

ISSUE BRIEF

No. 4761 | SEPTEMBER 13, 2017

Removing Tax Barriers to Competitive Currencies

David R. Burton and Norbert J. Michel

Policymakers rarely consider improving money with the same competitive market forces that improve other goods and services. Nonetheless, such policies should not be summarily dismissed. Money is the means of payment for virtually all goods and services. Suppressing competition among competing currencies, if history is any guide, only deprives citizens of beneficial innovations in the means of payment.

The current tax treatment of alternative currencies creates a major barrier to the widespread use of alternative currencies. Congress should remove these specific barriers to entry in the market for alternative monies, and ensure that no single type of money enjoys a regulatory advantage.

Competitive Forces Can Improve Money

Competitive forces improve people's well-being because prices convey vitally important information.¹ The price of money is no different. When government has a monopoly on money, important information about the demand for money and whether there is an oversupply or undersupply of money is lost.² In addition, information about the expectations of market participants and the relative demand for various features of competing currencies is lost.

Ultimately, the competitive process is the optimal approach to discovering what people view as the best means of payment.

Policymakers and those operating in the marketplace are likely to be able to make more informed decisions in a competitive currency environment. In a competitive currency environment, the relative price of the competing currencies will rapidly incorporate information about current market conditions and about the supply of, and demand for, the various currencies available for exchange.³ The overall historical record, including recent monetary policy failures, highlights the importance of preserving citizens' ability to use whichever form of money they choose.⁴

Tax Impediments to the Use of Alternative Currencies

The current tax treatment of alternative currencies is a major barrier to the widespread use of such currencies. The tax system impedes the practical use of alternative currencies in four related ways:

1. The capital gains tax;
2. The investment income tax;
3. Information reporting requirements; and
4. Backup withholding.

Capital Gains Tax. In March 2014, the Internal Revenue Service (IRS) announced that it would treat virtual currencies (such as bitcoin) as property for U.S. tax purposes, a decision that confirms that bitcoin users are subject to both the capital gains tax

This paper, in its entirety, can be found at <http://report.heritage.org/ib4761>

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

and the investment income tax and therefore must also comply with various information reporting obligations when bitcoin is used in transactions.⁵ This treatment applies to the use of precious metals as well as to electronic payment mechanisms based on precious metals.

In general, the income tax imposes a tax on capital gains when property is sold or otherwise disposed. The amount of tax is a function of the applicable capital gains tax rate times the net capital gain. The net capital gain is generally the price realized when the asset is sold minus the cost of acquiring the asset.⁶ The applicable tax rate depends on one's income bracket and whether the asset has been held for more than one year.⁷ The tax rate is generally lower if the asset has been held for more than one year.⁸ This is called a long-term capital gain. The highest federal statutory long-term capital gains tax rate is generally 20 percent; the highest federal statutory short-term capital gains tax rate is generally 39.6 percent.⁹ Most state and local income taxes piggyback on the federal income tax, so the actual tax rate for taxpayers in states with an income tax is higher.

If an alternative currency is used to acquire a good, service, or other asset, the measure of the price realized for the sale or disposition of the alternative currency would be the fair market value in U.S. dollars of the good, service, or asset acquired. The lack of dollar-denominated price in the transaction may result in administrative and compliance difficulties when calculating gains and when reporting the transactions.

Every alternative currency transaction is a taxable event, reportable on Schedule D of the taxpayers' Form 1040 (or, if a business, the analogous business tax form, such as a Form 1120 or Form 1065).¹⁰ A taxpayer that used an alternative currency in daily life could have a Schedule D that runs to dozens of pages in length.¹¹

Investment Income Tax. Taxpayers with modified adjusted gross income over \$200,000 (single) or \$250,000 (joint) are subject to an additional investment income tax of 3.8 percent.¹² Investment income includes net capital gains. Thus, the top federal capital gains tax rate is actually 23.8 percent on long-term gains and 43.4 percent on short-term gains,

