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## The North Carolina State Tax Treatment of Virtual Currency: An Unanswered Question

### I. INTRODUCTION

Imagine a situation where Mr. and Mrs. Smith of Newark, New Jersey sell their home and retire to Chapel Hill, North Carolina, where they rent an apartment that they pay for with virtual currency.<sup>1</sup> Further, suppose that prior to moving, the Smiths had also converted the proceeds of their home sale into virtual currency. Theoretically, the Smiths could meet most of their daily needs by purchasing exclusively from retailers who accept virtual currency.<sup>2</sup> Because the issue of virtual currency has not been addressed for North Carolina tax purposes,<sup>3</sup> the Smiths could conceivably live in North Carolina without paying state sales taxes if virtual currency were to become so prolific that all of their needs could be met by retailers who accept virtual currency.

In June 2016, the General Assembly of North Carolina updated the state's Money Transmitter Statute.<sup>4</sup> This update explicitly states

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1. See Bitcoin Inv. Tr., Exchange Act Release No. 34-78282, 2016 WL 4363462, n.1 (July 11, 2016) (defining virtual currency as a “digital representation of value that can be digitally traded and functions as a medium of exchange; a unit of account; and/or a store of value, but does not have legal tender status”).

2. See e.g., Kirby Wilson, Tom Ferguson Becomes First Durham Business Owner to Accept Bitcoins, DUKE CHRONICLE (Feb. 26, 2014), [www.dukechronicle.com/articles/2014/02/26/tom-ferguson-becomes-first-durham-business-owner-accept-bitcoins](http://www.dukechronicle.com/articles/2014/02/26/tom-ferguson-becomes-first-durham-business-owner-accept-bitcoins) (discussing the fact that retailers in North Carolina are accepting bitcoin).

3. N.C. GEN. STAT. § 105-164.3 (2016); *Sales & Use Tax Navigator, N.C., 17. Taxation of Property, Services, and Indus.*, BLOOMBERG BNA [hereinafter *Tax Navigator*], <https://www.bloomberglaw.com/document/9566298152> (last visited Jan. 31, 2017) (“North Carolina does not address the tax treatment of Bitcoin or other virtual currency.”).

4. N.C. Money Transmitters Act, 2016 N.C. Sess. Laws 81; see N.C. GEN. ASSEMB., HB 289- N.C. MONEY TRANSMITTERS ACT SUMMARY (June 22, 2016) [hereinafter HB 289 SUMMARY], <http://www.ncleg.net/documentsites/committees/senatefinance/2016/6-23-2016/H289-NC%20Money%20Transmitters%20Act%20Summary.pdf> (“Among the reasons for regulating this industry are to prevent money laundering and the financing of terrorism and to protect consumers from the risk that money transfer businesses will fail to deliver the funds as agreed.”); Elliot Maras, *N.C. Governor Signs Bitcoin-Friendly ‘Virtual Currency Law.’* CRYPTOCOIN NEWS (Aug. 7, 2016), <https://www.cryptocoinsnews.com/north-carolina-bitcoin-law-signed/> (highlighting North Carolina’s efforts to work with leaders in the virtual currency industry to come up with a solution that provides regulation to protect consumers while taking the concerns of industry into account); Austin Mills, *A N.C. Proposal Can*

that certain businesses who “maintain control of virtual currency on behalf of others” must comply with the requirements of North Carolina’s Money Transmitters Act.<sup>5</sup> In so doing, the General Assembly recognized that virtual currency has monetary value.<sup>6</sup> Yet, North Carolina has not determined how it will address taxable purchases made with virtual currency or whether gains and losses in the value of virtual currency would be considered a taxable event.<sup>7</sup>

This Note addresses the current state of the law regarding taxation of virtual currency and how North Carolina should address state sales and income tax issues. Part II provides background information on virtual currency.<sup>8</sup> Part III explains how virtual currency is treated for federal tax purposes.<sup>9</sup> Part IV highlights how other states are addressing the issue of state taxation.<sup>10</sup> Finally, Part V recommends how virtual currency should be taxed in North Carolina.<sup>11</sup>

## II. BACKGROUND ON VIRTUAL CURRENCY

### A. *What is Virtual Currency?*

The Securities and Exchange Commission (“SEC”) has defined virtual currency as a “digital representation of value that can be digitally traded and functions as a medium of exchange; a unit of account; and/or a store of value, but does not have legal tender status.”<sup>12</sup> Its lack of legal tender status and the fact that it is not tied to a currency with legal tender status is what differentiates virtual currency from real currency and e-money.<sup>13</sup>

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*Cure Payments’ Regulatory Overreach*, PAYMENTSOURCE (May 15, 2015), <http://www.paymentssource.com/news/paythink/a-north-carolina-proposal-can-cure-payments-regulatory-overreach-3021341-1.html> (emphasizing how the North Carolina statute takes business concerns into account by limiting the regulation to transactions that are consumer facing).

5. N.C. GEN. STAT. § 53-208.42(12) (2016).

6. N.C. GEN. STAT. § 53-208.42 (13), (20).

7. N.C. GEN. STAT. § 105-164.3; *Tax Navigator*, *supra* note 3.

8. *See infra* Part II.

9. *See infra* Part III.

10. *See infra* Part IV.

11. *See infra* Part V.

12. Bitcoin Inv. Tr., Exchange Act Release No. 34-78282, 2016 WL 4363462, n.1 (July 11, 2016).

13. FIN. ACTION TASK FORCE, VIRTUAL CURRENCIES KEY DEFINITIONS AND POTENTIAL

Real currency, like the United States Dollar (“USD”), is issued by a sovereign power and is “designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country.”<sup>14</sup> E-money is similar to virtual currency in that it is a method of “electronically transfer[ing] value.”<sup>15</sup> However, e-money, unlike virtual currency, is merely a “digital representation” of real money—and thus its value is determined by a currency with legal tender status.<sup>16</sup> While Bitcoin is the most popular type of virtual currency, there are many other varieties of virtual currency.<sup>17</sup> Examples of other varieties of virtual currency include: Litecoin,<sup>18</sup> PPCoin,<sup>18</sup> Ripple,<sup>19</sup> Dash,<sup>20</sup> and Guncoin.<sup>21</sup>

Convertible virtual currency is a subset of virtual currency, which “has an equivalent value in real currency, or that acts as a substitute for real currency.”<sup>22</sup> The Internal Revenue Service (“IRS”) has highlighted bitcoin as an example of convertible virtual currency.<sup>23</sup>

### 1. How Bitcoin Works

In contrast to the USD, Bitcoin is not regulated by a central authority.<sup>24</sup> Rather, it depends on individual bitcoin users known as

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AML/CFT RISKS, 4 (June 2014), <http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> (noting that fiat currency, national currency, and real currency are the same concept and may be used interchangeably).

