed several tax questions. There must be a clear understanding of what virtual currency is for tax purposes. Is it property, currency, a service or something else? When do virtual currency transactions give rise to income? Since virtual currency can be cloned, how do we tax the clones? This article will attempt to answer these questions.

The digital economy has changed the way we consume, interact and do business.[1] This means that the tax system must change in order to keep up with the new environment. If the tax system cannot keep up with the shift from the physical world to the digital world, it will give rise to uncertainty for taxpayers and tax administrations.[2]

The current tax systems are unable to adequately tax the transactions conducted in the digital clouds[3] and this can impose financial burdens on society in the form of lost government tax revenues, distorted competition, international trade burdens and

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even criminal activities.[4] Cloud computing constitutes a significant part of the digital economy; therefore, it magnifies many of the problems the digital economy creates for tax systems.[5]

The use of the clouds generally eliminates the physical transfer of any physical items; therefore, border controls cannot apply to cloud transactions as they do to physical goods.[6] Since many cloud transactions are quite small in amount and are often concluded between parties in places unknown to all of the participants, it is difficult for suppliers, purchasers and tax authorities to acquire the information needed for efficient tax collection.[7]

II. UNITED STATES VIRTUAL CURRENCY REGULATIONS

A. TAXATION ISSUES

In its 2013 Annual Report to Congress, the United States Taxpayer Advocate (USTA) considered the need for more guidance on the tax treatment of virtual currencies to be one of the most serious problems the Internal Revenue Service (IRS) faces.[8] This report noted that since the use of virtual currencies is growing, it is the government's responsibility to inform the public about the rules they are legally required to follow. The USTA recommended that the IRS answer a number of questions including the following:[9]

1. What kind of virtual currency use triggers gains or losses?
2. Will virtual currency gains be treated as ordinary income or capital gains?

3. What are the virtual currency requirements for information reporting, withholding and recordkeeping?

In 2013, the Government Accountability Office (GAO) issued a report that explored the tax compliance risks associated with virtual currencies.[10] The GAO recommended that the IRS find relatively efficient ways to provide information to taxpayers on the various issues regarding virtual currencies.[11]

In 2014, the IRS issued a notice, *Virtual Currency Guidance*, to describe how the existing tax principles apply to virtual currency transactions. 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. In some environments, it operates like "real" currency – i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance – but it does not have legal tender status in any jurisdiction."[12]

So according to the IRS, virtual currency is treated as property for federal tax purposes – not a currency. This means that the same tax principles that apply to property transactions now apply to virtual currencies. A taxpayer who "mines" or receives virtual currency as payment for rendering goods and/or services must include the fair market value of the virtual currency when computing gross income. Furthermore, if virtual currency is paid as wages, the fair market value of the virtual currency is subject to federal income tax withholding, Federal Insurance Contributions Act tax and Federal Unemployment Tax Act tax.[13]

In 2016, the United States Treasury Inspector General for Tax Administration (USTIGTA) released a report recommending additional actions the IRS should take to address income produced through virtual currencies.[14] The USTIGTA Report stated that although the IRS issued Notice 2014-21 with guidance on virtual currency transactions, there has been little evidence of the IRS identifying and addressing potential taxpayer non-compliance issues for such transactions.[15]

B. MONEY LAUNDERING ISSUES

There are concerns that decentralized and untraceable virtual currencies (DUV) are a channel for tax evasion, money laundering and illicit financing. DUV may be used by terrorists to transfer money across national borders and by those who conduct illegal activities online anonymously. In response to these concerns, the United States Financial Crimes Enforcement Network (FinCEN), the regulatory agency charged with preventing money laundering and terrorist financing, started investigating DUV in order to prevent criminals from taking advantage of DUV for illegal and dangerous purposes.[16]

In 2013, FinCEN published a report, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, which addressed the relevance of the Bank Secrecy Act (BSA).[17] This report provides guidance to help taxpayers determine whether their virtual currency activities classifies them as a Money Service Business (MSB), which are non-bank financial institutions regulated by the BSA. According to the FinCEN guidance, a user who obtains virtual currency and then purchases real or virtual goods/services with that virtual currency is not an MSB. Furthermore, the FinCEN guidance states that an administrator/exchanger that accepts, transmits, buys or sells virtual currency for any reason is a

money transmitter (MSB) and therefore subject to BSA monitoring and reporting requirements.[18]

In 2014, the FinCEN issued two rulings on virtual currency miners and investors.[19] Under the first ruling, a user or miner is not an MSB if this user creates or mines a virtual currency for the user's own purposes. Under the second ruling, an entity purchasing and selling virtual currencies only as investments for the entity's own benefit is not an MSB.[20]

