

# Avoiding Liability: Changing the Regulatory Structure of Cryptocurrencies to Better Ensure Legal Use

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*ABSTRACT: Monitoring the transactions consumers in the United States make when buying and selling virtual currency requires an inventive regulatory system because many types of virtual currency, like Bitcoin, are operated anonymously and independently. In the United States today, the Internal Revenue Service (“IRS”) has little structure in how it monitors cryptocurrencies, merely classifying them as property and having the taxpayer report all losses and gains subject to the rules of personal property. This classification is difficult to apply because the IRS has little control over how the system is regulated. To solve this issue, the United States should either outlaw the use of cryptocurrency altogether or reclassify virtual currency as foreign currency. Making virtual currency use illegal might not be the most practical solution because of its prominence in the market today, but it would provide the federal government a clear way to deal with cryptocurrency. If the United States reclassifies virtual currency as a foreign currency, there would be an established regulatory framework in place that the IRS would be able to follow when attempting to monitor the use of virtual currency. With either solution, the United States will be better equipped to regulate the financial marketplace of virtual currencies.*

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## I. INTRODUCTION

Money is a tool of exchange, which can't exist unless there are goods produced and men able to produce them. Money is the material shape of the principle that men who wish to deal with one another must deal by trade and give value for value. . . . Money is made possible only by the men who produce.<sup>1</sup>

When Ayn Rand wrote those words in 1957, she could not have known that she was describing cryptocurrency, because the Internet did not yet exist. However, Rand was able to loosely describe today's preeminent form of cryptocurrency—Bitcoin.<sup>2</sup> The new structure of cryptocurrency is similar to a “deal by trade” where different consumers are willing to exchange “value for value” based upon work performed by the men willing to produce the electronic currency.<sup>3</sup> While coins and paper currency are still one of the most prominent forms of currency today, virtual currency has emerged and will

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1. AYN RAND, *ATLAS SHRUGGED* 313 (1957).

2. See generally Daniel Shane, *Bitcoin: What's Driving the Frenzy?*, CNN MONEY (Dec. 8, 2017, 6:23 AM), <http://money.cnn.com/2017/12/07/investing/bitcoin-what-is-going-on/index.html> (explaining the phenomenon behind Bitcoin's increasing popularity as an alternative means of exchange, giving new meaning to the term “money”).

3. See RAND, *supra* note 1, at 313.

likely continue to emerge as technology continues to advance,<sup>4</sup> bringing with it a host of new issues.

As this unprecedented new form of cryptocurrency has become more prominent, a myriad of issues have arisen due to the “currency” being significantly different from anything previously in existence. This Note explores the different issues surrounding Bitcoin and how the U.S. government, specifically the Internal Revenue Service (“IRS”), should regulate cryptocurrencies to solve the issues inherent within Bitcoin. Part II introduces the background of electronic currency, using Bitcoin as a case study. Part III looks at the difficulty in regulating Bitcoin because it was developed as a currency that is to be independent of banks and government interference. Part IV explores the different solutions and some of the potential counterarguments of the proposed solutions. Finally, Part V concludes that classification of cryptocurrency as a foreign currency would be the best way to regulate this new type of money.

## II. HISTORY AND REGULATION OF CRYPTOCURRENCY

This section will delve into the current regulatory background of cryptocurrency to aid in a more accurate understanding of the complexity of regulating virtual currencies. Section II.A explores what a cryptocurrency is. Section II.B explains Bitcoin specifically by analyzing the structure in which Bitcoin operates. Section II.C analyzes how the U.S. government currently classifies virtual currency within the tax system and the responsibilities taxpayers have in reporting cryptocurrencies for tax purposes.

### A. WHAT IS A CRYPTOCURRENCY?

Cryptocurrency, also known as cyber currency or virtual currency, is an “online payment system[] that may function as real currenc[y] but [is] not issued or backed by central governments.”<sup>5</sup> A simplified explanation of basically all virtual currency systems is that they are computer files that can be used when making purchases so long as the merchant accepts cryptocurrencies as a form of payment.<sup>6</sup> Essentially, a consumer purchases the computer file, which is the virtual currency, with a “government-backed currency”—i.e., something like the dollar bill or peso.<sup>7</sup> At this point, the

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4. See Kaitlin Mulhere, *Cash Is Still King*, MONEY (Nov. 4, 2016), <http://time.com/money/4558351/cash-popular-payment-form>; NOVA, *The History of Money*, PBS (Oct. 26, 1996), <http://www.pbs.org/wgbh/nova/ancient/history-money.html>.

5. Omri Marian, Comment, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST IMPRESSIONS 38, 38 (2013).

6. CAL. DEP’T OF BUS. OVERSIGHT, WHAT YOU SHOULD KNOW ABOUT VIRTUAL CURRENCIES 1 (2014), [http://www.dbo.ca.gov/Consumers/Advisories/Virtual\\_Currencies\\_0414.pdf](http://www.dbo.ca.gov/Consumers/Advisories/Virtual_Currencies_0414.pdf).

7. *Id.* (“Virtual currencies (also called crypto-currencies, virtual money, or digital cash), are essentially unique, typically encrypted, computer files that can be converted to or from a government-backed currency to purchase goods and services from merchants that accept virtual currencies.”).

consumer is able to purchase any goods or services he or she desires using the computer file, so long as the merchant is willing to accept this system of payment, which provides independence from the government and traditional financial institutions and gives individuals more flexibility and control over the “currency.”<sup>8</sup> This subjects consumers using cryptocurrency to the whim of merchants who are willing to accept payment in a form that is not an official government-backed currency.

Beyond the risk that merchants will not accept cryptocurrencies, consumers face numerous other obstacles when deciding whether to use cryptocurrencies. For example, because the federal government does not formally back any cryptocurrencies, there is no way to recover the “currency” if it is stolen.<sup>9</sup> Unlike a credit card, which can be cancelled and the money possibly recovered, if the system storing the cryptocurrency is lost or destroyed, there is no way to get the “currency” back because the system operates anonymously.<sup>10</sup> Not knowing who is making the monetary purchases makes it nearly impossible to recover money from the federal government, especially, because the government does not back cryptocurrencies.<sup>11</sup>

Further, there are two ways in which cryptocurrencies fluctuate, which can make them unreliable. First, the valuation of the “currency” can change rapidly.<sup>12</sup> For example, on February 5, 2018, the value of a single Bitcoin was \$8,253.91, but ten days later, the value of a Bitcoin had already increased to \$9,370.49.<sup>13</sup> For those who purchased Bitcoin ten days earlier, it was a sound investment, which could have potentially made the consumer a great deal of money. However, this fluctuation in price leads to market uncertainty. Second, as an emerging technology, cryptocurrencies are rapidly evolving, both legally and technologically.<sup>14</sup> Like all emerging technologies, there is the possibility that something bigger and better may come along, rendering whichever system of cryptocurrency the consumer chose obsolete. This leads to difficulty in predicting when to invest in a virtual currency and when to

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8. See *id.* at 1–2; see also William J. Magnuson, *Financial Regulation in the Bitcoin Era* 8 (Tex. A&M Univ. Sch. of Law, Legal Studies Research Paper No. 18-21, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3148036](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3148036). For a discussion of businesses that accept Bitcoin as a form of currency, see Sean Williams, *5 Big Companies that Currently Accept Bitcoin*, BUS. INSIDER (July 9, 2017, 10:56 AM), <http://www.businessinsider.com/5-big-companies-that-currently-accept-bitcoin-2017-7>.

9. CAL. DEP’T OF BUS. OVERSIGHT, *supra* note 6, at 2.

10. *Id.* at 1. It should be noted that while the money itself cannot be recovered, major virtual currency exchanges do insure lost funds for their consumers. *How Is Coinbase Insured?*, COINBASE, <https://support.coinbase.com/customer/portal/articles/1662379-how-is-coinbase-insured> (last visited Oct. 25, 2018).

11. For further discussion of the anonymity of cryptocurrencies, see *infra* notes 69–74 and accompanying text.

12. See *Bitcoin (USD) Price*, COINDESK, <https://www.coindesk.com/price> (last visited Sept. 4, 2018).

13. *Id.* (providing daily Bitcoin values, including between August 4 to August 14, 2018).

14. See Magnuson, *supra* note 8, at 8. For further explanation of the issues that could arise in the course of virtual currency transactions, see CAL. DEP’T OF BUS. OVERSIGHT, *supra* note 6, at 2.

avoid investing. Legally, there is a great deal of fluctuation in how the government defines what a cryptocurrency is and how to regulate its use.<sup>15</sup> Currently, the IRS treats cryptocurrency as property.<sup>16</sup> Typically, the IRS applies the “[g]eneral tax principles applicable to property transactions . . . to transactions using virtual currency.”<sup>17</sup>

### B. BITCOIN

For ease of analysis, this Note uses Bitcoin as a case study. Section II.B.1 delves into the organizational structure of Bitcoin to provide a better organizational framework. Section II.B.2 looks at how the Bitcoin system operates—both for consumers attempting to maintain the system and consumers making purchases.

#### 1. Structure

To simplify matters, this Note uses the cryptocurrency system of Bitcoin as a case study. Bitcoin is one of, if not the most, pervasive cryptocurrency system in use today.<sup>18</sup> Many countries have addressed the issues surrounding the regulation of Bitcoin, which makes it a good case study due to the ability to look at comparative regulatory policies.<sup>19</sup> However, because Bitcoin is a rather amorphous entity, federal governments have had difficulty classifying it within existing regulatory frameworks.

In 2008, a person (or entity) known by the pseudonym Satoshi Nakamoto<sup>20</sup> published a white paper entitled “Bitcoin: A Peer to Peer

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15. See generally Patrick McLeod, Comment, *Taxing and Regulating Bitcoin: The Government's Game of Catch Up*, 22 COMMLAW CONCEPTUS 379 (2014) (discussing the lack of a defined regulatory framework for dealing with cryptocurrency and proposing how the U.S. government should address the issue).

16. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938. Almost immediately after releasing the guidance on how to file taxes dealing with gains and losses of Bitcoin, commentators began to complain about the lack of clarity provided by the “guidance.” See, e.g., Jose Pagliery, *New IRS Rules Make Using Bitcoins a Fiasco*, CNN BUS. (Mar. 31, 2014, 7:01 AM), <http://money.cnn.com/2014/03/31/technology/irs-bitcoin/>; Johannes Schmidt & Alexander Derrick, *IRS Says Bitcoin to Be Taxed as Gains; New Rule Is Retroactive*, TAX FOUND. (Mar. 28, 2014), <https://taxfoundation.org/irs-says-bitcoin-be-taxed-gains-new-rule-retroactive>.

17. I.R.S. Notice 2014-21, *supra* note 16, at 938. For a more detailed discussion of U.S. regulations of virtual currencies, see *infra* Section II.C.2.

18. See Prableen Bajpai, *The 10 Most Important Cryptocurrencies Other Than Bitcoin*, INVESTOPEDIA, <http://www.investopedia.com/tech/6-most-important-cryptocurrencies-other-Bitcoin> (last updated Oct. 5, 2018, 12:09 PM).

19. Kristina Frunze, *Top Countries Where Bitcoin Is Legal*, ATOZ MARKETS (May 24, 2017), <https://atozmarkets.com/news/top-countries-where-bitcoin-is-legal/>; Allen Scott, *These Are the World's Top 10 Bitcoin-Friendly Countries*, BITCOIN.COM (Mar. 29, 2016), <https://news.Bitcoin.com/worlds-top-10-Bitcoin-friendly-countries>.

20. No one is certain who the creator of Bitcoin is because the entire system was launched under the pseudonym Satoshi Nakamoto which lends an air of anonymity to the system. *Who Is Satoshi Nakamoto?*, COINDESK, <https://www.coindesk.com/information/who-is-satoshi-nakamoto> (last

Electronic Cash System” which introduced the new development.<sup>21</sup> Bitcoin originated as a way to solve what Nakamoto referred to as the “trust based model” of commerce, which is the traditional monetary system that operates through financial institutions backed by the federal government.<sup>22</sup> The issue Nakamoto referenced was what he believed to be an unavoidable percentage of uncertainty within the monetary system, since it is fraught with fraud, cost and payment ambiguity, and reversible payments.<sup>23</sup> In order to solve what he saw as this system’s shortcomings, Nakamoto created a new system where the payments were not dependent upon the word of a person; rather, Nakamoto’s system based payments upon cryptographic proof.<sup>24</sup> He argued that by creating a system which was dependent upon computer transactions, sellers would be protected “from fraud [because] routine escrow mechanisms could easily be implemented to protect buyers.”<sup>25</sup> In order to better maintain a system that protects both buyers and sellers, Bitcoin operates almost completely anonymously. While all Bitcoin transactions are visible to the public, there is nothing linking an individual to the transaction being made.<sup>26</sup>

Today, Bitcoin functions as “a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity.”<sup>27</sup> The lack of backing by a government or legal entity leads to issues with taxation and regulation because it is unclear how the government is supposed to classify and monitor transactions made through this financial system.<sup>28</sup> The nature of Bitcoin, combined with the lack of formal recognition, contributes to the difficulty in regulating it.

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updated Feb. 19, 2016); Adrian Chen, *We Need to Know Who Satoshi Nakamoto Is*, NEW YORKER (May 9, 2016), <https://www.newyorker.com/business/currency/we-need-to-know-who-satoshi-nakamoto-is>.

21. See generally Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, BITCOIN, <https://bitcoin.org/bitcoin.pdf> (last visited Oct. 25, 2018) (explaining the idea surrounding Bitcoin and why the founder believes it’s necessary); Jamie Redman, *Satoshi Nakamoto’s Brilliant White Paper Turns 9-Years Old*, BITCOIN.COM (Oct. 31, 2017), <https://news.bitcoin.com/satoshi-nakamotos-brilliant-white-paper-turns-9-years-old> (commemorating Satoshi Nakamoto’s paper originating the idea of Bitcoin).

22. Makamoto, *supra* note 21, at 1 (“While the system works well enough for most transactions, it still suffers from the inherent weaknesses of the trust based model. Completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes.”).

23. *Id.*

24. *Id.* (“What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.”).

25. *Id.*

26. *Id.* at 6. While a decentralized, non-government backed currency is what Satoshi Nakamoto sought in the creation of Bitcoin, these goals have created inherent issues within the system because they lead to regulatory issues for countries. See *infra* Part III.

27. Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 160 (2012).

28. See *infra* Section II.C.

## 2. How the System Operates

In order to fully understand the government's role in monitoring cryptocurrency, it is important to more deeply understand how Bitcoin operates. The system runs on a series of peer-to-peer computer networks which are established through connections on the users' machines.<sup>29</sup> As a consumer attempts to make a purchase, a single Bitcoin is mathematically generated by the other computers in the network through the performance of complex equations.<sup>30</sup> The process of the computer hardware performing mathematical equations to confirm other Bitcoin transactions takes place through a system called mining.<sup>31</sup> Mining allows users within the network to solve the equations and, in exchange, rewards that user with transaction fees or new Bitcoin.<sup>32</sup> Because the system is designed to make the computer equations increasingly complex, it becomes increasingly more difficult to "mine" for new Bitcoins.<sup>33</sup>

This part of the system was intentionally designed by Nakamoto to help ensure there would be no outside regulation from a central bank, as it guarantees that new Bitcoins cannot be made, which would devalue the existing Bitcoins.<sup>34</sup>

The entire system, including the new Bitcoins being mined and the individual purchases of new Bitcoins, operate on a shared public ledger to which the entire Bitcoin network has access.<sup>35</sup> Identifying information is noticeably absent from this shared ledger.<sup>36</sup> While a cryptographic signature does attach to the information being shared across the public ledger, the "signature is [merely] a mathematical mechanism that allows someone to

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29. *How Does Bitcoin Work?*, ECONOMIST (Apr. 12, 2013), <http://www.economist.com/Bitcoinexplained>. For further explanation on how Bitcoin works, see Meghan E. Griffiths, *Virtual Currency Businesses: An Analysis of the Evolving Regulatory Landscape*, 16 TEX. TECH. ADMIN. L.J. 303, 307-08 (2015); Ethan D. Jeans, Note, *Funny Money or the Fall of Fiat: Bitcoin and Forward-Facing Virtual Currency Regulation*, 13 COLO. TECH. L.J. 99, 104-05 (2015); Nik Custodio, *Still Don't Get Bitcoin? Here's an Explanation Even a Five-Year-Old Will Understand*, COINDESK (July 19, 2016, 2:41 PM), <https://www.coindesk.com/bitcoin-explained-five-year-old>.

30. *How Does Bitcoin Work?*, *supra* note 29.

31. *Id.*

32. Michael Nielsen, *How the Bitcoin Protocol Actually Works*, DDI (Dec. 6, 2013), <http://www.michaelnielsen.org/ddi/how-the-bitcoin-protocol-actually-works>. For more information on transaction fees, see Kyle Torpey, *Bitcoin Transaction Fees Are Pretty Low Right Now: Here's Why*, BITCOIN MAG. (Jan. 31, 2018, 1:32 PM), <https://bitcoinmagazine.com/articles/bitcoin-transaction-fees-are-pretty-low-right-now-heres-why>.

33. *How Does Bitcoin Work?*, *supra* note 29 ("The mathematics of the Bitcoin system were set up so that it becomes progressively more difficult to 'mine' Bitcoins over time, and the total number that can ever be mined is limited to around 21 million.").

34. *Id.* ("There is . . . no way for a central bank to issue a flood of new Bitcoins and devalue those already in circulation.").

35. *How Does Bitcoin Work?*, *supra* note 29.

36. *See id.*

prove ownership” over the Bitcoins involved in the transaction.<sup>37</sup> The signature does this by attaching a private key showing that a person has a right to spend Bitcoin from a specific wallet.<sup>38</sup> There is no way for other users to guess to whom the publicly attached signature actually belongs; rather, it is included to show that someone had the ability to make the purchase from that wallet and that the transaction cannot be altered once it has been issued.<sup>39</sup> Because of the lack of public access to any identifying information in the public ledger, Bitcoin is operated anonymously with respect to what the general public views. Additionally, the lack of identifying information makes it difficult for the government to trace the transactions back to a single IP address, which would allow it to hold the owner at that IP address accountable, unless the consumer makes a mistake in the transaction process.<sup>40</sup>

### C. UNITED STATES REGULATION OF CRYPTOCURRENCY

Section II.C.1 explores why it is important for the government to properly classify and regulate cryptocurrency. Section II.C.2 analyzes how the IRS currently classifies and regulates Bitcoin in the United States today.

#### 1. Importance of Classifying Cryptocurrency

Since cryptocurrencies are growing in popularity, it is important for countries to determine the proper way to regulate them, especially because as the prominence of alternative currencies grows the number of issues increases. The lack of regulation surrounding non-federally backed “currencies” could quickly pose a legal issue. As a matter of fact, many scholars have made the argument that cryptocurrencies are being used as a cover for illicit activity.<sup>41</sup> Some people have stated “that [c]ryptocurrencies ‘could

37. *Some Bitcoin Words You Might Hear*, BITCOIN, <https://bitcoin.org/en/vocabulary> (last visited Oct. 25, 2018).

38. *Id.*

39. *How Does Bitcoin Work?*, *supra* note 29. For a more detailed analysis of the cryptographic operations of Bitcoin see PAUL ANNING ET AL., *THE LAW OF BITCOIN* 1–10 (Stuart Hoegner ed., 2015).

40. Cf. John Bohannon, *Why Criminals Can't Hide Behind Bitcoin*, SCIENCE (Mar. 9, 2016, 9:00 AM), <http://www.sciencemag.org/news/2016/03/why-criminals-cant-hide-behind-bitcoin> (warning that while the Bitcoin structure provides great anonymity, the “carelessness” of criminal consumers has led to leaks in anonymity and the government has progressed in tracing IP addresses back to consumers).

