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Inadequacies of Current Cryptocurrency Taxation

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By: Edgar Jurado

I. Introduction

Cryptocurrencies have been around for over three decades now yet the federal and state governments still lack a sensible approach to taxing them.[1] The lack of understanding for this form of payment phenomenon and tedious tax reporting requirements which then arise[2] have diminished cryptocurrency utilization and spending.[3] Regulators have made it difficult for individuals to spend and accept cryptocurrency by assessing both taxes inadequately: one on sales tax transactions with reference to the value of the cryptocurrency that was paid for a good and a second on income tax on gains realized from minuscule scale exchanges of cryptocurrency for hard currency. The States governments need to become "Crypto friendly" and ease the administrative burden for taxpayers, therefore increasing State revenue collections.

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[1] Primavera De Filippi, We Must Regulate Bitcoin. Problem Is, We Don't Understand It. (March. 1 ,2016), available at https://www.wired.com/2016/03/must-understand-bitcoin-regulate/. "But it is difficult to regulate today a technology that we do not yet fully understand. Given the experimental nature of blockchain technologies, whose possible uses and applications are still to a large extent unknown, regulation should be elaborated carefully and in a well-informed manner, to avoid precautionary measures from curtailing the future of these new technologies."

[2] Ryan Derousseau, There's a Hidden Bitcoin Tax You Need to Know About. (Nov. 2, 2017), available at http://money.com/money/5007068/theres-a-huge-hidden-bitcoin-tax-that-you-need-to-know-about/. "You're technically required to list every purchase you made in any given year with bitcoins, outlining the capital gain or loss from selling the digital currency to make the transaction, "no matter how small,". There's more: The capital gains hit would come on top of the sales tax that you would pay for the item you wind up purchasing, adding another fee to transactions using cryptocurrencies. "

[3] Id. "The Internal Revenue Service does not view bitcoins as a currency like the dollars in your wallet. Instead bitcoins are treated as "property," which means they're subject to capital gains taxes."

This note will examine the taxation of cryptocurrency and analyze its adequacy. Part II will present the history behind cryptocurrency. Part III will illustrate the advantages of using cryptocurrencies while acknowledging flaws of virtual currency usage and make the claim that the usage of such currencies should be encouraged rather than discouraged by federal, state and local tax laws. Part IV will discuss different jurisdictions' approaches to applying both sales and income tax laws to cryptocurrency transactions. Part V will argue that these approaches are generally inadequate. Finally, part VI will propose reforms to the tedious tax recording and reporting requirements.

II. Background of Digital Currency

A cryptocurrency is an instrument on a blockchain network. An amalgam of cryptography and currency, it is a virtual coin that uses cryptography for its security and verification. It is a form of payment used across the globe. Some online and offline merchants accept payment in the form of virtual currencies, including online retailers such as Overstock, as well as some local shops and restaurants.

The idea of a cryptocurrency has been around for four decades now. It can be traced back to the early 1980s. This concept came to be from cryptographers and other computer technologists who viewed peer to peer networks and encryption as the tools of freedom and liberty from governments. They called themselves "Cypherpunks." They believed that "without proper checks and balances, the deployment of modern information technology would narrow the sphere of personal privacy, resulting in pervasive government and corporate surveillance."[4]

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[4] Primavera De Filippi, & Aaron Wright, Blockchain and the law: the rule of code 18 (2018).

Basically, for Cypherpunks, securing privacy is crucial as technology advances. "The essential substrate of cypherpunks' dream was anonymous cash and other untraceable payment systems."[5]

A computer scientist named David Chaum, fascinated with "cryptography"[6], had the vision for electronic payments over the internet. Mr. Chaum in his 1982 "Blind signatures for untraceable payments" proposed the basic idea behind encrypted electronic cash.[7] In pursuit of this idea, he developed and created DigiCash Inc. The company allowed users to make electronic payments using encrypted keys without having to provide personal information. It was among the first currencies created exclusively for electronic use in the early 1990s, the company had secured its first ever electronic cash transaction over the internet.[8] However, in 1999, Chaum abandoned the project, leaving DigiCash. In an interview with Forbes, he stated: "It was hard to get enough merchants to accept it, so that you could get enough consumers to use it, or vice versa".[9]

In 1998, a computer engineer from Washington University named Wei Dai published a paper called "B-Money"[10]. His writing outlined a proposal very similar to that of what Bitcoin is

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[5] Id.

[6] Margaret Rouse, Cryptography. Available at https://searchsecurity.techtarget.com/definition/cryptography. "In computer science, cryptography refers to secure information and communication techniques derived from mathematical concepts and a set of rule-based calculations called algorithms to transform messages in ways that are hard to decipher. These deterministic algorithms are used for cryptographic key generation and digital signing and verification to protect data privacy, web browsing on the internet and confidential communications such as credit card transactions and email."

[7] Ernie Smith, Cryptocurrency is having a bit of a moment right now, thanks in no small part to bitcoin. (Nov. 27, 2017), available at https://tedium.co/2017/11/27/digicash-ecash-bitcoin-history/. "David Chaum, a computer scientist who had already proposed the basic ideas behind encrypted messaging tools, is widely seen as the father of electronic money, having proposed the idea in his 1982 paper Blind Signatures for Untraceable Payments."

[8] Id. "Was perhaps the first time that a digital currency was created for exclusively electronic use. In 1994 the company put forth the first-ever electronic cash transaction over the internet."

[9] Id.