1. F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 35, No. 4 (1945), pp. 519-530, <http://home.uchicago.edu/~vlima/courses/econ200/spring01/hayek.pdf> (accessed September 12, 2017).
2. See, for example, F. A. Hayek, *Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies* (London: The Institute Of Economic Affairs, 1990), p. 102, https://mises.org/system/tdf/Denationalisation%20of%20Money%20The%20Argument%20Refined_5.pdf?file=1&type=document (accessed September 12, 2017).
3. Demand for a currency would be based on characteristics that make it more or less useful, expectations about future supply and its value, or other factors.
4. See Norbert J. Michel, "Improving Money Through Competition," Heritage Foundation *Issue Brief* No. 4730, July 7, 2017, <http://www.heritage.org/monetary-policy/report/improving-money-through-competition>, and Norbert J. Michel, "Monetary Policy Reforms for Main Street," Heritage Foundation *Backgrounder* No. 3237, July 27, 2017, <http://www.heritage.org/monetary-policy/report/monetary-policy-reforms-main-street>.
5. Internal Revenue Service, "IRS Virtual Currency Guidance," *Internal Revenue Bulletin*, 2014-16, Notice 2014-21, April 14, 2014, http://www.irs.gov/irb/2014-16_IRB/ar12.html (accessed September 12, 2017).
6. This is known as its "basis."
7. Internal Revenue Code §1(h).
8. Internal Revenue Code §1222(3).
9. Internal Revenue Code §1(h)(1)(D). This does not include the Obamacare investment income tax (imposed by Internal Revenue Code §1411)—discussed below—and does not consider the effective marginal tax rate increase caused by the numerous phase-outs of various tax deductions, credits and exclusions or by state and local income taxes. Moreover, unrecaptured gains from depreciable realty are subject to a 25 percent tax (Internal Revenue Code §1250 and Internal Revenue Code §1(h)(1)(E)) and gains from collectibles and certain small business stock are subject to a 28 percent tax (Internal Revenue Code §408(m); Internal Revenue Code §1(h)(4)-(5); and Internal Revenue Code §1202).
10. Internal Revenue Service, "Schedule D (Form 1040) Capital Gains and Losses," <http://www.irs.gov/pub/irs-pdf/f1040sd.pdf> (accessed September 12, 2017). See also, Internal Revenue Service, "Form 8949: Sales and Other Dispositions of Capital Assets," <https://www.irs.gov/pub/irs-pdf/f8949.pdf> (accessed September 12, 2017).
11. Form 8949 lists 14 transactions per page. For example, then, the use of an alternative currency credit card to purchase goods or services five times a day would result in 1,825 reportable capital gains (or losses) per year and result in roughly 130 additional pages of tax forms.
12. Internal Revenue Code §1411.

raising the tax further on many individuals who use alternative currencies.¹³

Information Reporting. Using an alternative currency to acquire an asset, good, or service, or simply buying or selling an alternative currency, is likely to trigger a series of information-reporting requirements. The transaction is likely to be deemed a barter exchange or, if an electronic alternative currency is used, the service provider is likely to be deemed a broker.¹⁴ Such a determination may trigger a requirement to file a Form 1099-B (Proceeds from Broker and Barter Exchange Transactions)¹⁵ for each transaction, providing the name, tax number and address of the seller as well as transaction information. Failure to report these transactions is subject to a penalty of \$50 to \$250 per unreported transaction.¹⁶ These aspects of information reporting stem from the fact that each alternative currency transaction results in a capital gain or loss and constitutes a special impediment to using an alternative currency rather than dollars.

Employers who pay wages or salaries with an alternative currency or pay independent contractors in an alternative currency would be subject to the same reporting requirements as if they paid in dollars. For example, employers that pay wages must issue W-2 forms¹⁷ to employees and file a Form W-3.¹⁸ They must also withhold income and payroll taxes and pay various employer payroll taxes. Those who pay more than \$600 (or the equivalent in alternative currency) to an independent contractor must

file a Form 1099-MISC with respect to each payee. Because these requirements are generally the same for dollar transactions and alternative currencies, they pose no special impediment to the use of alternative currencies. However, alternative currencies would have an increased administrative burden because the exchange rate between the alternative currency and the dollar would need to be determined on the date of each transaction (such as wages paid) for purposes of making the report in dollars.