14. *Id.* (Fiat currency is also known as national or real currency.).

15. *Id.*

16. *Id.*

17. See Justin O’Connell, *These are the Most Popular Digital Currencies Three Years Running*, CRYPTOCOIN (Feb. 23, 2016), <https://www.cryptocoinsnews.com/most-popular-digital-currencies/> (highlighting other varieties of virtual currency).

18. Stephen T. Middlebrook & Sarah Jane Hughes, *Regulating Cryptocurrencies in the United States: Current Issues & Future Directions*, 40 WM. MITCHELL L. REV. 813, 819 (2014).

19. O’Connell, *supra* note 17.

20. Anthony Cuthbertson, *Darkcoin to Rebrand as DASH to Disassociate Itself from Dark Web*, INT’L BUS. TIMES (Mar. 17, 2015, 11:52 AM), <http://www.ibtimes.co.uk/darkcoin-rebrand-dash-better-represent-cryptocurrencys-digital-cash-platform-1492299>.

21. *About Guncoin*, GUNCOIN-CRYPTOCURRENCY FOR GUN ENTHUSIASTS, <http://guncoin.info/about-guncoin/> (last visited Dec. 20, 2016).

22. I.R.S. Notice 2014-21, 2014-16 I.R.B 938.

23. *Id.*

24. Kelsey L. Penrose, Note, *Banking on Bitcoin: Applying Anti-Money Laundering & Money Transmitter Laws*, 18 N.C. BANKING INST. 529, 529 (2014).

“miners”<sup>25</sup> who both (1) confirm transactions and (2) infuse more bitcoins into the system.<sup>26</sup>

Miners authenticate transactions by using a software program to solve algorithms, thus ensuring that other users have a sufficient balance of bitcoins for the transaction in which they are seeking to engage.<sup>27</sup> Once a group of transactions called a “block” has been authenticated, the “block” is added to the “blockchain.”<sup>28</sup> The rate at which a block is created—roughly ten minutes per block—is managed by adjusting the complexity of the algorithm.<sup>29</sup> In order to prevent users from spending the same bitcoin more than once, miners compare pending transactions to transactions that have already been added to the blockchain.<sup>30</sup>

One key feature of virtual currencies like Bitcoin is that transactions have a high degree of anonymity.<sup>31</sup> Miners confirm transactions without knowing the identity of the users.<sup>32</sup> A combination of numbers called the public key “encrypts the bitcoin.”<sup>33</sup> While, a different set of numbers, called the private key, “decrypts the bitcoin.”<sup>34</sup>

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25. Brad Jacobsen & Fred Peña, *What Every Lawyer Should Know About Bitcoins*, 27 UTAH BAR J. 40, 41 (2014) (“To begin mining, a user can download and run Bitcoin Network mining software, which turns the user’s computer into a “node” on the Bitcoin Network that validates transactions on the network.”).

26. Penrose, *supra* note 24, at 531.

27. Penrose, *supra* note 24, at 532–33.

28. Penrose, *supra* note 24, at 532–33 (explaining that a public ledger, called the blockchain, encompasses every bitcoin transaction that has ever been made since its inception).

29. Penrose, *supra* note 24, at 532–33.

30. Gerald Dwyer & Norbet Michel, *Bits and Pieces: The Digital World of Bitcoin Currency*, HERITAGE FOUND. (Sept. 16, 2015), <http://www.heritage.org/research/reports/2015/09/bits-and-pieces-the-digital-world-of-bitcoin-currency> (“The ledger is referred to as the blockchain, and all bitcoin transactions are checked against the blockchain to ensure that there is no double spending.”); see Joseph Bonneau, *How Long Does it Take for a Bitcoin Transaction to be Confirmed?*, COIN CENTER (Nov. 3, 2015), <https://coincenter.org/entry/how-long-does-it-take-for-a-bitcoin-transaction-to-be-confirmed> (stating that “once a transaction is included in a block in the blockchain which is followed up by at least 6 additional blocks, the transaction is called ‘confirmed’”) (“Sometimes confirmation may be tens of minutes and sometimes it may take over two hours, but on average it will take about an hour.”).

31. Penrose, *supra* note 24, at 535.

32. Penrose, *supra* note 24, at 535.

33. Penrose, *supra* note 24, at 535.

34. Penrose, *supra* note 24, at 535; *Bits and Bobs*, ECONOMIST (June 13, 2011, 8:30 PM), <http://www.economist.com/blogs/babbage/2011/06/virtual-currency> (explaining that the private and public keys are mathematically linked) (stating that an “intended recipient’s public key is used to encode payments, which can then only be retrieved with the help of the associated private key”).

The public keys are posted to the blockchain.<sup>35</sup> However, only the user who holds the private key can receive the bitcoin from the transaction.<sup>36</sup>

As compensation for verifying transactions, miners receive newly created bitcoin and transaction fees.<sup>37</sup> This reward is the only way in which new bitcoins are created.<sup>38</sup> Unlike with real currency, the amount of bitcoin that will ever be created has a set limit, which is a draw for individuals concerned about inflation of real currencies.<sup>39</sup>

## 2. Other Types of Virtual Currency

Other popular virtual currencies work in a similar fashion as Bitcoin.<sup>40</sup> For example, blocks of litecoin (the second most popular form of virtual currency) are added at a faster rate than bitcoin blocks.<sup>41</sup> Guncoin also creates blocks faster than bitcoin, averaging two minutes per block.<sup>42</sup> Because Guncoin has a faster mining rate, the maximum number of guncoins that can be created is 479 million more than the maximum number of bitcoins.<sup>43</sup> Further, PPCoin differs from Bitcoin in that it does not limit the number of coins that will be created.<sup>44</sup> Dash

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35. Penrose, *supra* note 24, at 535.

