Regulating Bitcoin: A Tax Case Study

Margaret Ryznar

Abstract This chapter adapts the Coffee bonding theory to the modern context of bitcoin, using tax as a case study. As the theory predicts, tax authorities may be able to increase the legitimacy of bitcoin by improving tax compliance and reducing tax evasion. Thus, while the Coffee theory arose two decades ago to explain the cross-listing of foreign company shares, it has implications for the modern context of bitcoin.

1 Introduction

Cross-listing of foreign company shares on American exchanges has been occurring for decades. Commentators have offered several explanations for this phenomenon, including the prominent Coffee bonding theory that there are legitimacy gains to adopting American securities laws through cross-listing (Coffee 2002). This theory about regulation has direct implications in the bitcoin context. Satoshi Nakamoto, a pseudonym for an unknown person, designed bitcoin and introduced it in a 2008 white paper titled "Bitcoin: A Peer-to-Peer Electronic Cash System" (Nakamoto 2008). At its essence, bitcoin is a cryptocurrency, which is a digital currency issued electronically by a computer program. Bitcoin has a predetermined cap of 21 million (Groshoff 2014). To implement bitcoin, Nakamoto devised the first blockchain to solve the double-spending problem for digital currency so that people cannot spend the same money twice (Shackelford and Myers 2017).

As bitcoin gained prevalence in the United States, it has drawn the attention of regulators. U.S. agencies considering bitcoin issues have included the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Financial Crimes Enforcement Network (FinCEN), and the Internal Revenue Service (IRS) (Burks 2017). These agencies have differed in their treatments of virtual currency, and comprehensive regulation has been unsuccessful to date (Burks 2017). Challenges include bitcoin's rapid growth and anonymity.

M. Ryznar (✉)
McKinney School of Law, Indiana University, Indianapolis, IN, USA
e-mail: mryznar@iu.edu

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Thus far, many bitcoin users have resisted any regulation (Zaytoun 2019). Yet, regulation may provide bitcoin with benefits that include legitimacy, as articulated by the Coffee theory that arose two decades ago to explain the cross-listing of shares in terms of regulatory benefits. This chapter explores the adaptability of this theory to bitcoin, examining the benefits of regulation in terms of increasing the legitimacy of bitcoin. In particular, this chapter uses the taxation of bitcoin in the United States as a case study, considering involuntary and voluntary noncompliance with the tax laws and their consequences for bitcoin's legitimacy.

2 The Coffee Bonding Theory

The Coffee bonding theory initially arose in the context of the cross-listing of foreign stocks (Coffee 2002). If they meet the regulatory requirements, foreign companies have the opportunity to cross-list their shares on a foreign stock exchange, such as the New York or London stock exchange. This allows foreign companies to list their shares on their own domestic exchange as well as a foreign exchange, usually in the United States (Pine 2010).

Cross-listing has traditionally been explained as an attempt to break down market segmentation and to increase investor recognition of the cross-listing firm (Baker et al. 2002). Another prominent explanation put forth by Professor Coffee is "bonding." Under this theory, issuers migrate to U.S. exchanges because by voluntarily subjecting themselves to higher disclosure standards and greater threat of enforcement both by public and private enforcers, they partially compensate for weak protection of minority investors under their own jurisdictions' laws and thereby achieve a higher market valuation (Coffee 2002). In other words, a firm's decision to cross-list on a U.S. exchange subjects it to a set of new disclosure and legal requirements (Ferris et al. 2009). Firms are thus choosing to "rent" the securities laws of other countries under the bonding theory (Pine 2010).

Although compliance with foreign regulators to cross-list is an expensive endeavor for companies (Saudagaran 1988), exposure to an international capital market can induce changes in corporate governance and improve investor perception of the quality of its governance (Ferris et al. 2009). A U.S. listing can also reduce the extent to which controlling shareholders can engage in expropriation and thereby increase the firm's ability to take advantage of growth opportunities (Doidge et al. 2004). In other words, U.S. regulation can provide increased legitimacy (Coffee 2002). This Coffee theory has implications for bitcoin.