[10] Jake Frankenfield, B-money. (Jun. 22, 2018), available at https://www.investopedia.com/terms/b/bmoney.asp. "One of these early proposed cryptocurrencies was called B-money. First revealed in 1998 by computer scientist Wei Dai, B-money aimed at being an "anonymous, distributed electronic cash system." In this way, it endeavored to provide many of the same services and features that contemporary cryptocurrencies today do as well."

today. It outlined “untraceable digital pseudonyms to pay each other with money and to enforce contracts amongst themselves without outside help."[11] Mr. Dai’s paper reiterated the importance of networking among peers to authenticate transactions. This method ensured that transactions were being completed and new ownership credits and debits were taking place.

Two decades and several more proposals, outlines and ideas from many cypherpunks gave rise to what we know today as “Bitcoin”. In 2008, "Bitcoin: A Peer-to-Peer Electronic Cash System"[12] was published by a still to this day unknown person or a group of people under the name of Satoshi Nakamoto. In this document Satoshi Nakamoto elaborated on the idea of a version of a peer to peer network of electronic cash transactions between users. This digital currency relies on a network of computers to validate and track all Bitcoin transactions.

Satoshi Nakamoto’s vision came to fruition the following year. The public took the guidelines and started using the Bitcoin software. The transactions were recorded on a decentralized ledger called Blockchain which was verified for peers by peers. This ensured that the Bitcoin network alerted its members that Bitcoin transactions took place and that the transaction was valid and should be stored in the Blockchain."Bitcoin is the world's first completely decentralized digital currency, and it is the decentralized part that makes it unique. Prior to Bitcoin's invention in 2009, online currencies or payment systems had to be managed by a central authority."[13] Prior to the invention of Bitcoin, a third party was required for electronic transactions, parties like PayPal or Visa.

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[11] Id. at 4.
[12] Id. at 3.
[13] H.R. Rep. No. 114-126, pt. 1, at 11 (2016).

In 2010, finally someone decided to spend Bitcoin and the transaction required valuation. The first Bitcoin transaction was in exchange for Pizza, 10,000 Bitcoins for 2 Pizza Pies.[14] Today, there are over 2,000 different kinds of cryptocurrencies out in existence. "Aside from bitcoin, there are hundreds of other digital currencies out there. These are known as "altcoins," or alternatives to bitcoin; for example, ether, ripple, zcash, monero and dash, to name just a few. Altcoins can differ from Bitcoin in a range of ways. Some have a different economic model or a different coin-distribution method"[15] The total Market Cap for the Coins is over $ 134,595,331,984.[16]

III. Advantages of using Cryptocurrencies

Cryptocurency offers many advantages that traditional fiat currencies do not, however there are drawbacks to its use that need to be addressed. Since its invention, concerns regarding two of its characteristics, anonymity and irreversibility, have evolved. "There is a divided support for the whole cryptocurrency and Blockchain hoopla. While one sect feels that it holds great potential as the future of currency, its equally high probability of misuse by cyber conman has kept cyber security experts on their toes."[17] Cryptocurrencies are constructed with the intention to let users utilize them while maintaining anonymity. This feature makes cryptocurrencies appealing for law abiding transactions where financial privacy is important.

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[14] Stefan Kostarelis, The first-ever Bitcoin transaction was used to buy two pizzas – today, it's worth $150 million. (Dec. 5, 2017), available at https://www.techly.com.au/2017/12/05/first-ever-bitcoin-transaction-used-buy-two-pizzas-today-worth-150-million/. "A developer named Laszlo Hanyecz who is credited with making the first Bitcoin transaction ever. In May 2010, when Bitcoin was worth a measly US$0.08, Hanyecz posted on the Bitcoin Forum that he'd use 10,000 bitcoins to pay for a couple of pizzas."

[15] What Is an Altcoin?. (April. 29, 2019), available https://bitcoinmagazine.com/guides/what-altcoin/

[16] CoinMarketCap, (Mar. 13, 2019), available at https://coinmarketcap.com/all/views/all/. "Total Market Cap: $134,462,259,034. Last updated: Mar 13, 2019 2:20 PM UTC."

[17] The Good and Bad of Cryptocurrency – Is Investing in Cryptocurrencies Wise?. (April. 28, 2019), available at https://www.techly.com.au/2017/12/05/first-ever-bitcoin-transaction-used-buy-two-pizzas-today-worth-150-million/.

However, the same trait could invite tax evasion or money laundering and trade of illegal goods. "There are reasons as to why regulators are hesitant about cryptocurrencies and so many view them with doubt. It is also important to note that many of the potential down-sides of Bitcoin are the same as those facing traditional cash. Cash has historically been the vehicle of choice for drug traffickers and money launderers, but policymakers would never seriously consider banning cash."[18] Policymakers primarily associate cryptocurrencies with illegal black markets. Policymakers affiliate cryptocurrencies with the black market site known as "Silk Road." Before getting shut down by authorities, Silk Road could be accessed through the dark web. "While in operation from February 2011 to October 2013, Silk Road took advantage of the anonymizing network Tor and the pseudonymous nature of Bitcoin to make available a vast digital marketplace where one could mail-order drugs and other licit and illicit wares."[19] Cryptocurrency transactions are irreversible. This characteristic shields small businesses from chargeback fraud. However, the same feature can hurt the consumer. "One cannot reverse a payment once it is done on a blockchain network. This is because the whole institution of blockchain works on the tenets of storing data in a way that prevents alteration and tampering."[20] If a bank decides to undo a transaction, a business can be at loss. This means that you have no one to plea to if you're scammed in a cryptocurrency transaction, for example, paying upfront for an item never received. Another significant concern is that mining[21] for cryptocurrency has a potentially