FinCEN has taken action against companies that haven't complied with their registration and reporting guidelines. In 2015, FinCEN assessed a $700,000 penalty against Ripple Labs, a San Francisco virtual exchange service, for: (1) violating the BSA by not registering with FinCEN; and (2) failing to implement an adequate anti-money laundering program.[21] Ripple Labs agreed to take actions to ensure compliance with the anti-money laundering regulations – such as having regular, independent compliance reviews and monitoring all future transactions for suspicious activities.[22]

In the case of *Florida v. Espinoza*, the judge dismissed the state's money laundering claims against Mitchell Espinoza, who was charged with illegally laundering $1,500 worth of bitcoins.[23] Espinoza sold bitcoins to undercover police who told him they wanted to use the money to buy stolen credit card numbers. The Court found that virtual currencies cannot be the object of money laundering because under Florida law, virtual currencies are not included as a category in the definition of a monetary instrument.[24]

In *Florida v. Espinoza*, the judge set forth the reasons why bitcoin cannot be considered "money" under the Florida statutes:

"Bitcoin may have some attributes in common with what we commonly refer to as money, but differ in many important aspects. While Bitcoin can be exchanged for items of value, they are not a commonly used means of exchange. They are accepted by some but not by all merchants or service providers. The value of Bitcoin fluctuates wildly and has been estimated to be eighteen times greater than the U.S. dollar. Their high volatility is explained by scholars as due to their insufficient liquidity, the uncertainty of future value and the lack of a stabilization mechanism. With such volatility, they have a limited ability to act as a store of value, another important attribute of money. Bitcoin is a decentralized system. It does not have any central authority, such as a central reserve, and Bitcoins are not backed by anything. They are certainly not tangible wealth and cannot be hidden under a mattress like cash and gold bars. This Court is not an expert in economics; however, it is very clear, even to someone with limited knowledge in the area, that Bitcoin has a long way to go before it is the equivalent of money."[25]

It appears that this Florida court agrees with the IRS in that virtual currency is not a currency. On the other hand, FinCEN believes that virtual currency may be a currency if an administrator/exchanger uses virtual currency for any reason – otherwise, virtual currency is not a currency.

The Florida Statute defines a "monetary instrument" as "coin or currency of the United States or any other country, travelers' checks, personal checks, bank checks, money orders, investment securities in bearer form or otherwise in such form that title thereto passes upon delivery."[26] So do virtual currencies meet the definition of money under Florida law? Not according to Florida's appeals court.

On January 30, 2019, Florida's Third District Court of Appeal reversed the trial court's decision in *Florida vs.*

Espinoza, instead holding that a Bitcoin business was a money transmitter according to Florida law.[27] The Court determined that Bitcoin meets the Florida statute's definition of a "payment instrument" as well as the its definition of "monetary value."[28]

C. SECURITIES REGULATIONS ISSUES

In 2014, the United Stated District Court in Texas decided the first case involving virtual currency with *Securities and Exchange Commission (SEC) vs. Trendon T. Shavers and Bitcoin Savings and Trust.*[29] Shavers established and operated Bitcoin Savings and Trust (BST) and solicited lenders to invest in Bitcoin-related investment opportunities.[30]

Shavers allegedly offered BST investments for approximately one year, during which time Shavers gave fraudulent assurances to bring in more investments and dissuade investors from questioning BST's strategies and dealings. He represented online that BST's risk was low, profits were high and orders were in high demand.[31] Shavers even claimed that when he sells his clients' Bitcoins, "anything not covered is hedged or I take the risk personally."[32]

The SEC brought claims against Shavers and BST under Section 17(a) of the Securities Act of 1933, Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, and Sections 5(a) and 5(c) of the Securities Act of 1933.[33] The basis of the claims was that Shavers defrauded investors by making false statements of material fact. The SEC sued under Section 5 on the basis that an investment in a fund holding Bitcoin is a security and this security was unregistered and not sold pursuant to a registration exemption.[34] It should be noted that the SEC did not regard Bitcoin as a security per se; rather, it was the interests in the Shavers fund that the SEC regarded as a security.[35] The court ruled in favor of the SEC on all of its claims; furthermore,

the court ruled that Shavers and BST were jointly and severally liable for a total of $40,404,667, representing the illicit profits from the fraudulent offering.[36]

D. COMMODITIES ISSUES

In *Commodity Futures Trading Commission (CFTC) vs. My Big Coin Pay,* the first enforcement action alleged that defendants My Big Coin Pay, Randall Carter and Mark Gillespie fraudulently offered a virtual currency called My Big Coin (MBC) for sale and raised $6 million from at least 28 customers.[37] According to the complaint, the defendants: (1) misrepresented that MBC was being traded on a number of currency exchanges; (2) falsely reported the daily trading price; and (3) fraudulently claimed that MBC was backed by gold.[38]