36. Penrose, *supra* note 24, at 535 (“All transactions published on the blockchain are identifiable by the public key. It is easy to see the trail of bitcoins, but difficult to determine whose trail it is.”).

37. Dwyer & Michel, *supra* note 30.

38. Dwyer & Michel, *supra* note 30.

39. Kevin V. Tu & Michael W. Meredith, *Rethinking Virtual Currency Regulation in the Bitcoin Age*, 90 WASH. L. REV. 271, 283 (2015). The amount of the reward decreases with time, so that the number of bitcoin in existence will never exceed 21 million. When the maximum number is reached, which is estimated to be in 2041, transaction fees will reward miners. Dwyer & Michel, *supra* note 30; Ellery Davies, *Why is Bitcoin’s Cap Set at Circa 21 Million ‘Coins’ and Not More or Less?*, QUORA (July 13, 2016), <https://www.quora.com/Why-is-Bitcoins-cap-set-at-circa-21-million-coins-and-not-more-or-less> (stating that the choice to pick 21 million as the limit was arbitrary).

40. Prableen Bajpai, *The 5 Most Important Currencies Other Than Bitcoin*, INVESTOPEDIA (Dec. 10, 2014, 2:45 PM), <http://www.investopedia.com/articles/investing/121014/5-most-important-virtual-currencies-other-bitcoin.asp>.

41. *Id.* (stating that litecoin miners receive more coins for each block they verify than bitcoin miners). The average amount of time required for a litecoin to be added to the block is 2.5 minutes. *What is the Difference between Bitcoin and Litecoin?*, COINDESK (Apr. 2, 2014), <http://www.coindesk.com/information/comparing-litecoin-bitcoin/>.

42. *About Guncoin*, *supra* note 21.

43. *See About Guncoin*, *supra* note 21 (stating that the maximum number of guncoin is 500 million); *see also* Dwyer & Michel, *supra* note 30 (stating that the maximum number of bitcoin is 21 million).

44. Bajpai, *supra* note 40.

(formerly Darkcoin) provides greater anonymity than Bitcoin, because transactions are not displayed over the entire network, and transactions are processed more quickly.<sup>45</sup>

### 3. Acquiring Virtual Currency

Convertible virtual currency users may acquire coins through exchanges, where users can both purchase virtual currency with real currency and trade virtual currency for real currency.<sup>46</sup> Alternatively, users can purchase virtual currency directly from other users in a face-to-face transaction.<sup>47</sup> In addition, ATMs allow users to exchange virtual currency for real currency and vice versa when they are on the go.<sup>48</sup> However, bitcoin ATMs are nowhere near as ubiquitous as cash ATMs.<sup>49</sup> Only 827 bitcoin ATMs exist worldwide while there are 432,000 cash ATMs in the United States alone.<sup>50</sup>

#### B. *Need for Regulation*

Convertible virtual currencies like Bitcoin have numerous benefits over traditional payment methods such as: “(1) lower costs and fees; (2) fewer risks for merchants; (3) increased anonymity for users; (4) speed and ease of transfer/payment; and (5) less susceptibility to government manipulation and inflationary pressure.”<sup>51</sup> Because of

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45. Bajpai, *supra* note 40; *see also* Cuthbertson, *supra* note 20 (highlighting the fact that the increased anonymity and speed has caused the virtual currency to be associated with nefarious activity).

46. Penrose, *supra* note 24, at 534.

47. *See* Penrose, *supra* note 24, at 534 (stating that websites help users find local bitcoin sellers).

48. *Bitcoin ATM Industry Statistics/ Charts*, BTC COIN ATM RADAR, <https://coinatmradar.com/charts/> (last visited Oct. 28, 2016); *see also Bitcoin ATM Machine in Chapel Hill at Mediterranean Deli*, BTC COIN ATM RADAR, [https://coinatmradar.com/bitcoin\\_atm/479/bitcoin-atm-lamassu-chapel-hill-mediterranean-deli/](https://coinatmradar.com/bitcoin_atm/479/bitcoin-atm-lamassu-chapel-hill-mediterranean-deli/) (last visited Sept. 3, 2016) (providing an example of a bitcoin ATM).

49. *See Bitcoin ATM Industry Statistics/ Charts*, *supra* note 48 (stating that there are 827 total bitcoin ATMs); Colin Gordon, *ATM Proves to be a Popular Banking Channel Among US Consumers*, NCR (May 5, 2015, 8:30 AM), <https://www.ncr.com/company/blogs/financial/atm-proves-popular-among-us-consumers> (stating that there are 432,000 ATMs in the United States).

50. *Bitcoin ATM Industry Statistics/ Charts*, *supra* note 48; Gordon, *supra* note 49.

51. Tu & Meredith, *supra* note 39, at 282.

these benefits, both online and brick and mortar retailers have started accepting virtual currency.<sup>52</sup> For example, a bakery owner in North Carolina, chose to accept bitcoin because of the lower transaction costs.<sup>53</sup> Further, a bar owner in Wilmington, North Carolina, decided to accept bitcoin because he viewed it as a good investment.<sup>54</sup> Reeds Jewelers, a North Carolina company, also accepts bitcoin online and in its retail stores.<sup>55</sup> The director of Marketing and Business Development at Reeds Jewelers, described the transactions involving bitcoin as “impressive.”<sup>56</sup>

The anonymity of convertible virtual currency transactions can also make them the preferred payment method for illegal operations.<sup>57</sup> One example is Silk Road, which was an online marketplace for illicit drugs and other illegal items before the government shut it down.<sup>58</sup> In another case, hackers prevented a Los Angeles hospital from accessing online patient medical records until the hospital paid a ransom of \$17,000 worth of bitcoin.<sup>59</sup> Additionally, some websites that are tied to

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52. Jonas Chokun, *Who Accepts Bitcoins as Payment? List of Companies, Stores, Shops*, 99 BITCOINS (Aug. 4, 2016), <https://99bitcoins.com/who-accepts-bitcoins-payment-companies-stores-take-bitcoins/#prettyPhoto>.

53. Wilson, *supra* note 2.

54. Caitlin Dineen, *Wilmington Bar Owner Banking on Bitcoin*, STARNEWS ONLINE (Feb. 10, 2014, 4:29 PM), <http://www.starnewsonline.com/news/20140210/wilmington-bar-owner-banking-on-bitcoin>.