[18] Jerry Brito & Andrea Castillo, BITCOIN A Primer for Policymakers 26 (2013).
[19] H.R. Rep. No. 87-403, pt. 1, at 44 (2014).
[20] Id. at 6.
[21] Blocktree Props. LLC v. Pub. Utility District, 54423 U.S. (2019). "For the blockchain to track cryptocurrency transactions, the transactions must be verified by independent blockchain participators. Blockchain verifiers, also known as cryptocurrency miners, are given the chance to verify cryptocurrency transactions by solving complicated mathematical problems. The first miner to solve the problem, and then verify the transaction on the blockchain, is rewarded with a small amount of cryptocurrency. Miners rely on advanced and specialized computer hardware to successfully mine cryptocurrency before others can secure the cryptocurrency reward for themselves. Because cryptocurrency mining is technologically complex and requires advanced equipment, one of a miner's biggest expenses is electricity."

harmful impact on the environment. Mining is heavily energy intensive. This issue can now be addressed by the use of environmentally friendly sources of energy. "In North America, cryptocurrency mining activities in Oregon is growing, thanks to the abundance of hydropower in the state. In China, the Sichuan mountain region is a favored destination among crypto mining operators, while in Europe, the geothermal energy-rich Iceland is a popular crypto mining destination."[22] The best answer to the potentially negative effects cryptocurrency mining has on the environment is fueling cryptocurrency mines with low- or no-carbon energy sources.

The potential benefits of cryptocurrencies outweigh the risks. "The public-key encryption and peer-to-peer networking properties combine to create a payment system that could lower transactions costs in business and remittances, alleviate poverty, provide an escape from capital controls and monetary mismanagement, allow for legitimate financial privacy online, and spur new financial innovations."[23] The advantages are responsible for the increasing wide spread acceptance as form of payment. Low restrictions for opening an account, accessibility, low transaction costs, transaction speed, identity protection and irreversibility make cryptocurrencies an ideal form of payment. Cryptocurrencies offer the benefits of financial products to those who do not have access to traditional banking services.

Low restrictions for opening cryptocurrency accounts make them appealing to individuals. There is no minimum amount required in opening and in maintaining a cryptocurrency account. Users of cryptocurrency do not need to reveal personal data thus lowering barriers to entry found in the traditional banking system."In order to open a bank

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[22] Gerald Fenech, Contrary to popular FUD, crypto mining is not a threat to environment. (Aug. 21, 2018), available at https://coingeek.com/contrary-popular-fud-crypto-mining-not-threat-environment/

[23] Id. at 7.

account, a person is required to expose his personal information."[24] Basically, individuals waive their Fourth Amendment rights since there is no expectation of privacy. "For customers seeking anonymity, Bitcoins provide more privacy than credit card transactions."[25]

Identity fraud is impossible in cryptocurrency transactions. The codes derived from mathematical algorithms and the blockchain structure secure privacy protection. "The blockchain technology uses a robust combination of hashing and proof-of-work to render the network tamper-evident. Moreover, they are a part of a Peer-to-Peer (P2P) network which allows everyone to join. Thus to tamper even a single block in a blockchain, one would have to redo the hashes and proof of work and take control over more than half of the P2P network. This is almost impossible to achieve, thus making cryptocurrency transactions secure."[26] Bitcoin permits individuals to make payments to merchants without requiring personal information that can be intercepted by criminals and used for fraudulent purposes. The permanent nature of Bitcoin allows "abstraction of personal information and significantly reduces the risk of fraud, something that merchants, card processors, and banks spend billions of dollars per year combating. With Bitcoin, for example, the target data breach that comprised 40 million consumers' credit card information would not have been possible."[27]

Additionally, cryptocurrencies appeal to many individuals because of their accessibility. Cryptocurrencies rely on cryptography to allow individuals to make pseudonymous accounts without requesting permission from anyone. "People store wallets on personal computers or maintain them using online applications, often maintained by third parties , making Bitcoin

[24] See, U.S. v. Miller, 425 U.S. 435 at 449 (Brennan, J., dissenting).
[25] Id. at 7.
[26] Id. at 6.
[27] Id. at 7.

readily accessible through a web browser or an everyday smartphone."[28] Just like an e-mail customer, virtual currency wallets assist individuals on the Bitcoin network manage their accounts.

Cryptocurrency payments are rapid means of exchange. "With a Bitcoin account, people can receive and send bitcoin to anyone around the world, in a matter of minutes, by executing and digitally signing a Bitcoin transaction with a private key"[29] Overseas payments by conventional fiat currencies take days and are delayed by bank holidays. Virtual currency transactions take minutes. Fees per transaction are minor. The use of cryptocurrencies for international payments save both time and money.