From its beginning, bitcoin has suffered from legitimacy concerns stemming from the lack of regulation. Without a central bank underlying cryptocurrencies, many people find it difficult to trust bitcoin as a currency (Kearns 2013). The volatility of bitcoin's price also makes it hard to trust (Christopher 2016). Bitcoin is neither intrinsically valuable, like gold, nor is it rooted in a commodity expressing a certain purchasing power (Plassaras 2013). There might be some value resulting from its

scarcity, but it is an artificial scarcity (Burge 2016). Generally, bitcoin as a currency is not regulated like stocks and futures, and lighter regulation facilitates price manipulation (Markham 1991). Bad actors can manipulate the price of cryptocurrencies and then cash out before other investors catch on. There are also concerns about initial coin offerings of bitcoin, with the main reason for going public being for insiders to cash out. Additional concerns arise regarding a bitcoin bubble (Giancarlo 2018). All of these contribute to bitcoin's price volatility (Ly 2014).

Tax compliance issues, some rising to the level of tax evasion, have also undermined the legitimacy of bitcoin, which has prompted efforts to increase regulation aimed at solving them. The next part of this chapter examines the benefits of tax regulation for bitcoin, which are consistent with the Coffee bonding theory.

3 A Tax Case Study

The anonymity of bitcoin can facilitate tax evasion, which has attracted illegitimate users among legitimate ones (Foley et al. 2019). Yet, virtual currencies are a potential source of highly secure, private, and fluid transactions. By providing better guidance that supports the legitimate purpose of virtual currencies, tax authorities such as the IRS can empower users to take advantage of the benefits that virtual currencies offer. Perhaps more importantly to the IRS, proper guidance could improve reporting of virtual currency gains, thereby increasing tax revenue.

Tax compliance can always be improved, but compliance issues particularly abound in the anonymous world of bitcoin, which is devoid of connections to governments and mortar banks. This has undermined the legitimacy of bitcoin (Gruber 2013).

Tax regulators have started to address the issues stemming from bitcoin's unique characteristics. Already, several countries including the United States have collaborated to increase enforcement (IRS 2018). The IRS may also soon be working to develop its own policies on virtual currencies (Information Reporting Advisory Committee 2018). Consistent with Coffee's theory, there would be added benefits to such regulation for bitcoin, including a legitimacy boost.

When it comes to the taxation of bitcoin, there are several ways to improve compliance with the tax laws to increase the legitimacy of bitcoin (Edward 2006). American authorities have already moved to implement some of them in an effort to improve tax noncompliance and reduce the use of bitcoin for tax evasion. It is important to address both involuntary and voluntary noncompliance given their differences.

3.1 Involuntary Noncompliance

Much involuntary noncompliance with the U.S. tax laws on bitcoin stems from confusion. The federal tax code is complex, yet it becomes even more so when applied to bitcoin. Even when people want to comply with the tax laws regarding bitcoin, they may have trouble doing so due to this complexity.

There are two main ways to acquire bitcoin—to buy it on an exchange such as Coinbase or to earn it by processing bitcoin transactions, called "mining" (Akins et al. 2014). Mining immediately triggers tax consequences, with the fair market value of the coins mined included in gross income. If the bitcoin is not liquidated at the time it was mined, then it becomes a capital asset and receives the same tax treatment as buying it on an exchange. While buying bitcoin has no tax consequences, selling it can yield capital gains or losses like other property investments.

This is the tax treatment outlined by IRS Notice 2014–2021 ("Notice"), the only guidance to date on the income taxation of virtual currency. In it, the IRS made clear that it treats virtual currency as property instead of currency. The Notice describes how existing tax principles apply to transactions using virtual currency and answers a variety of common questions relating to the income tax treatment of virtual currency gains or losses. However, it left many unanswered questions. Guidance from the IRS in addition to its 5-year-old Notice could improve reporting of virtual currency gains, thereby increasing tax revenues overall (U.S. Gov't Accountability Office 2013). The Treasury Inspector General for Tax Administration (TIGTA) has thus suggested in a recent report the need for better tax guidance (Treasury Inspector General for Tax Administration 2016).

Not only is it difficult for taxpayers to understand the tax law regarding bitcoin, but it may be difficult to comply given the nature of bitcoin, which includes a currency function. To simplify tax compliance, lawmakers in the future may choose to consider a de minimis exception for bitcoin transactions. Exempting gain on a transaction below a certain threshold would dispose of a huge segment of virtual currency transactions because smaller transactions would not be subject to taxation.

With such a de minimis exception, casual bitcoin users could therefore buy a certain amount of goods or services with virtual currency without any tax consequences, but the primary limitation would be the potential volatility of the value of bitcoin that might wildly fluctuate below and above the de minimis exception. Nonetheless, the threshold should be high enough to dispose of a large number of routine consumer transactions.