41. See, e.g., SEC v. Shavers, No. 4:13-CV-416, 2014 WL 4652121, at \*8, \*12 (E.D. Tex. Sept. 18, 2014) (granting summary judgment for the SEC against a Ponzi scheme operator who used bitcoins to defraud investors); Scott Isaacson, *The Bamboozling Bite of Bitcoin: Bitcoin Doesn't Make White Collar Crime Possible, but It Does Make It Easier!*, 30 UTAH B.J. 32, 35–36 (2017); Marco Santori, *Silk Road Goes Dark: Bitcoin Survives Its Biggest Market's Demise*, COINDESK (May 16, 2017, 4:30 PM), <https://www.coindesk.com/bitcoin-milestones-silk-road-goes-dark-bitcoin-survives-its-biggest-markets-demise>.



replace tax havens as the weapon-of-choice for tax-evaders.”<sup>42</sup> This is something the IRS is worried about and is trying to stop, as evidenced by *United States v. Coinbase, Inc.*<sup>43</sup> In *Coinbase, Inc.*, the United States sued Coinbase, a private company that sold Bitcoin to the public, “for judicial enforcement of an IRS summons.”<sup>44</sup> The IRS was attempting to obtain information about all people who had used Bitcoin purchased through Coinbase’s system to perform a transaction.<sup>45</sup> To understand why the IRS feels the best way to monitor Bitcoin is through subpoenaing records of private companies, it is important to understand how the United States defines and regulates Bitcoin.

Currently, Bitcoin exists in a legal gray area across numerous countries. This means that while it is currently legal in the United States to buy and sell Bitcoin,<sup>46</sup> there are many countries, including Iceland and Bolivia, where it is illegal to use cryptocurrencies.<sup>47</sup> This can make consumers and merchants anxious as to the legal future of Bitcoin and whether it can be used as a global currency. It is difficult for the government to classify and regulate Bitcoin through the IRS’s tax structure because the U.S. federal government has the “exclusive right to issue currency”<sup>48</sup> and Bitcoin is not an official currency of another government so it does not automatically get classified as a foreign currency. The complications, however, go beyond this concern because if Bitcoin transactions are classified in a way that makes the organization facilitating user transactions (i.e., Coinbase) appear to be taking deposits, the organization must be classified as a “fully-authorized financial institution[.]”<sup>49</sup> While this is more complicated for the existing Bitcoin sellers, classification in this manner could make it possible for the federal government to treat sellers in the same manner as foreign banks, which could increase transparency in reporting.<sup>50</sup>

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42. Sarah Gruber, Note, *Trust, Identity, and Disclosure: Are Bitcoin Exchanges the Next Virtual Havens for Money Laundering and Tax Evasion?*, 32 QUINNIPIAC L. REV. 135, 196 (2013) (quoting Marian, *supra* note 5, at 38).

43. See Petition to Enforce Internal Revenue Service Summons, *United States v. Coinbase, Inc.*, No. 3:17-cv-01431 (N.D. Cal. Mar. 16, 2017). For more information on the status of the case, see Jeff John Roberts, *IRS Blinks in Bitcoin Probe, Exempts Coinbase Transactions Under \$20,000*, FORTUNE (July 10, 2017), <http://fortune.com/2017/07/10/bitcoin-irs-coinbase>.

44. See Petition to Enforce Internal Revenue Service Summons, *supra* note 43, at \*2.

45. *Id.*

46. See Grinberg, *supra* note 27, at 182; see also Mara Lesemann, *Is Bitcoin Legal in the U.S.?*, INVESTOPEDIA, <https://www.investopedia.com/ask/answers/121515/bitcoin-legal-us.asp> (last visited Oct. 25, 2018) (confirming the legality of Bitcoin use in the United States).

47. Antonio Madeira, *Bitcoin Is Still Illegal in These 6 Countries*, BITCOINIST (May 18, 2017, 9:30 AM), <http://bitcoinist.com/bitcoin-still-illegal-six-countries>.

48. Brian W. Smith & Ramsey J. Wilson, *How Best to Guide the Evolution of Electronic Currency Law*, 46 AM. U. L. REV. 1105, 1111 (1997) (exploring the framework of currency today to help understand how electronic currency could fit within the existing regulatory structure).

49. *Id.*

50. For a more in-depth discussion of this idea, see *infra* Section IV.B.

Further, the lack of recognition of Bitcoin as a formal type of currency makes it more difficult because federal governments typically have not regulated currencies, other than the official form of currency, until those currencies became a threat to the official currency.<sup>51</sup> The only country that officially recognizes Bitcoin as a legal form of payment is Japan.<sup>52</sup> Having only a single government recognizing Bitcoin as a legal form of payment, not even an official currency, makes it difficult for other countries to find successful regulatory models to follow.<sup>53</sup>

## 2. Classification Within the Existing Tax Structure

The IRS acknowledges that “[v]irtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like ‘real’ currency . . . but it does not have legal tender status in any [U.S.] jurisdiction.”<sup>54</sup> The IRS further posits that if the cryptocurrency has a corresponding value in the market, it is referred to as a “‘convertible’ virtual currency.”<sup>55</sup> In classifying cryptocurrencies generally, the IRS uses Bitcoin as a case study and points out that Bitcoin is considered a convertible virtual currency because it holds a comparable value to an existing legal currency.<sup>56</sup> In March of 2014, the IRS formally recognized cryptocurrencies as property for tax purposes.<sup>57</sup> However, this classification does not mean cryptocurrencies will *always* be treated as property.<sup>58</sup> For example, in September of 2014, a money-

51. Noah Vardi, *Bit by Bit: Assessing the Legal Nature of Virtual Currencies*, in *BITCOIN AND MOBILE PAYMENTS: CONSTRUCTING A EUROPEAN UNION FRAMEWORK* 63 (Gabriella Gimigliano ed., 2016) (providing a detailed analysis of the regulatory framework surrounding Bitcoin transactions in numerous European countries).

52. Arjun Kharpal, *Bitcoin Value Rises Over \$1 Billion as Japan, Russia Move to Legitimize Cryptocurrency*, CNBC (Apr. 12, 2017, 11:44 AM), <https://www.cnbc.com/2017/04/12/bitcoin-price-rises-japan-russia-regulation.html>.

53. To better understand the benefits that could stem from classification of Bitcoin as an illegal currency see *infra* Section IV.A.

54. I.R.S. Notice 2014-21, *supra* note 16, at 938. The notice was filed on March 25, 2014. *IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, IRS (Mar. 25, 2014), <https://www.irs.gov/newsroom/irs-virtual-currency-guidance>. This filing was prior to Japan changing its classification of cryptocurrency and recognizing it as a legal tender in April 2017. Kharpal, *supra* note 52. While a legal tender, Bitcoin is still not considered an official currency for the country. See *id.*

55. I.R.S. Notice 2014-21, *supra* note 16, at 938.

56. *Id.*

57. *Id.* at 939. While the IRS has published this notice offering guidance about the most efficient way for taxpayers to report gains and losses related to virtual currency, there is not an official provision in the tax code stipulating how taxpayers should report their virtual currency gains and losses. *Id.*; *IRS Virtual Currency Guidance*, *supra* note 54.

58. See Tara Mandjee, *Bitcoin, Its Legal Classification and Its Regulatory Framework*, 15 J. BUS. & SEC. L. 1, 35–36 (2014) (explaining that while the IRS classifies Bitcoin as property, taxpayers are responsible for reporting Bitcoin gains and losses in a myriad of ways).

laundrying case was brought against Reid and Michell Abner Espinoza.<sup>59</sup> The Espinozas were alleged to have laundered approximately \$30,000 of cash through Bitcoin.<sup>60</sup> The defendants attempted to argue that because the IRS classifies cryptocurrencies as property rather than a currency, the money laundrying charges should be completely dismissed because Bitcoin is not technically a currency.<sup>61</sup> This case shows that even though the IRS classifies cryptocurrency as property it is attempting to enforce money laundrying charges as though Bitcoin is a currency. This could lead to arguments that cryptocurrency should be classified differently, as well as counterarguments that the IRS should continue to classify virtual currency as property.

Currently, the IRS has taxpayers self-report cryptocurrency transactions on their returns.<sup>62</sup> With cryptocurrencies, like Bitcoin, the price fluctuates with the market, so all transactions must be reported at the fair market value on the day of the transaction.<sup>63</sup> The IRS expects consumers to accurately report transactions taking place through the marketplace. For Bitcoin specifically, when people fail to submit their transactions, the IRS has the ability to view on the shared public ledger that transactions are taking place, but it is unable to see who is participating in these transactions. Further difficulties arise because cryptocurrency sellers' websites contain little information about when and how one must submit taxes, which differs depending on whether the consumer purchased or mined the currency.<sup>64</sup> This is problematic because it leads to people who use virtual currency to fail to properly, if at all, report transactions. With such a decentralized, anonymous system of accounting, the question becomes: Can the IRS effectively regulate these transactions and, if so, how?

Additionally, merely understanding the regulatory system and classification of cryptocurrencies as property is not enough to determine when it is appropriate to report transactions. It is difficult to determine under the existing U.S. regulatory structure what is the best way to report transactions, because the broad category of property is a squishy classification with numerous preexisting loopholes in the tax code. For example, while the IRS currently classifies cryptocurrencies as property, there are times when

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59. *Id.* at 10.

60. *Id.*

61. *Id.* at 10–11 (“Both defendants have filed to have the money laundrying charges dismissed, invoking the IRS guidance to the effect that Bitcoin is not money, but it is unlikely that such a defense will be retained.”).

62. *Id.* at 35–36.

63. I.R.S. Notice 2014-21, *supra* note 16, at 939.

64. *Id.* at 938–39. The website for Coinbase, the organization whose records are being subpoenaed in *United States v. Coinbase, Inc.*, has very little information regarding how to report taxes. As a matter of fact, the questions specifically state “Coinbase cannot provide legal or tax advice.” *Taxes FAQ*, COINBASE SUPPORT, <https://support.coinbase.com/customer/en/portal/articles/1496488-taxes-faq> (last visited Oct. 25, 2018). The site proceeds to link the reader to the IRS Notice 2014-21. *Id.*

organizations need to disclose transactions as something other than property. The Bank Secrecy Act states that “[t]he regulatory definition of ‘money transmission services’ includes the phrase ‘or other value that substitutes for currency’ to state that businesses that accept stored value or currency equivalents as a funding source and transmit that value are providing money transmission services.”<sup>65</sup> This is an important distinction because businesses that use digital currencies are required to obtain a license as a registered money transmitting business.<sup>66</sup>

Bitcoin transactions frequently fall within this definition of money transmitting business, making it necessary to classify and report these transactions as something other than property.<sup>67</sup> The amorphous nature of cryptocurrencies creates problems under the IRS’s existing classification system because cryptocurrencies do not succinctly fall within what is typically considered, and reported as, property.