Cryptocurrencies perform as an alternative for traditional banking services and open the doors to doing business with underdeveloped countries. The majority of people around the world do not have credit cards or access to electronic payments, but they do have access to the internet via smart phones. "Bitcoin allows anyone with access to the internet to engage in mobile commerce even if PayPal or Visa do not serve their country. This is a boon not just to the billions of unbanked persons in the developing world, but also to merchants in the developed world who can now trade with previously untapped markets."[30]

Cryptocurrencies offer the benefits of financial products to those who do not have access to traditional banking services. Cryptocurrencies have the ability to better the quality of life for the marginalized people in the United States. Facilitating access to basic financial services is a promising combat technique against poverty. Despite an extending and diverse financial

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[28] Id. at 3.
[29] Id. at 3.
[30] Id. at 5.

industry, "more than one-quarter of Americans don't have adequate access to basic banking tools, such as checking accounts, credit cards, or loans"[31]

Cryptocurrencies can perform as a sound alternative payment option between businesses and consumers in low income areas. Some businesses, in economically challenged inner cities, prefer cashless payments for security reasons and ease of transaction. While federal law allows owners and businesses to set their own rules for the types of payments to accept, several states[32] have made it illegal to refuse cash. Massachusetts and New Jersey have enacted laws making it illegal for most brick and mortar shops to refuse physical cash payments, primarily because it effectively shuts out many lower-income customers who do not have credit cards. Considering "6.5 percent of all U.S. households did not have an account at a banking institution in 2017, the percentages are much higher for black households (16.9 percent) and Latino households (14 percent)."[33]

Businesses are attracted to virtual currencies due to the low transaction costs. They opt to accept cryptocurrencies for many reasons, including to be at the leading edge of new technology, to appeal to customers now using Bitcoin, "to lower transaction fees from credit and debit cards, and to eliminate certain kinds of fraud." [34] Cryptocurrencies can significantly reduce transaction costs for businesses. "For a small company accepting major credit cards, each card swipe can cost as much as one-quarter of a cent in addition to having to return 3 to 6 percent of sales total to the credit card company. Some credit card companies also charge businesses to join the

[31] Gillian B. White, America's Poor Still Lack Access to Basic Banking Services. (Nov. 30, 2016), available at https://www.theatlantic.com/business/archive/2016/11/americas-underbanked/509138/

[32] N.J. stores and restaurants must accept cash under new law banning them from requiring credit card payments. (2019), available at https://www.nj.com/politics/2019/03/nj-bans-stores-and-restaurants-from-refusing-to-accept-cash-from-customers.html

[33] FDIC National Survey of Unbanked and Underbanked Households (2017)

[34] Id. at 7.

network. By contrast, when utilizing Bitcoin, there is no cost of joining the network. Fees are less than 1 percent ."[35]

Virtual currencies' low transaction costs also appeal to charitable organizations. Cryptocurrencies' efficiency and money-saving features for transferring funds makes it an a preferred option to lower operation costs for charities. "The Bitcoin100 charity campaign has contributed bitcoin donations to a number of causes since 2011. Sean’s Outpost, a homeless-outreach organization located in Pensacola, Florida, has been providing meals and toiletries to Pensacola’s neediest solely with bitcoins."[36]

Another reason why small businesses are attracted to virtual currencies is that all transactions are final. And again, "because there is no central intermediary, there is no third party that can reverse the transaction. this protects small businesses from chargeback fraud, which often results not just in the loss of a sale but also in penalty fees."[37] Decentralization allows businesses to now accept international payments that were not previously possible. "There are over 50 countries that traditional payment processors do not serve, often because of high fraud rates. Because Bitcoin payments are global and final, doing business with consumers in those countries, especially in developing countries is now feasible."[38]

IV. Current Cryptocurrency Taxation

The emergence of cryptocurrencies has raised a variety of practical questions related to their place within the legal regime. First and foremost among them is the issue of taxation , given that cryptocurrency operates both as an investment and a currency, it is generally subject to a

[35] Id. at 7.
[36] Id. at 7.
[37] Id. at 7.
[38] Id. at 7.

variety of tax laws, specifically federal and state income taxes and state sales tax. Virtual currencies are treated as "property" under federal law. That means that every cryptocurrency transaction creates a taxable event. The way it is taxed also changes according to its use. Daily cryptocurrency usage, like paying for goods and services, can become a real problem for record keeping.

A. Particular State Sales Tax Approaches

For there to be a Sales Tax, there first must be a sale. States share a similar definition for a sale: "Any transfer of title or possession or both, exchange[39] or license to use or consume, conditional or otherwise, in any manner or by any means whatsoever for a consideration, or any agreement therefore, including the rendering of any service, taxable under this act, for a consideration or any agreement therefore. N.J. Stat. Ann. Sec54:32B-2(f); N.Y. Tax Laws, Sec1101(b)(5)."[40] "A sales tax is a direct tax on consumption that many states and local governments impose when you purchase goods and services. The amount of tax you pay is typically figured as a percentage of the sale price."[41] This tax applies to tangible personal property. Sales taxes are classified as: "(a) Retail Sales Tax, which is imposed only on sales of tangible personal property at retail or for use or consumption. This tax also includes sales of utility services and levies on admissions. (b) General Sales Tax, which reaches sales of tangible personal property both at retail and for resale, and also the acts of extracting natural resources

[39] Great S. Bank v. Dir. of Rev., 269 S.W.3d 22 (Mo. 2008); Hutton v. Johnson , 956 S.W.2d 484 (Tenn. 1997).
[40] Certain States define the transfer of possession a transaction sale. See, e.g., Cal. Rev. & Tax. Code Sec6006(a). Other definitions for sales look at the transfer of title as definition for a sale. See, e.g., Conn. Gen. Stat. Sec12-407(2).
[41] What Are State Sales Taxes. (2018), available at https://turbotax.intuit.com/tax-tips/state-taxes/what-are-state-sales-taxes/L3AqiZctj.

and of manufacturing."[42] Cryptocurrencies are relevantly new to the states. Different states will tackle cryptocurrencies from different angles. The majority of the states in the United States have not yet finalized the the rules and guidelines regarding the taxation on virtual currencies. Some states created their own treatments for how sales tax should be calculated when purchasing goods using cryptocurrencies as form of payment. Individual states use different bases for calculating the sales tax on a good when using cryptocurrencies. Some states use the fair market value of the coin at the time of sale to determine the sales tax. Other states look at the listing price of the good in order to determine the cost of the sales tax on the good.