55. Pete Rizzo, *Reeds Jewelers: Bitcoin Sales Impressive Online and In Store*, COINDESK (Aug. 26, 2014, 8:05 PM), <http://www.coindesk.com/reeds-exec-bitcoin-sales-impressive-online-and-in-store/>.

56. *Id.* (quoting Mitch Cahn: “The transaction amount is significantly higher than our average order value, and I think that’s a direct correlation to the fact that a lot of bitcoin owners that are shopping are holding on to a lot of bitcoin.”).

57. Katy Barnato, *Will Terror Attacks End Bitcoin Free-for-All in Europe?*, CNBC (May 2, 2016, 1:16 AM), <http://www.cnn.com/2016/05/02/will-terror-attacks-end-bitcoin-free-for-all-in-europe.html>; *see* Middlebrook & Hughes, *supra* note 18, at 819 (stating that Bitcoin has a “bad-boy reputation”).

58. Middlebrook & Hughes, *supra* note 18, at 819; Andy Greenberg, *End of the Silk Road: FBI Says It’s Busted the World’s Biggest Anonymous Drug Black Market*, FORBES (Oct. 2, 2013, 12:35 PM), <http://www.forbes.com/sites/andygreenberg/2013/10/02/end-of-the-silk-road-fbi-busts-the-webs-biggest-anonymous-drug-black-market/#4d98d1cc347d> (“The Department of Justice has seized the Silk Road’s website as well as somewhere between \$3.5 to 4 million in bitcoins, the cryptographic currency used to buy drugs on the Silk Road.”) (“The FBI spokesperson declined to offer details about the investigation, but told me that ‘basically he made a simple mistake and we were able to identify him.’”).

59. Justin Moyer, *After Computer Hack, L.A. Hospital Pays \$17,000 in Bitcoin Ransom to Get Back Medical Records*, WASH. POST (Feb. 18, 2016), <https://www.washingtonpost.com/news/morning-mix/wp/2016/02/18/after-computer-hack-l-a-hospital-pays-17000-in-bitcoin-ransom-to-get-back-medical-records/> (explaining that the hackers were not caught).

terrorist organization solicit bitcoin donations.<sup>60</sup> As such, ISIS has received at least the equivalent of \$3 million in bitcoin since 2012.<sup>61</sup> While the ties to terrorism have been heavily reported upon, other methods of financing such as kidnapping and oil sales have been used to a greater degree.<sup>62</sup>

### 1. Federal Regulation

Because the anonymous nature of virtual currency makes it susceptible to nefarious activity, the Federal Government has started to regulate virtual currency transactions.<sup>63</sup> This has been done largely under the existing anti-money laundering framework, which regulates money services businesses (“MSB”) which includes money transmitters.<sup>64</sup>

The Financial Crimes Enforcement Network (“FinCEN”), which was established under the Bank Secrecy Act (“BSA”), is the “primary regulator of money transmitters for criminal activity monitoring purposes.”<sup>65</sup> As such, money transmitters must register with, and be regulated by, FinCEN.<sup>66</sup> In the past, businesses involved in the

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60. Aaron Brantly, *Financing Terror Bit by Bit*, 7 CTC SENTINEL Issue 10 1, 4 (Oct. 2014), <https://www.ctc.usma.edu/v2/wp-content/uploads/2014/10/CTCSentinel-Vol7Iss101.pdf>; see Jason Murdock, *Dark Web Crime Services Could be Used by Terrorist to Attack Europe Warns Europol*, INT’L BUS. TIMES (Sept. 28, 2016, 3:26 PM), <http://www.ibtimes.co.uk/dark-web-cybercrime-services-could-be-used-by-terrorists-attack-europe-warns-europol-1583756>, (stating that it is “logical to assume that some smaller criminal communities may be abusing lesser-known cryptocurrencies in order to stay under the radar”).

61. Jonathan Chester, *How Questions About Terrorism Challenge Bitcoin Startups*, FORBES (Dec. 14, 2015, 11:06 AM), <http://www.forbes.com/sites/jonathanchester/2015/12/14/is-bitcoin-the-currency-of-terrorism/#74450ce15e7c>.

62. Brantly, *supra* note 60; Janie Di Giovanni et al., *How Does ISIS Fund it’s Reign of Terror?*, NEWSWEEK (Nov. 16, 2014, 7:30 AM), <http://www.newsweek.com/2014/11/14/how-does-isis-fund-its-reign-terror-282607.html> (“Ransoms from kidnappings make up about [20%] of ISIS’s revenue.”) (“Ransom, looting, extortion, sex trafficking and taking over the Iraqi Central Bank may help fund ISIS’s day-to-day operations, but it is the organization’s energy assets that are believed necessary to refill its war chestFalse”).

63. Penrose, *supra* note 24, at 536.

64. Penrose, *supra* note 24, at 536.

65. M. MacRae Robinson, Note, *Easing the Burden on Mobile Payments: Resolving Current Deficiencies in Money Transmitter Regulation*, 18 N.C. BANKING INST. 553, 558 (2014); Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (“USA PATRIOT Act”) § 361(a)(2), 31 U.S.C. § 310 (2015).

66. USA PATRIOT Act § 359(b), 31 U.S.C. § 5330(a)(1) (2015); see FIN. CRIMES ENF’T NETWORK, U.S. DEP’T OF TREAS., GUIDANCE TO MONEY SERVICES BUSINESSES ON

transmission of virtual currency were unsure whether they were required to register as a money transmitter because virtual currency is not technically a currency.<sup>67</sup>

Consequently, FinCEN issued guidance in 2013 where it stated that although virtual currency was not a currency, “administrators” and “exchangers” of virtual currency would be considered money transmitters subject to registration and oversight.<sup>68</sup> An administrator is defined as “a person engaged as a business in issuing a virtual currency, and who has the authority to redeem such virtual currency.<sup>69</sup> Additionally, an exchanger is “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.”<sup>70</sup>

This clarification initially created uncertainty for miners dealing in virtual currencies because miners were not explicitly mentioned in the guidance.<sup>71</sup> Thus, FinCEN issued an administrative ruling stating that miners who mined virtual currency solely for their own benefit would not be subject to registration requirements.<sup>72</sup> The ruling highlighted that the amended BSA broadly defined money transmitter services as accepting “currency, funds, or other value that substitutes for currency from one person” and transmitting the “currency, funds, or other value that substitutes for currency to another location or person by

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OBTAINING AND MAINTAINING BANKING SERVICES (Apr. 6, 2005), <https://www.fincen.gov/sites/default/files/guidance/fincenadv04262005.pdf> (“FinCEN has made comprehensive resources available to money services businesses, free of charge, that provide information about compliance with the Bank Secrecy Act and explain how money services businesses can prevent money laundering.”).