On September 26, 2018, the U.S. District Court for Massachusetts held that the CFTC had sufficiently alleged that MBC was a commodity under the Commodity Exchange Act (CEA).[39] The Court found that the CEA defines "commodity" generally and categorically, "not by type, grade, quality, brand, producer, manufacturer, or form." The Court gave an example: "……the Act classifies "livestock" as a commodity without enumerating which particular species are the subject of futures trading."[40]

E. PROPERTY, SECURITY, MONEY OR COMMODITY?

As a basic survey of the U.S. regulations reveals, different agencies and courts define virtual currencies in different ways depending on their own agendas. Apparently,

virtual currencies can be property, security, money or commodities depending on the nature of the transactions.

If virtual currencies can be defined in different ways, then how would one classify the gains or losses realized from virtual currency transactions? Again, the IRS concluded that "virtual currency is treated as property for U.S. federal tax purposes."[41] The IRS also said that:

- Wages paid using virtual currency to employees are taxable to the employee and must be reported by an employer on Form W-2.
- Virtual currency payments made to independent contractors and other service providers are taxable and self-employment tax rules apply – payers must issue Form 1099.
- The nature of gain or loss from the virtual currency sales or exchanges depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A virtual currency payment is subject to information reporting to the same extent as any other payment made in property.[42]

Although the IRS issued its *Virtual Currency Guidance*[43] in 2014, virtual currency investors weren't quick to report their trading gains. In 2014 and 2015, only 893 and 802 individuals, respectively, reported their Bitcoin-related transactions according to an affidavit filed by an IRS agent.[44]

So, the IRS will determine the tax category of a virtual currency based on the associated transaction. But if the transaction isn't reported, how will the IRS determine the tax category of the virtual currency, especially when the virtual currency exists in the cloud? How will the IRS even know about

the virtual currency at all? And what if the virtual currency is cloned?

III. THE CLONES IN THE CLOUDS

A. *THE BITCOIN CLONE*

While there may be some uncertainty as to what exactly virtual currency is, this uncertainty is compounded by the fact that virtual currency can be cloned.

In 2017, Bitcoin produced an offshoot currency called Bitcoin Cash. Bitcoin Cash was not created out of nothing; rather, Bitcoin was cloned as it existed on August 1, 2017.[45] Why was Bitcoin cloned? Because the members of the Bitcoin community disagreed on how Bitcoin should change in response to its growing popularity. Bitcoin and virtual currencies like it are controlled by "communities" and "consensus."[46] So, the community members who wanted more structural changes left the Bitcoin community and created a new community – Bitcoin Cash.[47]

When Bitcoin Cash cloned the Bitcoin system, it produced a jackpot for Bitcoin owners. Those who owned Bitcoin units on August 1, 2017 became the owners of an equal number of Bitcoin Cash units.[48] The Bitcoin owners did nothing to earn this jackpot as their Bitcoin "private keys" (similar to passwords) allowed them to transfer and control equal amounts of Bitcoin cash whenever they wished.[49] On August 28, 2020, the market capitalizations for Bitcoin and Bitcoin Cash were $212, 477,896,445 and $4,965,541,238, respectively.[50]

B. *CLOUDY CLONE TAXATION*

This created a serious income tax problem. Did the Bitcoin owners have gross income as a result of the Bitcoin Cash jackpot? According to the IRS *Virtual Currency Guidance,* cryptocurrencies are property but not foreign currency. Since they are property, cryptocurrencies can produce capital gains and losses. Since they are not foreign currency, cryptocurrencies do not qualify for de-minimis exclusions.[51]

The IRS Code defines gross income as "all income from whatever source derived."[52] The U.S. Supreme Court has stated that gross income should be interpreted broadly.[53] The U.S. Treasury Regulations enforce the expansive definition of gross income: "Gross income includes income realized in any form, whether in money, property or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash."[54]

Despite its name, Bitcoin Cash isn't cash and some academics have claimed that non-cash profits aren't gross income unless specifically included as such by the IRS.[55] The IRS has claimed the virtual currencies are property.[56] But what kind of property is Bitcoin? If one clones Bitcoin to form Bitcoin Cash, what kind of property is Bitcoin Cash?

Bitcoin is "notional" property, which means that it exists only as a type of recordkeeping.[57] Owners may transfer their interests in notional property but they cannot occupy or use notional property in the way they would occupy or use real property. While Bitcoin may appreciate in value, it is not backed by any property and it offers no dividends, interest, rents or royalties.[58] So how does one tax notional property and how does one tax the clone of notional property?