### III. PROBLEMS REGULATING BITCOIN IN THE UNITED STATES AND OTHER COUNTRIES

This section analyzes the issues that arise in regulating Bitcoin because it was originally developed by Nakamoto as a currency that was to be independent of financial institutions and government interference.<sup>68</sup> Section III.A looks at problems with Bitcoin by exploring the issues which have arisen due to criminal activity and the failure to report Bitcoin for taxation. Section III.B explores how different countries have classified and regulated cryptocurrencies within their own tax structure to highlight the inherent difficulties surrounding regulation.

#### A. ISSUES WITH BITCOIN’S STRUCTURE IN THE UNITED STATES

Bitcoin’s structure has caused numerous problems. This section discusses two issues that have developed due to Bitcoin’s structure and the existing tax system: (1) Bitcoin’s structure has aided in the funding and evasion of certain criminal activity; and (2) people fail to report Bitcoin for taxation.

##### 1. Criminal Activity

First, it is important to understand why Bitcoin’s structure promotes using Bitcoin for criminal activity. Bitcoin transactions are classified as

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65. Bank Secrecy Act Regulations: Definitions and Other Regulations Relating to Money Services Businesses, 76 Fed. Reg. 43,585, 43,592 (July 21, 2011) (to be codified at 31 C.F.R. pts. 1010, 1021–22).

66. Joseph B. Evans, *Bitcoin, Money and Funds: The Application of the Unlicensed Money Transmitting Services Statute to Virtual Currency*, FORDHAM J. CORP. & FIN. L.: BLOG (Nov. 14, 2016), <https://news.law.fordham.edu/jcfl/2016/11/14/bitcoin-money-and-funds-the-application-of-the-unlicensed-money-transmitting-services-statute-to-virtual-currency>.

67. See *id.*

68. See *supra* notes 20–25 and accompanying text.

“pseudo anonymous.”<sup>69</sup> One commentator has defined this concept by stating, “Bitcoin is largely without effective regulation and transactions in Bitcoin are relatively anonymous. This makes it attractive to people who prefer to operate in the shadows.”<sup>70</sup> This means that when a transaction is made, anyone with access to the shared public ledger is able to view the transaction information; however, “[t]here is no personal information attached to the transaction.”<sup>71</sup> The lack of personal information attached to the transaction makes it possible for a regulator to learn the balance of the Bitcoin account located at that address, but the regulator will be unable to easily discern the user’s true identity.<sup>72</sup> This has led to a growing concern that Bitcoin is being used to hide illicit activity.<sup>73</sup> Commentators have argued that Bitcoin consumers are using it for everything from purchasing illegal substances to tax havens to funding terrorism.<sup>74</sup>

One of the most prominent examples of the use of Bitcoin for illicit purposes was the online marketplace known as Silk Road.<sup>75</sup> Silk Road was a well-known interface where consumers could use Bitcoin to anonymously purchase goods—both legal and illegal.<sup>76</sup> While it was not only used for the sale of illegal substances, the federal government shut down Silk Road because it was notorious for facilitating drug transactions.<sup>77</sup> Upon closing Silk

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69. McLeod, *supra* note 15, at 384 (citing Danny Bradbury, *How Anonymous Is Bitcoin?*, COINDESK (Aug. 19, 2013, 12:50 PM), <https://www.coindesk.com/how-anonymous-is-bitcoin>).

70. Theodore W. Reuter, *Bitcoin’s Digital Enterprise Creates Alternative Business Transactions*, 57 ADVOCATE 33, 36 (2014).

71. McLeod, *supra* note 15, at 384.

72. *Id.* To determine a user’s true identity, the government has to be able to trace who is connected to the address used to make a sale or purchase. See *Protect Your Privacy*, BITCOIN, <https://bitcoin.org/en/protect-your-privacy> (last visited Oct. 25, 2018).

73. See, e.g., *Bitcoin Hit by Denial of Service Attacks as Regulators Prepare Clampdown*, CNBC (Feb. 12, 2014, 7:40 AM), <https://www.cnbc.com/2014/02/12/bitcoin-hit-by-denial-of-service-attacks-as-regulators-prepare-clampdown.html> (commenting that Canada “will toughen rules targeting money laundering and terrorist financing to keep a closer eye on the use of virtual currencies”); Ryan W. Neal, *Bitcoin Foundation Meets with Regulators: Open Dialogue on Future of Digital Currency*, INT’L BUS. TIMES (Aug. 29, 2013, 5:01 PM), <https://www.ibtimes.com/bitcoin-foundation-meets-regulators-open-dialogue-future-digital-currency-1401755>.

74. See, e.g., Gruber, *supra* note 42 and accompanying text; Sean Foley & Jonathan R. Karlsen, *Sex, Drugs, and Bitcoin: How Much Illegal Activity Is Financed Through Cryptocurrencies*, OXFORD BUS. L. BLOG (Feb. 19, 2018), <https://www.law.ox.ac.uk/business-law-blog/blog/2018/02/sex-drugs-and-bitcoin-how-much-illegal-activity-financed-through>.

75. Jeff John Roberts, *The Feds Just Collected \$48 Million from Seized Bitcoins*, FORTUNE (Oct. 2, 2017), <http://fortune.com/2017/10/02/bitcoin-sale-silk-road>. For a further explanation of how profitable the Silk Road marketplace was prior to being shut down, see Andy Greenberg, *Black Market Drug Site ‘Silk Road’ Booming: \$22 Million in Annual Sales*, FORBES (Aug. 6, 2012, 2:28 PM), <https://www.forbes.com/sites/andygreenberg/2012/08/06/black-market-drug-site-silk-road-booming-22-million-in-annual-mostly-illegal-sales>.

76. Vitalik Buterin, *The Silk Road Report*, BITCOIN MAG. (July 4, 2012, 11:40 PM), <https://bitcoinmagazine.com/articles/the-silk-road-report>.

77. *Id.*

Road, online black markets quickly took its place.<sup>78</sup> While the government was able to shut down Silk Road, it did so through electronically closing the virtual marketplace and arresting its founder,<sup>79</sup> which kept the users performing illegal transactions from facing liability.

Adding another level of complexity to the issue of anonymity is that many consumers using online marketplaces to complete illegal transactions through cryptocurrency hide their transactions by accessing the marketplace through Tor.<sup>80</sup> Due to consumers' use of networks like Tor, the government is unable to obtain records of the consumers using the marketplaces as they are shut down.<sup>81</sup> This means that there is an entire group of consumers who performed illegal transactions who are likely still prepared to use the black marketplaces and, with the added help of Tor's anonymity, are able to continue making illegal purchases. Similarly, the anonymous nature of Bitcoin is part of what makes it difficult for regulators to track the person using Bitcoin to make illegal transactions even when he or she fails to use the protections of a network like Tor.

Unfortunately, marketplaces like Silk Road are not unique. The Digital Citizens Alliance conducted a study that found that a mere six months after Silk Road was shut down, new dark markets proliferated the internet.<sup>82</sup> The surge in illicit online drug markets is problematic for the federal government when considering the regulation of Bitcoin because "dark web markets . . . transact almost exclusively in bitcoin."<sup>83</sup> This anonymity makes it an appealing "currency" to perform transactions with because unless law enforcement is able to work with financial cryptographers to develop a method to backtrack internet transactions to an IP address without the consumer themselves making a mistake, the government will not be able to hold purchasers liable for illegal purchases they made.<sup>84</sup>

## 2. Failure to Report Bitcoin in Taxes

A second issue with Bitcoin's current framework is that the U.S. tax system provides an insufficient and unclear basis for the IRS to monitor who

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78. Joon Ian Wong, *Dark Markets Grow Bigger and Bolder in Year Since Silk Road Bust*, COINDESK (Oct. 7, 2014, 2:36 PM), <https://www.coindesk.com/dark-markets-grow-bigger-bolder-year-since-silk-road-bust>.

79. Roberts, *supra* note 75.

80. *Tor: Overview*, TOR, <https://www.torproject.org/about/overview.html.en> (last visited Oct. 25, 2018). Tor is a free online software that allows users to browse the Internet anonymously by bouncing an Internet transaction through various servers to protect user identity by making it difficult, if not impossible, for the transaction to be tracked to a destination. *Id.*

81. *See id.*

82. Wong, *supra* note 78.

83. *Id.* (explaining that six months after Silk Road was shut down "the number of drugs listings on the biggest dark markets had almost doubled . . . to 32,029").

84. *See* Bohannon, *supra* note 40 and accompanying text.

is performing transactions within the marketplace.<sup>85</sup> As stated above, the IRS has defined cryptocurrency, and thereby Bitcoin, as property.<sup>86</sup> While this definition places the responsibility on the consumer to report the use of Bitcoin in taxes, the majority of people using the virtual currency for illicit transactions have not reported Bitcoin as part of their taxes.<sup>87</sup> To note the gross disparity in the number of Bitcoin users as compared to the people reporting the use on tax forms, one need look no farther than the IRS's case against Coinbase. The federal government stated that it launched the investigation into Coinbase's private records, "because the price of bitcoin soared from \$13 to over \$1,100 [from 2013 to 2015], and because only 802 people reported their bitcoin gains or losses in 2015 to the agency."<sup>88</sup> This demonstrates that huge numbers of people are not reporting their Bitcoin transactions properly to the IRS.

To make matters more confusing, the U.S. Department of the Treasury announced that the regulations for businesses selling Bitcoin are different from the regulations for traditional money services businesses ("MSBs").<sup>89</sup> Businesses like Coinbase that act as a platform for Bitcoin transactions are held to more stringent guidelines than traditional MSBs, which could be beneficial if the United States elects to monitor cryptocurrencies more closely.<sup>90</sup> The Financial Crimes Enforcement Network ("FinCEN") has attempted to create more stringent guidelines for cryptocurrency transactions by redefining what the rules for MSBs dealing in cryptocurrency are "and establishing a more comprehensive regulatory approach."<sup>91</sup>

In 2014, the IRS released a notice attempting to answer frequently asked questions to help the public better understand "how existing general tax principles apply to transactions using virtual currency."<sup>92</sup> In this notice, the IRS explained that when a person is reporting his or her taxes, cryptocurrency

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85. See *supra* Section II.C.2.