Consider, for example, the oft-envisioned future of bitcoin, where users pay for daily small purchases, such as a cup of coffee, directly from their virtual wallets. Indeed, coffee seller Starbucks plans to accept payment in bitcoin starting in 2020. Without a de minimis exception, purchasing a cup of coffee would be a taxable event, requiring taxpayers to calculate their gain or loss on the transaction. A de minimis exception would eliminate this result.

The unsuccessful Cryptocurrency Tax Fairness Act, proposed in the United States in September 2017, contained such a de minimis exception. Under its approach, any transaction resulting in $600 or less of gain would be excluded from taxation. The

United Kingdom has already adopted a de minimis exception, although its threshold is much higher—£11,700 of gain in cryptocurrency transactions is tax-free under certain conditions (Crypto Daily 2018).

Overall, taxpayers would benefit from the simplified process resulting from a de minimis exception and the IRS would still capture significant revenue from large virtual currency transactions. Such decreased tax regulation in low-value transactions would raise the efficiency of using bitcoin without jeopardizing its legitimacy. Meanwhile, high-volume bitcoin users would benefit from additional information beyond Notice 2014–2021 to assist with tax compliance. These changes would provide a boost to the legitimacy of bitcoin by increasing tax compliance.

3.2 Voluntary Noncompliance

Voluntary noncompliance with the tax laws may rise to the level of tax evasion, which is a felony crime in the United States punishable by a $100,000 fine and 5 years imprisonment per 26 U.S. Code §7201. Thus, more so than involuntary noncompliance stemming from confusion, bitcoin's use to evade taxes undermines its legitimacy.

While there is an incentive to report bitcoin losses to claim tax deductions, the same is not true of bitcoin gains. As a result, some bitcoin users intentionally do not report their gains. Despite the existence of penalties for underreporting tax liability in the United States, they are difficult to apply due to the anonymity of bitcoin. This has led to bitcoin's ability to function like Swiss banks (Morris 2014). Voluntary noncompliance with the tax laws costs the U.S. Treasury billions of dollars each year (Marian 2013).

To combat the anonymity surrounding bitcoin, the IRS has made progress in establishing its authority to summon records from a virtual currency platform through a "John Doe" anonymous summons. In U.S. v. Coinbase, Inc., the IRS served a summons on Coinbase seeking information on essentially all of its users. The IRS ultimately limited its request to information for users with the equivalent of $20,000 in one transaction—around 10,000 users. The district court enforced, in part, the narrowed summons, ordering Coinbase to produce records revealing the name, taxpayer identification number, birth date, address, transactions logs, and account statements of certain users. While the scope of the summons was significantly narrowed, it still represented a victory for the IRS. The ability of the IRS to gather records necessary to examining a taxpayer's virtual currency transactions will only increase the frequency and accuracy of reporting of gains and losses.

As in other tax contexts, third party reporting could also improve compliance (Hatfield 2015). Coinbase, the largest bitcoin platform, currently issues voluntary Form 1099-K to a select group of users—those with at least 200 annual transactions totaling at least $20,000 who use Coinbase for business purposes (Coinbase, 1099-K Tax Forms 2018). In order to provide the IRS with a better picture of the true scope of bitcoin transactions, all virtual currency platforms can be required to report user activity on more than just large-volume business users.

In sum, noncompliance with tax laws regarding bitcoin can be voluntary or involuntary. Voluntary noncompliance, in particular, has given bitcoin the reputation of facilitating tax evasion, undermining the legitimacy of bitcoin. Despite the novelty surrounding bitcoin and other virtual currencies, traditional tax compliance methods can be adopted to address many of these noncompliance issues. Such tax regulation would increase bitcoin's legitimacy, as the Coffee bonding theory would predict.

4 Conclusion

While the Coffee bonding theory originally arose two decades ago in the context of the cross-listing of foreign stocks, it also has implications today for bitcoin. In the same way as it does for foreign stocks, regulation legitimizes bitcoin to a certain extent, particularly important given its start as an anonymous cryptocurrency for illegal activities (Foley et al. 2019). Historically, the legitimizing effect of regulation has brought some value (Coffee 2002). On the other hand, criticism has generally targeted the enforcement of any regulation. For example, there is the possibility of bias in enforcement of the laws (Heminway 2003). Furthermore, there are separate critiques regarding over-regulation of the business environment (Woody 2012). These concerns regarding regulation no doubt hold true in the bitcoin context, but must be considered alongside the benefits of regulation, including those predicted by the Coffee bonding theory.

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