C. *HARD FORKS AND AIRDROPS*

In response to the issues brought about by the cloning of Bitcoin, the IRS issued Rev. Ruling 2019-24 (the Ruling) in 2019.[59] The Ruling 2019-24 discusses two issues:

- Does a taxpayer have gross income under § 61 of the Internal Revenue Code as a result of a "hard fork" of a cryptocurrency if the taxpayer doesn't receive units of a new cryptocurrency?
- Does a taxpayer have gross income under § 61 as a result of an "airdrop" of a new cryptocurrency following a "hard fork" if the taxpayer receives units of new cryptocurrency?[60]

A hard fork occurs when a cryptocurrency undergoes a protocol change on a distributed ledger, which results in a permanent diversion from that distributed ledger[61] – in other words, a clone. An airdrop is a means of distributing cryptocurrency units to the distributed ledger addresses of multiple taxpayers[62] – in other words, a delivery of the clones to the taxpayers' clouds.

The Ruling takes the position that cryptocurrencies created by a hard fork that is followed by an airdrop are taxed immediately upon the creation of the new cryptocurrency. Basically, the IRS is saying that a hard fork followed by an airdrop is taxable as gross income under § 61 but a hard fork with no following airdrop is not taxable.[63]

D. *PROBLEMS WITH RULING 2019-24*

One problem with the Ruling is that it appears to treat the Bitcoin Cash hard fork as being created at a specific date and time.[64] This is not the case. Bitcoin Cash may have been created at 3:20 p.m. on August 1, 2017 when Bitcoin and Bitcoin Cash ceased having a common transaction history.[65] Or it may have been created at 8:30 p.m. on August 1, 2017 when miners validated new blocks on the Bitcoin Cash blockchain.[66]

This time difference is important because the prices fluctuated from $200 to $400 per Bitcoin Cash unit over the initial five hours.[67] Furthermore, these prices may not be reliable because trading volumes were quite low. Bitcoin Cash wasn't even supported by a cryptocurrency exchange until more than four months after August 1, 2017.[68] Some taxpayers may make a protective § 83(b) election and report the value of their Bitcoin Cash units as zero.[69]

Another problem with the Ruling is that it taxes a hard fork only when it is followed by an airdrop.[70] The IRS maintains that it will tax a clone when the clone is deposited in some account. But that is not the way Bitcoin Cash worked. The Bitcoin Cash units (the clones) were created by the hard fork – no new transactions were created.[71] The Bitcoin Cash developers or cloners simply released software that recognized Bitcoin owners as the owners of Bitcoin cash. These Bitcoin owners did not receive any formal notice that they would become Bitcoin Cash owners and they didn't have to do anything to accept their Bitcoin Cash units – in other words, there was no airdrop.[72] Even though the Bitcoin owners now own Bitcoin Cash, since there was no airdrop of the Bitcoin Cash, there is no taxable transaction according to the Ruling.

IV. RECOMMENDATIONS AND CONCLUSION

It is quite clear that the current U.S. legal system is struggling with the definition and treatment of virtual currencies, especially the clones in the digital clouds. Virtual currencies appear to be treated as currencies, properties, securities and commodities depending on the various transactions and legal jurisdictions that deal with virtual currencies. Since virtual currencies have moved from the fringes of the financial markets to an over $300 billion asset class traded on exchanges, the definition and tax treatment of virtual currencies must be clarified.[73] Any loss of tax revenue due to an inconsistent and inadequate legal system can be devastating to society especially in troubled economic times.[74]

Perhaps a separate enforcement agency specializing in the study and regulation of virtual currencies should be established. Virtual currency exchanges would be required to register with this enforcement agency and their transactions would be monitored. Before cloning a particular virtual currency, the actors would need the guidance and/or supervision of this enforcement agency. As we saw with Bitcoin, the cloning of Bitcoin was done by the "communities" who wanted more structural changes.[75] The Bitcoin owners did not receive any formal notice that they would become Bitcoin Cash owners – it just happened because the "communities" decided it should be done.[76] This is not the way the operation of an asset class worth billions should be conducted.

Central banks could play a role in by granting licenses, under supervision, to virtual currency providers.[77] The central banks could hold virtual currency providers responsible for customer screening, transaction monitoring and reporting suspicious activity in accordance with financial regulations.

Since virtual currencies are a recent phenomenon, their market value is subject to significant short-term fluctuations when new information is revealed.[78] The regulatory uncertainty is at the very least, partly responsible for the volatility observed in the virtual currency markets[79] and will lead to the loss of massive amounts of tax revenue as virtual currencies continue to grow in size. A better regulatory system is needed if we are to tax the clones in the clouds.

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[11] *Id.*
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