86. I.R.S. Notice 2014-21, *supra* note 16, at 938 ("For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.").

87. Roberts, *supra* note 43.

88. *Id.* (highlighting why the IRS felt compelled to become more involved in the reporting of Bitcoin transactions).

89. U.S. DEP'T OF THE TREASURY FIN. CRIMES ENF'T NETWORK, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES 1 (2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

90. See *id.* However, this Note focuses on private individuals' use and reporting of Bitcoin without further examination of how the federal government structured the tax system for MSBs. For a more specific analysis of how the federal government regulates MSBs, see *Fact Sheet on MSB Registration Rule*, U.S. DEP'T TREASURY FIN. CRIMES ENFORCEMENT NETWORK, <https://www.fincen.gov/fact-sheet-msb-registration-rule> (last visited Oct. 25, 2018).

91. U.S. DEP'T OF THE TREASURY FIN. CRIMES ENF'T NETWORK, FINCEN ISSUES PREPAID ACCESS FINAL RULE: BALANCING THE NEEDS OF LAW ENFORCEMENT AND INDUSTRY 1 (2011), <https://www.fincen.gov/sites/default/files/shared/20110726b.pdf>.

92. I.R.S. Notice 2014-21, *supra* note 16, at 938.

should be treated as property, with taxable income resulting from transactions completed with virtual currency.<sup>93</sup> While the general tax principles that apply to property transactions apply to transactions using virtual currency, it is complicated to report because the transaction must be converted to U.S. currency.<sup>94</sup> The requirement can cause confusion because consumers are responsible for reporting the fair market value of virtual currency on the date of payment or receipt of the Bitcoins.<sup>95</sup> Further, merely reporting Bitcoin transactions a couple days off of the actual realization date can cause further complications for the IRS in its attempt to monitor transactions made through virtual currency, as the price equivalent fluctuates so much.<sup>96</sup> While the reporting of fair market value is done through comparable exchange rates, the rates have recently been changing substantially in just a matter of days.<sup>97</sup> This causes further corruption of the reporting system because the amount of Bitcoin that is eventually reported to the IRS can be easily manipulated.

The minimal guidance provided by the IRS in the 2014 Treasury Regulation regarding the reporting of cryptocurrency has been insufficient to maintain a strong reporting system, as evidenced by the mere 802 people reporting Bitcoin gains and losses from 2013 to 2015.<sup>98</sup> In 2016, the Treasury Inspector General for Tax Administration (“TIGTA”) conducted an investigation to determine how the IRS should modify the tax structure to adapt to the changing market as more people begin using virtual currencies to make taxable purchases.<sup>99</sup> In its study, the TIGTA made three

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93. *Id.*

94. *Id.* at 938–39. “For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.” *Id.* at 938.

95. *Id.* at 938–39. The extent of the guidance offered by the IRS when attempting to calculate the fair market value of Bitcoin is as follows:

For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. 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 (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

*Id.*

96. *See Bitcoin (USD) Price, supra* note 12 (demonstrating the fluctuation of the price exchange of Bitcoin by comparing the value equivalent to the U.S. dollar; for example, valuing Bitcoin at \$8,253.91 on February 5, 2018, and demonstrating that the rate had already risen to \$9,370.49 by February 15, 2018).

97. *See id.*

98. Roberts, *supra* note 43.

99. TREASURY INSPECTOR GEN. FOR TAX ADMIN, AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE 1–3 (2016), <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf>.



recommendations to the IRS: (1) different government agencies should work together to develop a comprehensive strategy for the IRS to implement when dealing with cryptocurrency; (2) the Deputy Commissioner for Services and Enforcement should provide additional guidance on what documents are required and how to report virtual currency depending on its' use; and, (3) the regulations for third-party reporting for the amount of cryptocurrency should be revised.<sup>100</sup> While the IRS did not appear resistant to the recommendations made, there has been no change in the structure of the IRS or further guidance issued.

On June 2, 2017, Congress acted in response to the IRS's lack of change after the TIGTA report was published. To help ameliorate the situation, Congress wrote to the IRS seeking "additional guidance on the tax consequences and basic tax reporting requirements for transactions using virtual currencies."<sup>101</sup> Congressional members requested that the IRS implement the recommendations made in the TIGTA report to assist taxpayers in complying with the reporting of cryptocurrencies.<sup>102</sup> This would be a step in the right direction for the IRS and could potentially increase reporting of cryptocurrencies, especially for people using the "currency" for legal transactions. However, to date, no change has been made.

Without further guidance, it is likely taxpayers will continue underreporting Bitcoin because there is no clear guidance for how taxpayers need to report their transactions.<sup>103</sup> One of the most succinct explanations of how consumers need to report Bitcoin transactions, based upon the way that individual taxpayer uses the currency, is outlined on TurboTax's website.<sup>104</sup> However, while TurboTax's explanation is intended to be easy for taxpayers to understand, it highlights the difficulty of reporting virtual currencies because it shows that Bitcoin is being held as a capital asset that must be reported as a property to be taxed.<sup>105</sup> On the other hand, Bitcoin is taxed as income when the taxpayer uses Bitcoin for the payment of goods and services

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100. *Id.* at 8, 11, 16.

101. Letter from Jared Polis & David Schweikert, Congressmen, to John Koskinen, Comm'r, Internal Revenue Serv. (June 2, 2017), [https://polis.house.gov/uploadedfiles/060217\\_ltr\\_irs\\_digital\\_currency.pdf](https://polis.house.gov/uploadedfiles/060217_ltr_irs_digital_currency.pdf) (seeking further information for the taxpayers to clarify the murky system of tax reporting surrounding virtual currencies).

102. *Id.* at 2.

103. See Robert A. Green, *How to Report Bitcoin Cash and Avoid IRS Trouble*, FORBES (Aug. 4, 2017, 10:51 AM), <https://www.forbes.com/sites/greatspeculations/2017/08/04/how-to-report-bitcoin-cash-and-avoid-irs-trouble> (using language such as "I suggest reporting" and "I don't think" to explain how the author, a licensed CPA, would report Bitcoin transactions through the existing tax structure).

104. *Tax Tips for Bitcoin and Virtual Currency*, INTUIT TURBOTAX, <https://turbotax.intuit.com/tax-tips/tax-payments/tax-tips-for-bitcoin-and-virtual-currency/L1ZOgUooq> (last visited Oct. 25, 2018) (providing information updated for the 2018 tax year and explaining how the consumer has to report Bitcoin as income even when the government classifies it as property).

105. *Id.*

or the taxpayer mines Bitcoin “to validate . . . transactions and maintain the public . . . ledger.”<sup>106</sup> Based on the difficulties in the current system, the IRS needs to structure its regulations in a more efficient manner to ensure the public can effectively report transactions. This is especially true because of the IRS’s difficulties in monitoring who performs transactions due to issues of anonymity.

#### B. FOREIGN COUNTRY’S REGULATION OF CRYPTOCURRENCY

To formulate a way for the United States to efficiently regulate the tax structure of virtual currency, this Note looks to other countries’ regulation of cryptocurrencies. In comparing the U.S. classification of cryptocurrencies as property, understanding that the IRS has provided little illumination regarding the proper way to handle the intricacies surrounding cryptocurrencies, we are able to explore whether there is a more efficient system for reporting cryptocurrency transactions which limits consumer’s ability to use them for illegal means or tax evasion.<sup>107</sup> Below is a discussion of the manner in which China, Japan, and Iceland regulate cryptocurrency.

##### 1. China

As a country, China has taken a hardline stance on its regulation of Bitcoin. The Chinese government issued a Notice on Precautions Against the Risks of Bitcoins on December 2, 2013.<sup>108</sup> In the Notice, the issuing bodies defined Bitcoin “as a special ‘virtual commodity’”; however, the Chinese government refuses to view Bitcoin as a currency.<sup>109</sup> In its refusal to acknowledge Bitcoin as a currency, the Chinese government said that because of the existing classification Bitcoin cannot be circulated in the marketplace by monetary institutions.<sup>110</sup> Further, banks and payment institutions are no longer allowed to deal in Bitcoin, making it difficult for consumers to find a marketplace willing to accept Bitcoin.<sup>111</sup> More recently, China has strengthened its stance toward Bitcoin by outlawing initial coin offerings

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106. *Id.*

107. See generally LAW LIBRARY OF CONG.: GLOB. LEGAL RESEARCH CTR., REGULATION OF BITCOIN IN SELECTED JURISDICTIONS (2014), <https://www.loc.gov/law/help/bitcoin-survey/regulation-of-bitcoin.pdf> (providing a report performed by the Library of Congress comparing foreign jurisdictions and their varying regulations of Bitcoin).

108. *Id.* at 6. Prior to issuing the Notice refusing to allow business with Chinese Bitcoin exchanges, China Daily stated on November 29, 2013 that “China now transacts half of the global Bitcoin volume and is a leader in pushing up the exchange rate.” John Coulter, *Beware of the Baneful Bitcoin Bug*, CHINA DAILY USA (Nov. 29, 2013, 7:02 AM), [http://usa.chinadaily.com.cn/epaper/2013-11/29/content\\_17140806.htm](http://usa.chinadaily.com.cn/epaper/2013-11/29/content_17140806.htm).

109. LAW LIBRARY OF CONG., *supra* note 107, at 6.

110. *Id.*

111. *Id.*

(“ICOs”)<sup>112</sup> and closing the country’s three largest exchanges which dealt in the sale of Bitcoin.<sup>113</sup> Before these changes, the country allowed ICOs to deal in Bitcoin, even though the marketplace would not typically accept Bitcoin as a currency. Now, however, not only is the marketplace not allowed to accept Bitcoin for transactions, there is no place within China to legally purchase Bitcoin.