Backup Withholding. Backup withholding is required with respect to a wide variety of payments where the payor does not have a valid taxpayer identification number (TIN) for the payee.¹⁹ In particular, 28 percent of the payment must be withheld and paid to the IRS.²⁰ Failure to do so results in substantial penalties.²¹ The payor often obtains the TIN by requiring that a payee fill out a Form W-9 prior to payment.²² Thus, users of alternative currencies are potentially subject to TIN reporting requirements.

Recommendations for Congress

Congress should avoid policies that single out alternative forms of money for adverse legal treatment and prevent people from using their preferred medium of exchange. Congress should remove legal requirements that foster government monopoly and obstruct the use and development of competitive currencies. The tax system is currently the greatest single impediment to the use and development of competitive currencies.²³

13. As above, this does not consider the effective marginal tax rate increase caused by the numerous phase-outs of various tax deductions, credits, and exclusions, or state and local income taxes.

14. Internal Revenue Code §6045; 26 Code of Federal Regulations §1.6045-1.

15. Internal Revenue Service, "Form 1099-B," <https://www.irs.gov/pub/irs-pdf/f1099b.pdf> (accessed September 12, 2017).

16. Internal Revenue Code § 6721-6722; 26 CFR 301.6721-1 "Failure to file correct information returns."

17. Internal Revenue Service, "Form W-2: Wage and Tax Statement," <https://www.irs.gov/pub/irs-pdf/fw2.pdf> (accessed September 12, 2017).

18. Internal Revenue Service, "Form W-3: Transmittal of Wage and Tax Statements," <https://www.irs.gov/pub/irs-pdf/fw3.pdf> (accessed September 12, 2017).

19. Internal Revenue Code §3406.

20. Internal Revenue Code §3406(a)(1)(D).

21. See 26 Code of Federal Regulations, §35a.9999-3, A-2: "A payor is subject to the same requirements and penalties for failing to impose backup withholding as an employer making a payment of wages."

22. Internal Revenue Service, "Form W-9: Request for Taxpayer Identification Number and Certification," <https://www.irs.gov/pub/irs-pdf/fw9.pdf> (accessed September 12, 2017).

23. For a discussion of additional barriers, such as legal tender laws and anti-money laundering rules, see Michel, "Improving Money Through Competition,"; and, Gerald Dwyer and Norbert J. Michel, "Bits and Pieces: The Digital World of Bitcoin Currency," Heritage Foundation *Background* No. 3047, September 16, 2015, <http://www.heritage.org/government-regulation/report/bits-and-pieces-the-digital-world-bitcoin-currency>.

Congress could take one of two approaches to ensure that competitive currencies and the dollar are treated comparably for tax purposes.

1. Adopt a fundamental tax reform plan in which financial transactions are irrelevant to determining the tax base or one in which capital gains are not taxed.²⁴ Replacing the income tax with the Hall-Rabushka Flat Tax, a business flat tax, or a national sales tax—such as the FairTax—would accomplish this goal.²⁵ Adopting this type of tax reform plan is the most straightforward solution because it avoids the difficulties—both practical and political—associated with properly defining *currency* (or *alternative currency*) for the sole purpose of ensuring equal tax treatment among alternative currencies.

2. Define the term *currency* (or *alternative currency*) in the Internal Revenue Code, absent adopting a fundamental tax reform plan to ensure equal tax treatment among alternative currencies. One way to implement this method would be for Congress to (a) define capital asset in Internal Revenue Code §1221(a) to exclude “alternative currencies” from the definition of capital asset, and (b) exclude gains or losses from the sale or exchange of an alternative currency from gross income.²⁶ Under this approach, alternative currency could be defined as:

- gold, silver, platinum or palladium bullion or coin;
- a transferable certificate, electronic or otherwise, redeemable in gold, silver, platinum or palladium bullion or coin; or

- a medium of exchange based on blockchain or similar technology.

Congress also could consider adding foreign currencies, or certificates redeemable in foreign currency, to the definition of alternative currency. Defining capital asset in this manner would also exclude the gains from tax under the §1411 investment income tax.