67. See 31 C.F.R. § 1010.100(m) (2016) (defining currency as “the coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance”); see also FIN. CRIMES ENF’T NETWORK, U.S. DEP’T OF TREAS., FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING OR USING VIRTUAL CURRENCIES (Mar. 18, 2013) [hereinafter FIN-2013-G001] (stating that virtual currency “operates like a currency in some environments”).

68. FIN-2013-G001, *supra* note 67.

69. FIN-2013-G001, *supra* note 67.

70. FIN-2013-G001, *supra* note 67.

71. Penrose, *supra* note 24, at 540.

72. FIN. CRIMES ENF’T NETWORK, U.S. DEP’T OF TREAS., FIN-2014-R001, APPLICATION OF FINCEN’S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS (Jan. 30, 2014) [hereinafter FIN-2014-R001] (qualifying the ruling by stating “a user wishing to purchase goods or services with bitcoin it has mined, which pays the bitcoin to a third party at the direction of a seller or creditor, may be engaged in money transmission”).

any means.”<sup>73</sup> Further, the ruling emphasized that whether an activity is considered to be a money transmitter under the broad definition is “a matter of facts and circumstances.”<sup>74</sup> Experts in blockchain technology law have argued that the facts and circumstances test, used to determine whether an individual is engaging in money transmission, is “very fuzzy.”<sup>75</sup> For example, in the ruling, FinCEN stated that a miner who makes a purchase by paying bitcoin to a party that is not the seller himself or herself, at the seller’s direction, *may* be a money transmitter.<sup>76</sup> However, FinCEN did not elaborate as to what would tip the balance in the hypothetical situation.<sup>77</sup>

## 2. State Regulation

State regulation of money transmitters is important, regardless of whether the federal government regulates virtual currency under federal money transmitter laws, because state laws have a different objective.<sup>78</sup> Generally, state money transmitter laws focus on consumer

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73. 31 C.F.R. § 1010.100(ff)(5) (2016).

74. FIN-2014-R001, *supra* note 72.

75. Elliot Maras, *Arrests and Prosecutions Reveal Big Vagaries in Bitcoin Selling Regulations*, CRYPTOCOIN NEWS (May 23, 2016), <https://www.cryptocoinsnews.com/arrests-and-prosecutions-reveal-big-vagaries-in-bitcoin-selling-regulations/>.

76. FIN-2014-R001, *supra* note 72; FIN. CRIMES ENF’T NETWORK, U.S. DEP’T OF TREAS., FIN-2014-R007, APPLICATION OF MONEY SERVICES BUSINESS REGULATIONS TO THE RENTAL OF COMPUTER SYSTEMS FOR MINING VIRTUAL CURRENCY (Apr. 29, 2014) (finding that “even if the company rents a computer system to third parties that will use it to obtain convertible virtual currency to fund their activities as exchangers, such rental activity, in and of itself, would not make the Company a money transmitter subject to BSA regulation”) [hereinafter FIN-2014-R007]; *see also* Luke Parker, *FinCEN Ruling Declares Asset-based Cryptocurrency Vendor a Money Transmitter*, BRAVE NEW COIN (Aug. 19, 2015), <http://bravenewcoin.com/news/fincen-ruling-declares-asset-backed-cryptocurrency-vendor-a-money-transmitter/> (“This ruling has put a lot of miners in an uncomfortable situation, but to date none have been fined or arrested over any violations.”).

77. FIN-2014-R007, *supra* note 76.

78. *See* HB 289 SUMMARY, *supra* note 4 (“Among the reasons for regulating this industry are to prevent money laundering and the financing of terrorism and to protect consumers from the risk that money transfer businesses will fail to deliver the funds as agreed.”); *see also* Tu & Meredith, *supra* note 39, at 307 (explaining the consumer protection goals of state legislation); CONFERENCE OF STATE BANK SUPERVISORS & MONEY TRANSMITTER REGULATORS ASS’N, THE STATE OF STATE MONEY SERVICES BUSINESS REGULATION & SUPERVISION (2016), <https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/State%20of%20State%20MSB%20Regulation%20and%20Supervision%202.pdf> (“Most state regulatory agencies license and regulate MSBs to ensure compliance with state and federal regulatory requirements, to help prevent the use of MSBs to finance illicit activities such as narcotics trafficking and terrorism, while also providing protections for

protection to a greater degree than federal statutes.<sup>79</sup> State laws and federal law are interconnected in that federal law requires money transmitters to be licensed at the state level.<sup>80</sup>

Many states define money transmitters broadly.<sup>81</sup> However, many states also “provide exemptions for various entities,” which typically include entities that are already subject to regulation such as banks and departments or agencies within the federal or state government.<sup>82</sup> Entities covered by the definition of money transmitters in state money transmission statutes, which do not fall within an exception, must secure a license with the state’s banking authority.<sup>83</sup> As with federal regulations, there has been confusion regarding whether state money transmitter statutes apply to virtual currency entities.<sup>84</sup>

Florida was the first state to criminally charge bitcoin exchangers under state money transmitter statutes for operating an unlicensed money transmitter business.<sup>85</sup> The Florida judge gained national attention<sup>86</sup> when she dismissed charges against a man on the grounds that bitcoin is not money.<sup>87</sup> The case was appealed to Florida’s Third District Court of Appeals.<sup>88</sup>

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customers.”).

79. Tu & Meredith, *supra* note 39, at 307.

80. 18 U.S.C. § 1960 (2015); Tu & Meredith, *supra* note 39, at 307.