Commentators are uncertain what the Chinese government’s next steps will be as it attempts to regulate Bitcoin, but some commentators believe that the government will maintain a hard line toward Bitcoin by continuing to restrict the already severely limited marketplaces available for consumers to perform Bitcoin transactions.<sup>114</sup> CoinDesk<sup>115</sup> has stated that the Chinese government is “[h]eavily critical of cryptocurrency exchanges” and looking to stop these transactions which the government perceives to be illegal activity.<sup>116</sup> In order to do this, the Chinese government feels it must meet Bitcoin regulations with an “iron fist” and “zero tolerance.”<sup>117</sup> Overall, the Chinese government has given Bitcoin transactions little leeway, which is substantially different from the regulation system in the United States today. The Chinese government does not have an established reporting system for taxpayers and there are a limited number of markets in which a consumer can use Bitcoin. In contrast, the United States has clearly stated that the taxpayer is responsible for reporting gains and losses of cryptocurrencies through filing taxes.

## 2. Japan

Japan has taken a much more open stance toward the regulation of virtual currencies. The Japanese government waited until May 25, 2016, to

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112. Tian Chuan & Rachel-Rose O’Leary, *China Outlaws ICOs: Financial Regulators Order Halt on Token Trading*, COINDESK (Sept. 5, 2017, 11:24 AM), <https://www.coindesk.com/china-outlaws-icos-financial-regulators-order-halt-token-trading>. An ICO is an “initial coin offering,” which “is a fundraising means in which a company attracts investors looking for the next big crypto score by releasing its own digital currency in exchange, typically, for [B]itcoin.” Shawn Langlois, *What Is an ICO?*, MARKETWATCH (Oct. 12, 2017, 5:52 AM), <https://www.marketwatch.com/story/what-are-icos-and-why-is-the-sec-taking-steps-to-protect-investors-from-them-2017-07-27>.

113. Charles Bovaird, *Bitcoin Trades Sideways as Investors Look to China*, FORBES (Sept. 24, 2017, 7:00 PM), <https://www.forbes.com/sites/cbovaird/2017/09/24/bitcoin-trades-sideways-as-investors-look-to-china>.

114. See *id.*; Rachel Rose O’Leary, *China State News Calls for ‘Iron Fist’ Regulation of Bitcoin Exchanges*, COINDESK (Oct. 5, 2017, 8:00 PM), <https://www.coindesk.com/china-state-news-calls-for-iron-fist-regulation-of-bitcoin-exchanges>.

115. CoinDesk considers itself “the leading digital media, events and information services company for the crypto asset and blockchain technology community. Its mandate is to inform, educate and connect the global community as the authoritative daily news provider dedicated to chronicling the space.” *About CoinDesk, Inc.*, COINDESK, <https://www.coindesk.com/about> (last visited Oct. 25, 2018).

116. Chuan & O’Leary, *supra* note 112 (attempting to predict what the Chinese government will do next with Bitcoin regulation after outlawing ICOs).

117. *Id.*

begin regulating Bitcoin, when it amended the Japanese Payment Services Act (“PSA”).<sup>118</sup> The amendment to the PSA did four major things to regulate cryptocurrencies: (1) defined virtual currency;<sup>119</sup> (2) required virtual currency exchanges to register with the federal government;<sup>120</sup> (3) regulated the operations of virtual currency exchanges;<sup>121</sup> and, (4) supervised virtual currency exchanges.<sup>122</sup> On April 1, 2017, Japan recognized Bitcoin as a legal payment method, with many of the country’s major retailers supporting the law and beginning to accept Bitcoin as payment.<sup>123</sup> While the Japanese government has recognized Bitcoin as a formal payment method, the government has not yet recognized it as a currency.<sup>124</sup> This classification limits what the government can do under the existing tax structure to regulate cryptocurrency use. However, on July 1, 2017, the Japanese government further relaxed the regulation of Bitcoin to make it easier for consumers to make purchases with Bitcoin by eliminating consumption taxes on the virtual currency.<sup>125</sup> The virtual currency exchanges now must report certain consumer information and monetary amounts helping the government concerning taxation and leaving individual consumers with less responsibility for reporting gains and losses.<sup>126</sup>

In contrast to the United States, Japan has recognized virtual currency as a formal method of payment and placed the responsibility for monetary

118. YASUTAKE OKANO, VIRTUAL CURRENCIES: ISSUES REMAIN AFTER PAYMENT SERVICES ACT AMENDED 2 (2016), <http://fis.nri.co.jp/~media/Files/publication/kinyu-itf/en/2016/lakyaravol243.pdf>.

119. *Id.* Virtual currency was defined “as a store of value that can be used in the settlement, trade or exchange of goods and/or service transactions among large numbers of unspecified parties and is transferable via information processing systems.” *Id.*

120. *Id.* After defining virtual currency exchanges, the Japanese government requires that businesses operating virtual currency exchanges must “meet capital/financial requirements and register with the national government.” *Id.*

121. *Id.* at 2–3. Virtual currency exchanges are regulated through disclosure requirements to users on a variety of matters, IT regulations, asset segregation, and audits performed periodically. *Id.*

122. *Id.* at 3. Virtual currency exchanges were given requirements on the types of records they needed to maintain, reports they are required to submit, examinations they must comply with, and others. *Id.* Virtual currency exchanges were also added to lists of businesses that had “to comply with the Act on Prevention of Transfer of Criminal Proceeds.” *Id.* The author of the piece posits that the strict regulations by the government are going to inhibit businesses from entering the currency exchange business; however, that has not been what happened in practice. *Id.*; Kevin Helms, *How Japan Prepares to Recognize Bitcoin as Method of Payment on April 1*, BITCOIN.COM (Mar. 30, 2017), <https://news.bitcoin.com/japan-bitcoin-method-payment-april-1>.

123. See Kharpal, *supra* note 52.

124. Helms, *supra* note 122.

125. Joseph Young, *It’s Official: Japan Has Eliminated Tax on Bitcoin, Rise in Trading Expected*, COINTELEGRAPH (July 3, 2017), <https://cointelegraph.com/news/its-official-japan-has-eliminated-tax-on-bitcoin-rise-in-trading-expected>.

126. Kevin Helms, *How Japan’s New Regulations Affect Bitcoin Exchanges*, BITCOIN.COM (Feb. 14, 2017), <https://news.bitcoin.com/japan-regulations-bitcoin-exchanges>.

reporting on someone other than the consumer—primarily, the virtual currency exchanges.<sup>127</sup> In Japan, the government shifted the burden and regulation to virtual currency exchanges, with taxpayers having less accountability.<sup>128</sup> However, even with stricter regulations on virtual currency exchanges, there is not currently an explicit responsibility for businesses or taxpayers to report Bitcoin holdings while accounting for their taxes, the Japanese government will continue to face issues moving forward.<sup>129</sup> The government is aware of the lack of personal taxation regulation and the Accounting Standards Board of Japan is attempting to create a framework for how to treat virtual currency when dealing with taxes.<sup>130</sup>

### 3. Iceland

The final country this case study will contrast with the U.S. cryptocurrency regulation is Iceland. The Central Bank of Iceland released a statement, which made it illegal to conduct transactions using cryptocurrency because of the Icelandic Foreign Exchange Act.<sup>131</sup> While the country has not officially declared cryptocurrencies illegal, the country has stated “that Icelandic currency cannot leave the country and that foreign currency cannot be used in the country.”<sup>132</sup> This means that it is not officially illegal for taxpayers to conduct Bitcoin transactions, however, they are unable to purchase the Bitcoin being used for the transaction from a foreign exchange and the Bitcoin must have been mined in Iceland.<sup>133</sup> The Icelandic government has not yet regulated the tax structure to provide a concise reporting method, likely because of the strict regulation and limited availability for use in the marketplace.

This method of classification is entirely different from the U.S. regulatory system. While the United States is currently in a murky area of classification for cryptocurrency, it has offered some guidance. On the other hand, the Icelandic government has offered its residents substantially less guidance.<sup>134</sup>

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127. *See id.*

128. Helms, *supra* note 122.

129. *Virtual Money Poses Accounting Dilemma for Japan's Early Adopters*, NIKKEI ASIAN REV. (Mar. 29, 2017, 3:00 PM), <https://asia.nikkei.com/Business/Trends/Virtual-money-poses-accounting-dilemma-for-japan-s-early-adopters>.

130. *Id.* (providing a more in-depth analysis of the Japanese accounting rules surrounding virtual currencies).

131. LAW LIBRARY OF CONG., *supra* note 107, at 11.

132. Madeira, *supra* note 47.

133. *Id.* The article quotes the full statement given by the Central Bank of Iceland in March 2014 relating to the regulation of Bitcoin, which states “[t]here is no authorization to purchase foreign currency from financial institutions in Iceland or to transfer foreign currency across borders on the basis of transactions with virtual currency. For this reason alone, transactions with virtual currency are subject to restrictions in Iceland.” *Id.*

134. For example, there currently is no clear outline on when taxpayers are obligated to report Bitcoin transactions that do not violate the Icelandic Foreign Exchange Act.

However, due to the existing ban on the use of all foreign currency, it appears that the Icelandic government is reluctant to permit consumers to use cryptocurrencies.

#### IV. CHANGING HOW THE UNITED STATES CLASSIFIES CRYPTOCURRENCY

This Note proposes two potential solutions to the issues of criminal activity<sup>135</sup> and inadequate tax reporting that exist with cryptocurrencies in the United States.<sup>136</sup> The first solution takes a hardline stance toward cryptocurrencies that would help eliminate the criminal activity that Bitcoin has made possible, and would make reporting taxes unnecessary; however, it is likely not the best solution due to the pervasiveness of cryptocurrencies today. The second, and preferred, solution provides a more concrete system of reporting taxes, which will in turn help resolve some of the issues with criminal use and help overcome the inherent issues with Bitcoin's anonymity.