1. The State of New Jersey

According to the New Jersey Department of Treasury, "The New Jersey Sales and Use Tax Act imposes a tax[43] on the receipts from every retail sale of tangible personal property, specified digital products, and the sale of certain services, except as otherwise provided in the Act. Tangible personal property can include prewritten computer software delivered electronically. In addition, most services performed on tangible personal property and specified digital products are taxable unless they are specifically exempted by law."[44]

The State of New Jersey calculates sales tax using the value of the cryptocurrency at the time of the sale, not the listing price of the good. For example, "If a consumer purchased a taxable item listed at $50, with an amount of Bitcoin evaluated at $49.57, the sales tax would

[42] Walter Hellerstein, Kirk Stark, John Swain & Joan Youngman., STATE AND LOCAL TAXATION 649 (10th ed. 2014). "Today state sales taxes are in force in 45 states, they apply to an increasing number of services, and their rates average between five and six percent"
[43] N.J. Sales Tax Guide. New Jersey Department of Treasury. "Effective January 1, 2018, the New Jersey Sales and "Use tax rate is 6.625%."
[44] Id.

likely be calculated on from the $49.57."[45] "New Jersey conforms to the federal tax treatment of convertible virtual currency as detailed in Notice 2014-21 issued by the IRS. Because transactions using virtual currency must be reported in U.S. dollars for federal tax purposes, taxpayers are required to determine the fair market value of the convertible virtual currency in U.S. dollars as of the date of payment or receipt."[46] Businesses in New Jersey accepting cryptocurrencies must record in their books the value of the virtual currency received at the time of each transaction and convert them to US dollars.

2. The State of California

California values cryptocurrency payment transactions in a manner that differs from the approach of New Jersey. "California's model calculates sales tax using the list price of a good, not the value on the Bitcoin. If the consumer purchases a good marketed for sale at $50 list price then the seller would be obligated to collect sales tax based on the $50 list price"[47] This method of calculating sales tax based on the listing price of the good does not require anyone to compute the precise ticker value of the Cryptocurrency at the time of the sale. This method is more straightforward than New Jersey's sales tax calculation, because sellers do not need to maintain records of the virtual currency accepted at the time of each transaction. This is straightforward and it is exactly the same procedure used by retailers and other businesses when calculating sales tax on goods using cash.

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[45] Priyeshu Garg, The New York and California Way: How Countries in the U.S. Are Taxing Bitcoin. (Sept. 13, 2018), available at https://btcmanager.com/the-new-york-and-california-way-how-countries-in-the-u-s-are-taxing-bitcoin/?q=/the-new-york-and-california-way-how-countries-in-the-u-s-are-taxing-bitcoin/&.

[46] NJ. TAM. Convertible Virtual Currency. TAM-2015-1(R) (Jul. 28, 2015). Available at https://state.nj.us/treasury/taxation/pdf/pubs/tams/tam-2015-1.pdf

[47] Id. at 14..

B. Federal & State Income Tax

Income Taxes are the primary source of revenue for the federal and state governments. Gross Income consists of income from all sources. Under the Internal Revenue Code section 61, taxable income also includes, but is not limited to: "Gains derived from dealings in property."[48] The Internal Revenue Code states that capital gains is profit realized on the sale or exchange of the capital asset[49]

Although states are not required to conform to the federal tax code, many states choose to do so.[50] "The degree to which a given state conforms to federal tax rules impacts state tax compliance for both businesses and individuals. Whenever a new federal tax law goes into effect, it can affect the applicability of state taxes, as well a state taxpayer's tax liability. Your tax liability on both your federal return and your state return could be affected if your state conforms to the new law."[51]

One might believe cryptocurrencies are a form of currency, but this is not the case because none of the over 2000 types of coins hold a legal tender status in any jurisdiction.[52] Cryptocurrencies are subject to capital gains/losses tax because they are viewed as property for federal tax purposes[53].

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[48] I.R.C. § 61. (2019)

[49] I.R.C. § 1222.

[50] Tonya Moreno, What is IRC Conformity?. (Mar. 5, 2019), available at https://www.thebalance.com/what-is-irc-conformity-3193333. "Most states conform in some respects, but they "decouple" from other federal provisions, leaving them out of their own tax codes."

[51] Id. at 15.

[52] I.R.S. 2014-36, (March. 25, 2014). "In some environments, virtual currency operates like "real" currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance — but it does not have legal tender status in any jurisdiction."

[53] I.R.S. 2014-36, (March. 25, 2014).

The IRS notice 2014-21 holds that taxpayers recognize gains or losses on the exchange of cryptocurrency for other property, thus every transaction for goods using cryptocurrencies as form of payment will result in recognized capital gains/losses. Many states have indicated that they intend to follow IRS guidance.