81. Robinson, *supra* note 65, at 563.

82. Robinson, *supra* note 65, at 563–65; *see also* FLA. STAT. ANN. § 560.104 (West 2016) (excluding banks, credit unions, financial depository institutions, the United States government, Fla. and any political divisions of Fla.); CAL. FIN. CODE §§ 2010-11 (West 2016) (excluding the United States (including agencies and departments), Cal. (including agencies and subdivisions of states), and insured depository institutions).

83. Penrose, *supra* note 24, at 545 (citing Robin Sidel & Andrew R. Johnson, ‘Virtual’ Currencies Draw State Scrutiny, WALL ST. J. (May 31, 2013), <http://online.wsj.com/news/articles/SB10001424127887324682204578517604191541>).

84. Judd J. Baroff, *Op-ed: The Legality of Virtual Currency*, ARSTECHNICA (Mar. 30, 2014, 7:00 PM), <http://arstechnica.com/tech-policy/2014/03/op-ed-the-legality-of-virtual-currency/> (stating “the laws governing bitcoins are already shockingly disordered”) (stating “most states haven’t even mentioned virtual currency specifically, so we’re working with regulations that are ill-designed for a new medium”).

85. *Fla. Bitcoin Prosecution to Test Limits of Money Laundering Laws on Virtual Currency*, FOX NEWS (April 9, 2014), <http://www.foxnews.com/us/2014/04/09/florida-bitcoin-prosecution-to-test-limits-money-laundering-laws-on-virtual.html>.

86. Jamie Redman, *Fla. Appeals Espinoza Decision, Bitcoin Status at Stake*, BITCOIN.COM (Aug. 28, 2016), <https://news.bitcoin.com/florida-appeals-espinoza-decision/> (stating that the case made headlines).

87. Order Granting Def’s Motion to Dismiss the Information, *State v. Espinoza*, F14-2923 (11th Fla. Cir. Ct. July 22, 2016).

88. Stan Higgins, *Florida Files Appeal After Charges Against Bitcoin Seller Were Dismissed*, COINDESK (Aug. 22, 2016, 10:35 PM), <http://www.coindesk.com/florida-files->

In an effort to eliminate vagueness, some states have issued guidance or updated their money transmitter statutes to clarify how their statutes treat virtual currency.<sup>89</sup> New York elected not to regulate virtual currencies within its existing money transmitter statute.<sup>90</sup> Rather, New York created a separate licensing regime for virtual currencies that has requirements “similar to those imposed by money transmitter regulation”<sup>91</sup> and additional requirements that are tailored to virtual currency transmitters in particular, such as special suspicious activity reports (“SARs”)<sup>92</sup> and cyber security programs.<sup>93</sup>

North Carolina opted to amend its Money Transmitter Act to clarify its application to virtual currency.<sup>94</sup> The amendment specifies that engaging in the business of “receiving money or monetary value for transmission or holding funds incidental to transmission” that is “primarily for personal, family, or household purposes” is considered to be money transmission.<sup>95</sup> Further, the amendment explicitly states that “maintaining control of virtual currency on behalf of others” falls within the definition provided that it is “primarily for personal, family, or

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appeal-charges-bitcoin-seller-dismissed/ (stating that the case would be reviewed *de novo*).

89. Peter V. Valkenburgh, *State Digital Currency Regulation Tracker*, COIN CENTER (June 7, 2016), <http://coincenter.org/entry/state-digital-currency-regulation-tracker>; see T.X. DEP’T OF BANKING, SUPERVISORY MEMO. 1037 (April 3, 2014) (stating that “absent the involvement of sovereign currency in a transaction, no money transmission can occur”); see also TENN. DEP’T OF FIN. INST., REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE TENN. MONEY TRANSMITTER ACT (Dec. 16, 2015) (using the language of Texas’s guidance).

90. N.Y. Comp. Codes R. & Regs. tit. 23, § 200.1 (2017); John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 47 (2016).

91. Douglas, *supra* note 90, at 47.

92. N.Y. Comp. Codes R. & Regs. tit. 23, § 200.

93. N.Y. Comp. Codes R. & Regs. tit. 23, § 200.15.

94. N.C. GEN. STAT. § 53-208.41-64 (2016).

The NC MTA requires all persons engaged in the business of money transmission to obtain a license. Because the NC MTA defines ‘money transmission’ as the ‘act of engaging in the business of receiving money or monetary value for transmission within the United States or to locations abroad by any and all means, including payment instrument, wire, facsimile, or electronic transfer,’ and further defines ‘monetary value’ as a ‘medium of exchange, whether or not redeemable in money,’ virtual currency is within the scope of the NC MTA.

*Money Transmitter Frequently Asked Questions*, N.C. COMM’R OF BANKS, <https://www.nccob.org/Public/financialinstitutions/mt/mtfaq.aspx> (last visited Feb. 10, 2017).

95. N.C. GEN. STAT. § 53-208.42(12).

household purposes.”<sup>96</sup> Businesses that conduct the activities specified must acquire a license from the state.<sup>97</sup> Knowingly or willingly failing to comply with licensing requirements and regulation may result in criminal penalties.<sup>98</sup> Noncompliance could also result in civil monetary penalties.<sup>99</sup>

Designation as a money transmitter also requires businesses to comply with certain consumer protection mechanisms.<sup>100</sup> For example, money transmitters must post surety bonds or deposits to ensure they can fulfill the transmission.<sup>101</sup> Further, they must provide documentation of their “internal business controls, including controls specific to information technology and data integrity.”<sup>102</sup>

### III. FEDERAL TAX TREATMENT

Although the SEC treats virtual currency as if it were money

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96. *Id.*; Defining control as:

the power, directly or indirectly, to direct the management or policy of the licensee or person subject to this Article, whether through ownership of securities, by contract, or otherwise. Any person that (i) is a director, general partner, or executive officer; (ii) directly or indirectly has ownership of or the power to vote ten percent (10%) or more of a class of outstanding voting securities; (iii) in the case of a limited liability company is a managing member; or (iv) in the case of a partnership, has the right to receive upon dissolution, or has contributed, ten percent (10%) or more of the capital, is presumed to control the licensee or person subject to this Article.

N.C. GEN. STAT. § 53-208.42(5).

97. N.C. GEN. STAT. § 53-208.43.

98. N.C. GEN. STAT. § 53-208.57(c)(1).

99. *See* N.C. GEN. STAT. § 53-208.58 (stating that civil penalties are “not to exceed five thousand dollars (\$ 5,000) for each violation or, in the case of a continuing violation, one thousand dollars (\$ 1,000) for each day that the violation continues”).