##### A. FOLLOW CHINA/ICELAND'S MODEL TO ELIMINATE BITCOIN USAGE

One of the easiest ways for the federal government to restructure the tax system would be to completely ban Bitcoin usage through the implementation of more stringent regulations on platforms facilitating Bitcoin transactions, like those in place on virtual currency exchanges in China,<sup>137</sup> combined with a ban similar to the Icelandic ban on foreign currency.<sup>138</sup> To ensure a complete ban of cryptocurrency, the United States will need to make minor modifications to both countries' regulations. China has currently "ordered third-party payment companies 'not to do business with Bitcoin exchanges in China, meaning that holders of the virtual currency would lack a channel to exchange their Bitcoins for such currencies as the Chinese yuan or US dollar.'"<sup>139</sup> This severely limits the options consumers have when attempting to perform transactions using Bitcoin as currency, making it so the only transactions being performed with Bitcoin are illegal transactions. This narrows the scope of transactions the government will need to monitor because it knows which transactions are using Bitcoin illegally—all of them taking place within the United States. The government will then be able to

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135. See *supra* Part III.A.1.

136. See *supra* Part III.A.2.

137. See Luke Graham, *Another Major Country Joins China and Japan in Cracking Down on Bitcoin Exchanges*, CNBC (Aug. 17, 2017, 6:32 AM), <https://www.cnbc.com/2017/08/17/bitcoin-faces-regulations-crackdown-by-asia-pacific-country.html> (explaining that the Australian government is following the lead of China and creating more stringent guidelines for Bitcoin exchanges so it becomes more difficult for consumers to use the virtual currency for money laundering or terrorism financing).

138. Madeira, *supra* note 47.

139. Lawrence Trautman, *Virtual Currencies; Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox?*, 20 RICH. J.L. & TECH. 1, 73–74 (2014) (quoting Wu Yiyao, *Bitcoin Falls on 3rd-Party Pullback*, CHINA DAILY (Dec. 18, 2013, 7:01 AM), <http://usa.chinadaily.com.cn/a/201312/18/WS5a2fa18ca3108bc8c6727d7e.html>).

allocate resources to follow transactions in a manner similar to what it did when catching the creator of Silk Road. Iceland's ban under the Icelandic Foreign Exchange Act will need to be modified because the ban does not completely stop the use of cryptocurrencies as the restrictions are only on international purchases or sales, not on cryptocurrency mined or bought in Iceland.<sup>140</sup> A ban by the United States would not be on all foreign currency, just cryptocurrency. By only banning cryptocurrency the United States ensures that it remains a global financial market because every other foreign currency will still be valued the same in the financial markets.

Through combining the two regulatory schemes, the United States would be able to ban the use of cryptocurrencies more stringently than either country's model has thus far because it creates a marketplace where any Bitcoin transaction within the United States is an illegal transaction. Like China, the U.S. government needs to completely ban—and very carefully monitor—the use of platforms facilitating Bitcoin transactions. While this does not prevent consumers from completing transactions outside of exchanges like Coinbase, it narrows the focus to darknet marketplaces, which already exist. While it is difficult for the government to monitor these illegal marketplaces, especially due to proxies like Tor, it allows the United States to allocate resources to a single outlet. This may prove difficult until the government develops a way to trace an IP address from a Bitcoin transaction because it is hard to otherwise connect a consumer to a wallet due to the anonymity of cryptocurrencies. However, the closing of Silk Road shows that it is not impossible so long as the government is persistent in monitoring the sites.

In addition to creating regulations for virtual exchanges, the federal government would need to implement a complete ban on transactions performed with cryptocurrencies.<sup>141</sup> A recent study estimated that 25% of Bitcoin users perform illegal activity with the currency.<sup>142</sup> A ban cuts back the number of transactions the United States would have to monitor by 75%, making it easier for the United States to allocate resources to go after a single individual. By banning any financial transactions performed with virtual currency for both the consumer and the currency exchanges, the government will have to develop new technology to catch people en masse. Until that point, the government could catch individuals by planting an officer as a

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140. Madeira, *supra* note 47.

141. For an example of a partial ban on cryptocurrency, see generally *Significant Risk Attached to Use of Virtual Currency*, CENT. BANK ICE. (Mar. 19, 2014), <https://www.cb.is/publications-news-and-speeches/news-and-speeches/news/2014/03/19/Significant-risk-attached-to-use-of-virtual-currency> (“[T]here is no authorisation to purchase foreign currency from financial institutions in Iceland or to transfer foreign currency across borders on the basis of transactions with virtual currency. For this reason alone, transactions with virtual currency are subject to restrictions in Iceland.”).

142. Kyle Torpey, *Study Suggests 25 Percent of Bitcoin Users Are Associated with Illegal Activity*, NASDAQ (Jan. 22, 2018, 6:06 PM), <https://www.nasdaq.com/article/study-suggests-25-percent-of-bitcoin-users-are-associated-with-illegal-activity-cm908949>.

buyer or seller. While this will not always be successful, if the officers are able to connect an individual with a mailing address where the purchase is being shipped, they can begin catching a small number of individuals.

When considering this as a potential solution, though, the government needs to realize that the difficulty in completely banning cryptocurrencies does not lie solely in monitoring the illegal marketplace. Implementing a ban like that outlined in the Icelandic Foreign Exchange Act is much more difficult for a country like the United States because it is a global financial marketplace. Even though this solution does not go to the level of banning all foreign currency, just cryptocurrency, it could still close an entire marketplace from consumers. While it appears to be a simple solution that will allow more strict monitoring of criminal activity and eliminate the necessity of tax reporting, it would likely be difficult to implement because cryptocurrencies have become pervasive and the government will still struggle to track illegal consumers because it has not yet developed the capability of connecting an IP address to a single consumer. Additionally, experts predict that cryptocurrencies will continue to increase in value and become more pervasive, which will make it less likely the IRS will want to eliminate cryptocurrencies altogether.<sup>143</sup>

*B. FOLLOW JAPANESE MODEL TO TREAT CRYPTOCURRENCIES AS  
FOREIGN CURRENCY*

As it is likely that if the U.S. government were to attempt to ban virtual currencies entirely a number of consumers and marketplaces would be upset because of the pervasiveness of virtual currency, the U.S. government should consider a more viable solution.<sup>144</sup> The most effective solution would be for the IRS to treat virtual currency not as property that has to be reported according to general property standards, but as a foreign currency. This classification would allow the IRS to better regulate cryptocurrency.<sup>145</sup> The standard would be similar with regard to the taxpayers, but would allow the federal government to implement more control over businesses that operate in the cryptocurrency market. This system creates a second layer of reporting similar to Japan's regulation of virtual currency exchanges. While U.S. regulation would differ in that it would have control over both the taxpayer

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143. Arjun Kharpal, *Cryptocurrency Market Could Hit \$1 Trillion This Year with Bitcoin Surging to \$50,000, Experts Say*, CNBC (Feb. 7, 2018, 7:35 AM), <https://www.cnbc.com/2018/02/07/bitcoin-price-could-hit-50000-this-year-experts-say.html>.

144. For more information on the number of people who currently use Bitcoin internationally, see Kyle Torpey, *Report Estimates There Are More Than 10 Million Bitcoin Holders Worldwide*, COINJOURNAL (Jan. 11, 2017), <https://coinjournal.net/report-estimates-10-million-bitcoin-holders-worldwide>.

145. Classifying Bitcoin as a foreign currency for the purposes of taxation would require the U.S. government to formally acknowledge that Bitcoin is a "currency," which is something that no country has yet done.



and the businesses selling cryptocurrency, this is better because there is an increased regulatory control with dual reporting.

First, if the IRS classifies virtual currencies as a foreign currency and taxes it as such, there is a clear regulatory path for the IRS to follow to prevent people from using cryptocurrencies for illicit means such as tax evasion or illegal purchases.<sup>146</sup> The IRS has previously had to determine how taxpayers were using foreign banks to hide foreign money, which will make it easier for the IRS to create a regulatory system to monitor virtual currency exchanges.<sup>147</sup> Foreign banks are “required to disclose identification of account holders as well as finer details pertaining to the assets and transactions” of the account holders.<sup>148</sup> Imposing the same requirement on virtual currency exchanges ensures that not only is the IRS receiving a financial report from taxpayers making the transactions, but it is receiving the same report from the institutions being used as a medium for exchange. This provides a double layer of accountability, which goes a step further than Japan who merely places the burden of reporting on virtual currency exchanges. This is a step toward eliminating criminal activity because the IRS will have identifying information about the consumer.<sup>149</sup> It is important to note that while the IRS obtains identifying information about consumers, it is only the consumers using virtual currency exchanges to complete transactions that can be monitored by this dual layer of reporting.

One limitation to this solution is that it is only a step in the right direction. In an initial purchase from a virtual currency exchange, the purchaser must turn over identifying information to the company from which he or she is buying the cryptocurrency. However, after consumers have purchased the “currency” from said virtual currency exchange, he or she is able to turn around and sell those virtual currencies in a way that may or may not be monitored. Due to the unregulated nature of the later sales, requiring virtual currency exchanges to report the transactions will only allow the IRS

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146. The IRS has already attempted to stop tax evasion through foreign banks so there is a structure in place for the government to monitor and audit accounts. *IRS Issues Key Foreign Currency Tax Regulations: Treasury Regulations Apply to Non-U.S. Branch Operations*, RSM (Dec. 9, 2016), <http://rsmus.com/what-we-do/services/tax/international-tax-planning/irs-issues-key-foreign-currency-tax-regulations.html>.

147. See Robert W. Wood, *Will IRS Find Your Small Foreign Bank Account?*, FORBES (June 25, 2013, 2:05 PM), <https://www.forbes.com/sites/robertwood/2013/06/25/will-irs-find-your-small-foreign-bank-account>.

148. *How Does the IRS Find Foreign Bank Accounts?*, DALLO L. GROUP (Jan. 31, 2016), <https://dallolawgroup.com/how-does-the-irs-find-foreign-bank-accounts>. Foreign banks are further “required to withhold and pay the IRS 30% of the accounts source income and/or gross proceeds from the sale of securities which occur in [(1)] [n]on participating financial institutes[,] [(2)] [a]ccounts that are owned by individuals who have not disclosed whether or not they are U.S. citizens[, and] [(3)] [f]oreign entity accounts where the identity of the owners is unknown.” *Id.*

149. This Note suggests that the identifying information provided by the virtual currency exchanges would be the same as that currently provided by foreign banks.

to gain insight into the initial purchase. However, this is a step in the right direction, especially in attempting to get more transparency in reporting.