When it comes to determining the amount of recognized capital gains/losses that results from using cryptocurrency, for transactions for goods, it is important for cryptocurrency users to properly track basis. The basis is generally defined as the price the taxpayer paid for the cryptocurrency asset. "If Jane purchased a slice of pizza with one Bitcoin that she purchased on June 1 2017, she would have to determine the basis of the Bitcoin and then subtract that by the cost of the slice of pizza to determine if any gain was recognized."[54] Currently, the tax laws in place require capital gains/losses to be reported regardless of how miniscule the amount is. As a side note, it is worth mentioning that an apparent double taxation arises when the digital coins are taxed as property when sold for cash[55] and then taxed on the item purchased; however, the sales tax base depends on the state in which an individual resides. Cryptocurrency receives the same tax treatment as stocks do. If you sell a stock at a gain, you are taxed on the difference between proceeds received and the cost originally paid for the stock . The cash proceeds, from the sale of stock used to make a purchase of a good, impose a second tax on the consumer, a sales tax. "Every time you purchase a sandwich or video game with the cryptocurrency, you're essentially making two transactions: first, you are selling property (bitcoins) in the eyes of the

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[54] Adam Bergman, What You Should Know About Taxation Of Cryptocurrencies. (Jan. 3, 2018), available at https://www.forbes.com/sites/greatspeculations/2018/01/03/what-you-should-know-about-taxation-of-cryptocurrencies/#6b7615231346.

[55] Jerry Brito, Bitcoin taxation is broken. Here's how to fix it. (April. 12, 2017), available at https://coincenter.org/entry/bitcoin-taxation-is-broken-here-s-how-to-fix-it. "IRS announced that cryptocurrencies like Bitcoin are treated as property, which means gains from sale or exchange are taxed as capital gains rather than ordinary income."

IRS and then you are using the proceeds of that sale to make a purchase (whether it's a sandwich or a credenza). And when property is sold, you must report the purchase on your tax forms."[56]

V. Inadequacies of current cryptocurrency taxation

Some states do not currently have the correct treatment and procedures for individual consumer and merchant utilization of cryptocurrencies. The States have made it difficult and uninviting to spend and accept cryptocurrencies in exchange for goods. Instead of encouraging the use of virtual currencies, the states have curbed it and its innovation. Three problems in particular warrant special emphasis: first , Internal Revenue Service's lack of guidance on reporting cryptocurrencies in addition to the inexistence of instructions at state level; second, calculating sales tax by reference to the fair value of the cryptocurrency creates unnecessary uncertainty and administrative work; third, taxing minuscule gains, realized from the exchange of cryptocurrency, as income imposes onerous record keeping obligations on taxpayers.

There aren't enough guidelines for reporting cryptocurrencies. Many cryptocurrency users lack the knowledge required to accurately record and report the outcome of their virtual currency exchanges. The Internal Revenue Service was prompt in labeling cryptocurrency as property for tax purposes but not efficient in instructing taxpayers on how and when to report them. "The IRS claimed that only 800 to 900 people electronically filed a Form 8949, Sales and Other Dispositions of Capital Assets, that included a property description likely related to bitcoin each year from 2013 to 2015"[57] The lack of guidance is definitely a contributing factor to the vast amount of unreported gains of cryptocurrency. "Credit Karma reported that only 0.04 percent of

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[56] Id. at 2.

[57] Brad Polizzano, Cryptocurrency: Compliance challenges and IRS enforcement, (Oct. 1, 2018), https://www.thetaxadviser.com/issues/2018/oct/cryptocurrency-compliance-challenges-irs-enforcement.html

Americans that have already filed their 2017 taxes had claimed their cryptocurrency gains and losses."[58] While it is clear that many individuals do not report their cryptocurrency activities intentionally, there are many taxpayers who simply do not know how to.

Sales tax obligations for cryptocurrency transactions have become tedious to maintain and record. Merchants and sellers are discouraged to accept cryptocurrency as a form of payment from consumers because of the difficult and time consuming process involved. Businesses collect and remit sales tax to the state for transactions involving legal tender . However, an additional requirement is imposed on them when cryptocurrencies are the form of payment. “Sellers who accept convertible virtual currency as payment for taxable property or services shall: register for Sales Tax purposes; record in their books and records the value of the convertible virtual currency accepted at the time of each transaction, converted to U.S. dollars; record in their books and records the amount of Sales Tax collected at the time of each transaction, converted to U.S. dollars; and report such sales and remit any Sales Tax due in U.S. dollars when filing their periodic Sales Tax returns.”[59] The task of recording each transaction ,when cryptocurrencies are accepted , can become a hassle for the small businesses , because the seller must first determine the coins' fair market value at the time of sale for each individual purchase. Small businesses do not have the time, knowledge or technology required in order to document and maintain proper records of all their Bitcoin transactions and to figure out the exact fair value of the cryptocurrency at the time of calculating the correct sales tax. It may not be an issue for larger corporations like Overstock.com[60] who accept cryptocurrencies as form of

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[58] Chelsea Roh, Cryptocurrency and Taxes: You MUST Claim Your Cryptocurrency, (Feb. 15, 2018), https://cryptocurrencynews.com/regulations/tax-season-claim-cryptocurrency/
[59] Id. at 14.
[60] Lily Katz, Overstock Is the Latest Stock to Surge Thanks to the Cryptocurrency Craze, (Oct. 25, 2017), https://www.bloomberg.com/news/articles/2017-10-25/overstock-rides-cryptocurrency-craze-as-ico-drives-latest-surge. "Overstock accepts many different types of cryptocurrencies as form of payment for their goods."

payment for their goods. They have the funds necessary for record keeping."Small businesses tend to incur greater costs in collecting and administering the sales tax than do larger businesses. Smaller businesses generally have fewer accounting controls and records of sales and are less likely to know the legal requirements of collecting tax from their customers."[61]