100. N.C. GEN. STAT. § 53-208.47(a), (f); N.C. GEN. STAT. § 53-208.45(a)(9); *see* Electronic Fund Transfers (Regulation E), 12 C.F.R. §1005.9(a) (2016) (providing consumer protection provisions for money transmitters) (“Except as provided in paragraph (e) of this section, a financial institution shall make a receipt available to a consumer at the time the consumer initiates an electronic fund transfer at an electronic terminal. The receipt shall set forth the following information, as applicable.”).

101. N.C. GEN. STAT. § 53-208.47(a), (f).

102. N.C. GEN. STAT. § 53-208.4 (a)(9) (stating that documentation is sent to the NMLS); *see About NMLS*, NMLS RESOURCE CENTER <http://mortgage.nationwidelicingsystem.org/about/Pages/default.aspx> (last visited Dec. 16, 2016) (“NMLS is the system of record for non-depository, financial services licensing or registration in participating state agencies.”).

under the securities laws,<sup>103</sup> and FinCEN requires exchangers of virtual currency to register as money transmitters,<sup>104</sup> the IRS decided against treating virtual currency as if it were currency under the tax laws.<sup>105</sup> In April 2014, the IRS issued a notice (“Notice”) that stated, for federal tax purposes, convertible virtual currency would be treated as property and as such, general tax principles regarding income received in the form of property would apply.<sup>106</sup> Further, tax principles regarding adjustments to taxable income based on gains or losses in the fair market value of property also apply.<sup>107</sup>

A. *Requirements*

The IRS Notice requires taxpayers to determine the value of virtual currency received as payment for goods and services in terms of USD at the time of the payment.<sup>108</sup> Taxpayers are required to determine the value of virtual currency in a “reasonable manner that is consistently applied.”<sup>109</sup> The Notice makes clear that the value of the virtual currency cannot be assumed to be the amount that a taxpayer would accept in USD for the same or similar good or service.<sup>110</sup> Rather, a retailer or service provider has to determine the value of virtual currency in USD for each different type of virtual currency that he or she accepts.<sup>111</sup>

For virtual currencies that are traded on exchanges, taxpayers can calculate the fair market value in terms of USD by looking at the

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103. *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, SEC Litigation Release No. 23090 (Sept. 22, 2014), <https://www.sec.gov/litigation/litreleases/2014/lr23090.htm>.

104. FIN-2013-G001, *supra* note 67.

105. See I.R.S. Notice, *supra* note 22 (treating virtual currency as property); see generally *In re Coinflip, Inc.*, CFTC No. 15-29 (Sept. 17, 2015) (finding that Bitcoin was a commodity).

106. I.R.S. Notice, *supra* note 22; TREAS. INSPECTOR GEN. FOR TAX ADMIN., 2016-30-083, AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE 2 (Sept. 21, 2016) [hereinafter TREAS. INSPECTOR GEN. REPORT].

107. I.R.S. Notice, *supra* note 22.

108. I.R.S. Notice, *supra* note 22.

109. I.R.S. Notice, *supra* note 22.

110. I.R.S. Notice, *supra* note 22.

111. See I.R.S. Notice, *supra* note 22 (“A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received.”).

value of the virtual currency on a particular exchange for that day.<sup>112</sup> Given that the exchange price for bitcoin has varied by as much as 20% among different exchanges, the taxpayer must consistently use the same method in order to prevent the underestimation of tax liability.<sup>113</sup> However, for virtual currencies that have yet to trade on exchanges, it is unclear how a taxpayer should calculate the fair market value in terms of USD.<sup>114</sup> This confusion is further exacerbated by the fact that both the buyer and seller must calculate the fair market value of the virtual currency in order to report it on their respective income tax returns.<sup>115</sup>

A taxpayer who purchases goods or services must determine (1) the fair market value of the virtual currency at the time he or she acquired it and compare it to (2) its fair market value at the time of the purchase of goods or services with the virtual currency.<sup>116</sup> This is necessary because the taxpayer must report if he or she experiences a gain or loss in the fair market value of the virtual currency as either a gain or loss in income.<sup>117</sup> The tax treatment of the gain or loss to the taxpayer will differ depending on if the virtual currency is a capital asset.<sup>118</sup> If a taxpayer acquires and spends virtual currency within the

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112 I.R.S. Notice, *supra* note 22 (“If a virtual currency is listed on an exchange and the exchange rate is established by marked 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 in U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied); Ryan Selkis, *Bitcoin Tax Guide: Trading Gains and Losses - Fair Market Value*, INVESTOPEDIA, <http://www.investopedia.com/university/definitive-bitcoin-tax-guide-dont-let-irs-snow-you/definitive-bitcoin-tax-guide-chapter-2-trading-gains-and-losses-fair-market-value.asp> (last visited Sept. 12, 2016).

113 See Selkis, *supra* note 110 (stating that bitcoin’s value has varied “as much as [20%] between different exchanges”); Comment Letter from Am. Inst. of Certified Public Accountants, to I.R.S. (June 10, 2016) [hereinafter AICPA Comment Letter], <https://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-comment-letter-on-notice-2014-21-virtual-currency-6-10-16.pdf> (inquiring as to which method taxpayers should use to reconcile the variability of exchange rates).

114 See I.R.S. Notice, *supra* note 22 (failing to address how to determine the fair market value in the absence of an exchange based on market supply and demand).

115 I.R.S. Notice, *supra* note 22 (clarifying that buyers and sellers refer to participants in a transaction for which virtual currency is used as consideration for goods or services).

116 I.R.S. Notice, *supra* note 22; See generally Kashmir Hill, *How I Paid My Bitcoin Taxes*, FORBES (Apr. 15, 2014), <http://www.forbes.com/sites/kashmirhill/2014/04/15/how-i-paid-my-bitcoin-taxes/#4930c60c2c92> (providing an anecdote of paying bitcoin taxes).