Second, even though the taxpayer is still tasked with the responsibility of reporting foreign bank and financial accounts to the federal government, there is a clear reporting system which a taxpayer is required to follow as opposed to the loose guidelines currently in place for virtual currencies. When reporting taxes to the IRS, foreign currencies have more structured guidelines and regulations—as shown by the detailed information in the FinCEN form that was released in January of 2017<sup>150</sup>—than the brief notice supplying guidelines for cryptocurrency transactions.<sup>151</sup> Further, the federal government does not require taxpayers to report foreign currency payments unless they are over \$10,000 aggregate for an individual consumer.<sup>152</sup> This will eliminate many people who are making minor Bitcoin transactions from having to deal with the hassle of filing an additional tax form, but even the taxpayers who need to file the additional form can easily find it on the IRS's website,<sup>153</sup> with more detailed instructions accessible.<sup>154</sup> While criminals can easily structure transactions under \$10,000 so that they avoid being reported by virtual currency exchanges, it should be the responsibility of these platforms to monitor wallets that are continuously performing transactions at or under the limit.

Third, taxpayers are disincentivized from failing to file taxes on foreign accounts because the penalty is criminal as opposed to civil: Civil penalties can be in the tens of thousands of dollars, while criminal penalties can “include[e] a fine of \$250,000 and 5 years of imprisonment.”<sup>155</sup> The ability of the federal government to impose harsher punishment is another reason for taxpayers to accurately report cryptocurrency transactions and only use the virtual currency for legal means.<sup>156</sup> Taken together, this structure will aid in

150. See FIN. CRIMES ENF'T NETWORK, BSA ELECTRONIC FILING REQUIREMENTS FOR REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (FINCEN FORM 114) (2017), <https://www.fincen.gov/sites/default/files/shared/FBAR%20Line%20Item%20Filing%20Instructions.pdf>.

151. I.R.S. Notice 2014-21, *supra* note 16, at 938.

152. IRS NATIONWIDE TAX FORUM, REPORTING CASH TRANSACTIONS AND FOREIGN FINANCIAL ACCOUNTS (FOREIGN BANK ACCOUNT REPORTS “FBAR”) 2 (2011), [https://www.irs.gov/pub/irs-utl/reporting\\_cash\\_transactions\\_and\\_foreign\\_financial\\_accounts.pdf](https://www.irs.gov/pub/irs-utl/reporting_cash_transactions_and_foreign_financial_accounts.pdf).

153. Taxpayers whose foreign income exceeds \$10,000 must file IRS Form 8300. *Id.* at 2–3.

154. See generally FIN. CRIMES ENF'T NETWORK, *supra* note 150 (expanding on filing requirements and instructions provided in IRS forms).

155. Wood, *supra* note 147.

156. For more information on the benefits of deterrence in the criminal justice system see, e.g., Craig J. Albert, *Challenging Deterrence: New Insights on Capital Punishment Derived from Panel Data*, 60 U. PITT. L. REV. 321, 322–24 (1999); Donald A. Dripps, *Rehabilitating Bentham's Theory of Excuses*, 42 TEX. TECH L. REV. 383, 383–88 (2009); Erik Luna, *Spoiled Rotten Social Background*, 2 ALA. C.R. & C.L. L. REV. 23, 23–28 (2011); Paul H. Robinson & John M. Darley, *The Role of Deterrence in the Formulation of Criminal Law Rules: At Its Worst When Doing Its Best*, 91 GEO. L.J. 949, 950–53 (2003).

making the taxpayer more accountable and more likely to report transactions which, as discussed above, is not done today.

Overall, classifying cryptocurrencies as a foreign currency solves a lot of problems surrounding the regulation of virtual currency today. However, a number of issues arise when attempting to treat cryptocurrencies as foreign currency. First and foremost, in classifying cryptocurrency as a foreign currency, the U.S. government would have to be the first country to officially back cryptocurrencies as a legal currency.<sup>157</sup> By doing this, the United States would provide validity to a form of currency that will likely continue to be valuable but may not have a legitimate use in the international marketplace due to the uncertainty of the status.<sup>158</sup> Second, consumers using the system for legal and illegal means will likely object to the virtual currency exchanges being more heavily regulated, as evidenced by the aforementioned case *United States v. Coinbase, Inc.*, where John Does' objected to the government subpoenaing the company's records of Bitcoin purchasers.<sup>159</sup> This is because private consumer information is turned over to the federal government, but this is not prohibitive because the government has managed to implement the same reporting guidelines for foreign currency. Third, while this increases the number of consumers reporting tax gains, it only catches a few consumers using cryptocurrency for illicit transactions. Because many people using cryptocurrency to buy something illegal do so off mainstream markets with the use of proxies, the government will still have to deal with a way to reach the more complex consumers who go to greater protections for their illegal transactions. Even with these issues, this system will allow the IRS to combat criminal activity and the failure to report cryptocurrencies to avoid paying taxes evidenced by Bitcoin.

## V. CONCLUSION

Bitcoin's structure makes it appealing for consumers to use as a currency on the black market,<sup>160</sup> for money laundering,<sup>161</sup> or even for financing

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157. Steve Patterson, *Bitcoin Is Not Backed by Anything (And That's OK!)*, BITCOIN MAG. (Oct. 21, 2014, 2:53 PM), <https://bitcoinmagazine.com/articles/bitcoin-is-not-backed-by-anything-and-thats-ok-1413917586>.

158. See generally Torpey, *supra* note 144 (referencing "the difficulties with getting useful, identifiable user data from the [Bitcoin] blockchain" as one example of uncertainty with cryptocurrencies).

159. See generally Notice of Motion & Motion to Intervene, to Quash Summons, or for Protective Order, or for an Order Scheduling an Evidentiary Hearing & Permitting Limited Discovery, *United States v. Coinbase, Inc.*, No. 3:17-cv-01431-JSC (N.D. Cal. May 15, 2017) (objecting to bitcoin subpoenas).

160. See Andy Greenberg, *Follow the Bitcoins: How We Got Busted Buying Drugs on Silk Road's Black Market*, FORBES (Sept. 5, 2013, 10:36 AM), <https://www.forbes.com/sites/andygreenberg/2013/09/05/follow-the-bitcoins-how-we-got-busted-buying-drugs-on-silk-roads-black-market>.

161. See Kelsey L. Penrose, *Banking on Bitcoin: Applying Anti-Money Laundering and Money Transmitter Laws*, 18 N.C. BANKING INST. 529, 529 (2014); Owen Matthews, *Bitcoin and Blockchain:*

terrorism.<sup>162</sup> The fact that there is relative anonymity in transactions performed through Bitcoin makes it an appealing way to avoid criminal liability, especially with the added anonymity of proxies through websites like Tor, and there is little in the current U.S. regulatory structure which solves this issue. There is little guidance on how the average taxpayer should report cryptocurrency gains and losses other than the directive to treat it “as property” and follow the “general tax principles applicable to property transactions.”<sup>163</sup> Within this classification there is still confusion over the proper way for taxpayers to report virtual currency transactions based upon the different ways they can make or lose money in a cryptocurrency transaction.

While there are numerous proposals on the most efficient way for the federal government to restructure the tax system to resolve these issues,<sup>164</sup> this Note proposed two solutions for the IRS to follow when attempting to regulate virtual currencies. First, the United States could ban the use of cryptocurrency altogether, following the lead of countries like China and Iceland that are strictly regulating virtual currencies. Although it might be difficult to completely shut down the virtual exchanges and ban a currency entirely, doing so would limit the people the federal government needs to monitor. This solution narrows the pool and allows law enforcement to more effectively monitor criminal activity stemming from cryptocurrency because there is a single group of users.

The second and likely more practical solution is for the federal government to reclassify virtual currency from property to foreign currency. This would be a bold step for U.S. financial regulators because it would make the United States the first government to officially back cryptocurrency as a formal currency. However, it would be a more effective system of regulation for the government and taxpayers alike. The federal government’s reporting would be modeled after the Japanese government’s control over virtual currency exchanges, placing responsibility not solely on the consumer but also on the businesses dealing in the sale of virtual currency. As far as consumers go, there is a much more defined system of reporting for taxpayers to follow when attempting to report gains and losses made in foreign currency

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*A Russian Money Laundering Bonanza?*, NEWSWEEK (Sept. 18, 2017, 1:16 PM), <https://www.newsweek.com/russia-finally-embracing-virtual-currencies-666794>.

162. See Stephen Small, *Bitcoin: The Napster of Currency*, 37 HOUS. J. INT’L L. 581, 602–05 (2015); Kelly J. Winstead, Note, *The North Carolina State Tax Treatment of Virtual Currency: An Unanswered Question*, 21 N.C. BANKING INST. 501, 507–08 (2017); Levi Maxey, *Terror Finance in the Age of Bitcoin*, CIPHER BRIEF (June 11, 2017), <https://www.thecipherbrief.com/article/tech/terror-finance-age-bitcoin>.

163. I.R.S. Notice 2014-21, *supra* note 16, at 938.

164. See, e.g., V. Gerard Comizio, *Virtual Currencies: Growing Regulatory Framework and Challenges in the Emerging Fintech Ecosystem*, 21 N.C. BANKING INST. 131, 160–75 (2017); Patrick McLeod, *supra* note 15, at 405–06 (2014); Elizabeth M. Valeriane, Note, *IRS, Will You Spare Some Change?: Defining Virtual Currency for the FATCA*, 50 VAL. U. L. REV. 863, 903–10 (2016).

which can aid in issues with the tax structure. However, this solution does little to monitor the transactions, both legal and illegal, taking place outside of virtual currency exchanges, other than to change the reporting requirements to those of foreign currency.

All things considered, there are inherent issues in the structure of cryptocurrencies like Bitcoin that make it appealing to use for illicit purposes, and the current status of the regulatory system does little to discourage those illicit uses because it is so loosely monitored and confusingly structured. While there is little the IRS can do to change Bitcoin's structure, there are solutions to the existing tax system that could strengthen the regulation and reporting of virtual currency transactions to make Bitcoin a less appealing avenue for illicit purchases or tax evasion. More specifically, classification of cryptocurrency as a foreign currency will allow the federal government to move toward a solution of both issues, while really beginning to solve the problems with underreporting until technological strides can be made to link a consumer to an IP address.