Taxing as income gains realized from the exchange of cryptocurrency imposes troublesome record keeping obligations on taxpayers. Income gains recognized from de minimis transactions are currently not exempt by the federal and state governments for income tax purposes. "There is currently no "de minimis" exception to this gain or loss recognition. "The term "de minimis" describes something that's too small or insignificant to be of importance. It derives from the Latin phrase "de minimis non curat lex," which translates to "...about minimal things".[62] Taxpayers must record their virtual currency basis in order to determine the gain or loss recognized on each crypto transaction properly. "It is easy to see how this treatment can cause accounting issues with respect to everyday cryptocurrency transactions."[63] Individual consumers are discouraged to use their cryptocurrencies as form of payment for goods because it is far too tedious to record minimis recognized gains involved in each individual transaction when purchasing goods. Before computing[64] capital gains and losses, the consumer must start by establishing the cost basis. Cost basis is the actual amount paid for a virtual currency at the time of purchase. For multiple purchases and sales establishing the cost basis can become a laborious and time consuming process. "There are four commonly accepted methods of figuring out your

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[61] David Brunori, State Tax Policy 56 (2005).
[62] Jean Murray, What Does "De Minimus" Mean in Business Taxes?. (Jan. 7, 2019), available at https://www.thebalancesmb.com/what-does-de-minimis-mean-for-business-taxes-398218.
[63] Id. at 16.
[64] I.R.C. § 1001. "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

cryptocurrency cost basis: first in first out (FIFO), last in first out (LIFO), specific shares, or average cost."[65] Under FIFO, the coins acquired first are also the first sold. Under LIFO, the last coins acquired are the first ones sold. Under the specific shares method of establishing cost basis, a specific coin sold is identified. This requires detailed records to be kept. The average cost method determines a cost basis based on the average price of each coin at the time of purchase. While this may sound simple, doing the calculations for each and every small purchase, can turn into a complex and time consuming inconvenience. For example, assume that you made three virtual currency purchases in 2017: you bought one coin in June for $3,000; a second coin in September for $6,000; and a third coin in November for $12,000. If a taxpayer chooses to sell one coin at the end of December when the coins surged to $20,000. The four methods will result in different amounts of gains. According to the FIFO method, you are selling the first coins you purchased that year $3,000. This creates a $17,000 capital gain that would be taxed based on the individual's income tax bracket. Under the LIFO method, you are selling the last coin you purchased at $12,000 . Under this method, your capital gain would be $8,000, less of what it would be under FIFO. Under the specific share method, the gains will be different for each taxpayer according to their financial position. Lastly, under the average cost valuation, the cost basis is calculated at $7,000 by adding the sum of the three purchases and dividing it by three. This results in a capital gain of $13,000. "Calculating capital gains for cryptocurrency investments (and choosing which method to use) is anything but simple, especially if you've made multiple purchases, sales, or trades throughout the year."[66] The states have been following the federal government's footsteps in the treatment of transactions involving cryptocurrencies and have been limiting the use of cryptocurrencies in daily use. This results in an entire form of

[65] Mario Costanz, Crypto Taxes Made Happy 52 (2018).
[66] Id. at 21.

currency not being utilized, not circulating throughout the economy. Potential revenue is missed by states and federal government.

VI. Solution

States need to better craft their tax laws to accommodate cryptocurrencies. Virtual currency taxation regulations need to be simpler for businesses and individuals to ensure the ease of administration and compliance.

In applying their sales taxes, states should value cryptocurrency transactions by reference to the list price of the good, rather than the value of the cryptocurrency that was paid for it. The Streamlined Sales Tax Governing Board, comprised of member states, was created by the National Governor's Association and the National Conference of State Legislatures in 1999 "to provide a road map for states who want to simplify and modernize sales and use tax administration in their states in order to substantially reduce the burden of tax compliance. The SSUTA focuses on improving sales and use tax administration systems for all sellers and for all types of commerce.[67] The Streamlined Sales Tax Governing Board needs to step up and establish favorable guidelines for sales tax when crptocurrencies are utilized. Assessing sales tax on the listing price of the good for purchases involving virtual currencies would simplify the recording and reporting process.

In applying their income taxes, the federal government and states need to adopt a de minimis rule, which exempts from taxable income, gains recognized on small scale purchases of items with cryptocurrency. A 'de minimis exemption' would treat cryptocurrency transactions

[67] Streamlined Sales Tax Governing Board, Inc. (Mar. 19, 2019), https://www.streamlinedsalestax.org/Shared-Pages/faqs/faqs---about-streamlined.

the same way foreign currencies are being treated. By creating a de minimis exception, governments could ensure that individual users would never need to keep track of the insignificant gains on their daily purchases. A Cryptocurrency De Minimis Exemption Bill needs to be approved by Congress. In April of 2017, Rep. Jared Polis and Rep. David Schweikert, co-chairman of the Blockchain Caucus, unveiled a "Cryptocurrency Tax Fairness Act"[68] to Congress. Their bill would counter the problems consumers and merchants are facing when using cryptocurrencies as an every- day form of payment. In their bill, a de Minimis exemption would be allowed in connection with income taxes for cryptocurrency transactions for goods and service under the amount of $600.[69] The bill would treat cryptocurrency transactions for goods under $600 as hard legal tender[70]. This would mean that the consumer would not be required to keep track of gains on small purchases. Additionally, the individual wouldn't need to pay tax on any little gains that could arise. A de minimis exemption would not only exclude all small transactions under the limitation of $600 from taxation, but also remove the need for the transactions to be recorded and report. Not having to report all the insignificant purchases made throughout the year would make Federal and State income tax filing simpler. Having the federal government proclaim this de minimis exemption would definitely result in the individual States following it too.