Congress should also amend the information reporting requirements to make clear that capital gains (or losses) resulting from changes in the relative value of an alternative currency and the dollar need not be reported.²⁷ Finally, Congress should provide that capital gains and losses arising out of alternative currency transactions should not be subject to backup withholding.²⁸

An Alternative Approach: The Cryptocurrency Tax Fairness Act

On September 7, 2017, Representative David Schweikert (R-AZ) introduced H.R. 3708, the Cryptocurrency Tax Fairness Act.²⁹ This legislation would exclude from gross income any capital gains (but not losses) that stem from the “sale or exchange of virtual currency for other than cash or cash equivalents,” provided those gains do not exceed \$600 per transaction. Sales or exchanges which are part of the same transaction (or a series of related transactions) are treated as one sale or exchange. Virtual currency is defined as “a digital representation of value that is used as a medium of exchange” and excludes foreign currency. The Secretary of the Treasury is required to issue regulations governing the reporting of transactions.

24. This is sometimes referred to as an R-based (real) system as opposed to an R+F (real plus financial) based system.

25. David R. Burton, “Four Conservative Tax Plans with Equivalent Economic Results,” Heritage Foundation *Backgrounder* No. 2978, December 15, 2014, <http://www.heritage.org/research/reports/2014/12/four-conservative-tax-plans-with-equivalent-economic-results>. See also, David R. Burton, “The Business Flat Tax: How It Works, What It Means for the Economy,” Heritage Foundation *Backgrounder* No. 3117, August 15, 2016, <http://www.heritage.org/taxes/report/the-business-flat-tax-how-it-works-what-it-means-the-economy>.

26. See Internal Revenue Code §§101-140 for items explicitly excluded from gross income under current law.

27. Specifically, Congress should amend Internal Revenue Code §6045, §6721 and §6722.

28. Specifically, Congress should amend Internal Revenue Code §3406.

29. See Jerry Brito, “Reps. Polis & Schweikert introduce Cryptocurrency Tax Fairness Act in Congress,” Coin Center, September 7, 2017, <https://coincenter.org/entry/rep-polis-schweikert-introduce-cryptocurrency-tax-fairness-act-in-congress> (accessed September 12, 2017). Representative Jared Polis (D-CO) is an original co-sponsor. The two sponsors are Co-Chairman of the Congressional Blockchain Caucus, <https://www.congressionalblockchaincaucus.com/> (accessed September 12, 2017).

Although constructive, H.R. 3708 is too narrow in focus, and its drafting raises four concerns in particular.

1. Limiting the gains exclusion to transactions under \$600 will retain the discrimination against digital currencies.
2. While the legislation would presumably encompass digital alternative currencies that were based on either blockchain technology or a “digital representation” of precious metals, it would not apply to physical metals or non-digital certificates representing precious metal ownership.
3. The asymmetry of excluding gains but not losses will lead to tax-avoidance opportunities and, more importantly, raise significant problems as the Department of the Treasury drafts the reporting regulations. Because the reporting party does not necessarily know the basis of the person holding the alternative currency and therefore does not know whether a particular transaction gives rise to a gain or a loss, all transactions will need to be reported. Requiring the reporting of all transactions constitutes a major impediment to the use of alternative currencies.
4. The definition of “virtual currency” is dependent on the term “digital representation.” The term “digital representation” implies that it is a representation of something else. It is not clear what that would be. The use of the term “digital technology,” “blockchain or similar technology,” or “computer-based technology” would be less ambiguous and less subject to misinterpretation.

Conclusion

It is difficult to imagine privately produced monies replacing an established national currency. However, competitive currencies place a significant constraint on the ability of the federal government to devalue the national currency, distort economic decision-making, and harm economic growth. Alternative currencies will better meet the needs of some consumers and businesses and will provide market participants and policymakers with useful economic information. Congress should work diligently to eliminate tax and other legal impediments to the development of alternative currencies.

—*David R. Burton is a Senior Fellow in Economic Policy, in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom, at The Heritage Foundation. Norbert J. Michel, PhD, is Director of the Center for Data Analysis, of the Institute for Economic Freedom.*