The need for a de minimis exemption is asserted by the Institute of Certified Public Accountants too. The AICPA, the "world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving

[68] Cryptocurrency Tax Fairness Act, H.R. 3708, 115th Cong. (2017).
[69] Id.
[70] https://www.treasury.gov/resource-center/faqs/Currency/Pages/legal-tender.aspx. "Legal tender," which states: "United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues."

the public interest since 1887,"[71] submitted proposals to the IRS in regards to the current federal tax laws on cryptocurrencies. The AICPA had many recommendations for crafting and adjusting the current tax laws on cryptocurrency. Their suggestions were developed by the AICPA Virtual Currency Task Force. The Task Force recommended a "need for a De Minimis Election"."Tracking the basis and FMV of the virtual currency for each of these small purchases is time consuming, burdensome, and will yield a de minimis amount of gain or loss"[72] The AICPA recommends using the IRC Section 988(e)(2) "Treatment of certain foreign currency transactions" as a model for cryptocurrency transactions under $200. The Internal Revenue Code Section 988. "Treatment of Certain Foreign Currency Transactions" states: "no gain shall be recognized for purposes of this subtitle by reason of changes in exchange rates after such currency was acquired by such individual and before such disposition. The preceding sentence shall not apply if the gain which would otherwise be recognized on the transaction exceeds $200."[73] This de minimis exemption requested by the AICPA is solely for personal transactions. It does not apply to cryptocurrencies as an investment. Individuals will need to clarify to the IRS which cryptocurrencies are intended for personal usage and which are for investment purposes. The exemption would alleviate the burden of tax and recordkeeping for individuals who use cryptocurrencies in insignificant amounts. A cryptocurrency- friendly treatment at state level would encourage more people to use their cryptocurrencies in transactions for goods and thus potentially increase revenue collections which have been hurting because of underreporting throughout the years. There is no doubt that sales taxes and individual income taxes are just and

[71] AICPA , May. 2018. https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf.
[72] Id.
[73] I.R.C. § 988

necessary, but the States and the Federal government need to come to a better conclusion in regards to the taxation of digital currency. Sales and Income Taxes are the primary streams of revenue. It would be in the federal government and the State's best interest to work on becoming crypto friendly. "Legislators must raise sufficient revenue to pay for the public services. Because most states have strict balanced budget requirements, legislators must be willing to impose tax burdens on people and businesses that approximately equal the costs of providing those government services regardless of ant taxation sentiment and concerns about interstate competition"[74]

If the federal government wishes not to pursue enacting a form of de minimis ruling that would favor taxation utilizing cryptocurrencies for goods, the individual States need to take matters into their own hands regardless of the federal government approach. The States have to enact their own de minimis rules to eliminate the taxation that occurs when cryptocurrencies are converted to cash and hold the "Sales Tax" as the only form of taxation. All taxation barriers to using alternative forms of money should be removed. Eliminating capital gains taxes from small scale purchases with cryptocurrencies would be a major step toward evening out the field between virtual forms of payment and physical cash currency.

VIII. Conclusion

Senator Thomas Carper said it best: "Virtual currencies, perhaps most notably Bitcoin, have captured the imagination of some, struck fear among others, and confused the heck out of the rest of us."[75]

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[74] Id. at 19.

[75] Aruna Viswanatha, U.S. officials: virtual currencies vulnerable to money laundering. (Nov. 18, 2013), available at https://www.reuters.com/article/us-senate-virtualcurrency/virtual-currencies-vulnerable-to-money-laundering-u-s-justice-idUSBRE9AH0P120131118.

Cryptocurrencies appeal to small businesses because of the low transaction costs, low restrictions, irreversibility and to individuals because of the privacy and accessibility they offer. Cryptocurrencies offer the benefits of financial products to those who do not have access to traditional banking system.

The states and federal government need to come to a better conclusion regarding the taxation of cryptocurrencies. The states need to tax cryptocurrencies according to the list price of the good and the federal and state governments must establish an income tax exemption on de minimis amounts. An advantageous taxation would encourage the use of cryptocurrencies by individuals and businesses.

The digital era demands new forms of payment. The need for encouraging cryptocurrency utilization is expressed by the U.S. Treasury Department Secretary Jacob Lew : “in the United States, we have a deeply established financial system, and we have to simultaneously look at opening access to the traditional financial system but also looking at how technology can be used to expand the opportunities. New technologies have to afford the same degrees of consumer protection and have the same degrees of prudential security that traditional tools have."[76] With that said, cryptocurrencies could be the answer to the U.S. Treasury Department Secretary Jacob Lew's vision.

The inadequacy of current cryptocurrency taxation and the lack of guidelines from the federal government in addition to the inexistence of instructions at the state level has lead to compliance issues, such as non filing, underpayment and underreporting, resulting in potential tax revenue loss. "The challenge for policymakers will be to foster Bitcoin’s beneficial uses

[76] Id. at 10.

while minimizing its negative consequences."[77] Restricting cryptocurrecy use would only hurt lawful uses while leaving illegal handling undisturbed. Bitcoin is impossible to terminate because of its decentralized structure.

[77] Id. at 7.