117 I.R.S. Notice, *supra* note 22.

118 See I.R.S. Notice, *supra* note 22 (stating that “stocks, bonds, and other investment property are generally capital assets”); see also I.R.S. Publication 544, *Sales and Other Dispositions of Assets* at 22–23 (2015) (describing when assets are not capital assets); *Capital Asset*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/capitalasset.asp> (last visited Sept. 24, 2016) (“Capital assets are significant pieces of property such as homes,

course of a year, it is classified as a “short-term transaction” and is subject to ordinary income tax rates.<sup>119</sup> On the other hand, if a taxpayer holds virtual currency for over a year, it is considered a “long-term transaction” and is taxed at the capital gains rate.<sup>120</sup>

The virtual currency that miners receive for validating virtual currency transactions is subject to income taxes.<sup>121</sup> Miners must record the fair market value of the virtual currency at the time it is received, and track the changes in value once it is exchanged for real currency or used to make a purchase.<sup>122</sup>

Just as retailers who accept virtual currency are required to determine the value of the virtual currency in USD at the time of receipt, employers who pay in virtual currency are required to determine the value of the virtual currency in USD when they pay employees.<sup>123</sup> After doing so, employers must use the USD amount as the basis for determining federal income tax withholding on the virtual currency wages.<sup>124</sup>

### B. *Implications*

The decision to treat virtual currency as property and thus require reporting of gains or losses with every transaction, threatens to make “compliance with tax laws unnecessarily cumbersome.”<sup>125</sup>

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cars, investment properties, stocks, bonds, and even collectibles or art.”) (“For businesses, a capital asset is a type of asset with a useful life longer than a year, that is not intended for sale in the regular course of the business’s operation.”). *But see In re Coinflip, Inc.*, *supra* note 105 (stating that the CFTC determined Bitcoin was a commodity).

119. BERRYDUNN, *DOWN THE RABBIT HOLE: VIRTUAL CURRENCY TRANSACTIONS* (June 13, 2014), <http://www.berrydunn.com/news-detail/bitcoin-virtual-currency-transactions>. *But see* Jean Folger, *Intermediate Guide To E-Mini Futures Contracts - Tax Advantages*, INVESTOPEDIA, <http://www.investopedia.com/university/intermediate-guide-to-trading-e-mini-futures/tax-advantages.asp> (lasted visited on Sept. 16, 2016) (explaining how 60% of commodities futures are taxed at the long term capital gains rate while 40% are taxed at the ordinary income rate).

120. BERRYDUNN, *supra* note 119.

121. I.R.S. Notice, *supra* note 22.

122. I.R.S. Notice, *supra* note 22.

123. I.R.S. Notice, *supra* note 22.

124. I.R.S. Notice, *supra* note 22; TREAS. INSPECTOR GEN. REPORT, *supra* note 106, at 12–13 (calling for Form W-2 and Form 1099 to begin having a separate place to report virtual currency).

125. Marco Santori, I.R.S. Guidance Further Legitimizes Bitcoin and Provides Clarity, but Demands Unrealistic Reporting, BITCOIN FOUNDATION BLOG (Mar. 26, 2014),

Because some types of virtual currency, like Bitcoin, are used primarily as a “means of payment for virtual and real goods,” treating virtual currency as if it were property undermines its utility.<sup>126</sup> The property classification does not make an exception for small gains.<sup>127</sup> Thus, in order to comply with the letter of law, a gain of ten cents would have to be reported as a gain in income.<sup>128</sup>

Because of the anonymous nature of virtual currency, complying with federal income tax laws for the majority of users would essentially be left up to patriotic duty.<sup>129</sup> The fact that the IRS cannot get the information it needs to enforce violations of reporting requirements of consumer purchases, because virtual wallets are not tied to individuals, disincentives taxpayers from complying with the tax law.<sup>130</sup>

Professor Omri Marian, a scholar in the area of tax havens,<sup>131</sup> suggested that virtual currencies like Bitcoin could surpass the use of traditional tax haven offshore accounts because they have the advantage of eliminating intermediaries.<sup>132</sup> Thus, “traditional anti-tax-evasion

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[https:// bitcoinfoundation.org/2014/03/irs-guidance-further-legitimizes-bitcoin-and-provides-clarity-but-demands-unrealistic-reporting/](https://bitcoinfoundation.org/2014/03/irs-guidance-further-legitimizes-bitcoin-and-provides-clarity-but-demands-unrealistic-reporting/). *But see* Hill, *supra* note 116 (discussing services that help users keep track of their bitcoin transactions by allowing them to import their transactions).

<sup>126</sup> Nika Antonikova, *Real Taxes on Virtual Currencies: What Does the I.R.S. Say?* 34 VA. TAX REV. 433, 444–45 (2015).

<sup>127</sup> John E. Elmore, *Virtual Currency, Real Tax: Taxation and Valuation Issues Related to Emerging Digital Payment Systems*, EMERGING TREND INSIGHTS 60, 68 (2015).

<sup>128</sup> *Id.*

<sup>129</sup> Jose Pagliery, *New I.R.S. Rules Make Using Bitcoin a Fiasco*, CNN (Mar. 31, 2014, 7:01 AM), <http://money.cnn.com/2014/03/31/technology/irs-bitcoin/>; *see* TREAS. INSPECTOR GEN. REPORT, *supra* note 106 (stating there has been “little evidence of coordination between the responsible functions to identify and address, on a program level, potential taxpayer noncompliance issues for transactions involving virtual currencies”).

<sup>130</sup> Pagliery, *supra* note 129 (quoting Steven Rosenthal of the Tax Policy Center: “[n]obody in their right mind would ever comply with that”); Elizabeth E. Lambert, *The Internal Revenue Serv. & Bitcoin: A Taxing Relationship*, 35 VA. TAX REV. 88, 110 (2015). The 2016 Treasury Inspector General Report found that “nothing specific has been done” to address the use of virtual currency to “dodge taxes.” However, cases have been brought against virtual currency users in regards to narcotics and money laundering. Thus, it is possible to tie bitcoin users to a personal identity. TREAS. INSPECTOR GEN. REPORT, *supra* note 106, at 7.

<sup>131</sup> Omri Marian, *Assistant Professor of Law*, UNIVERSITY OF CALIFORNIA IRVINE SCHOOL OF LAW, <http://www.law.uci.edu/faculty/full-time/marian/> (last visited Sept. 24, 2016) (stating that Prof. Marian is an expert in international taxation and taxation of financial institutions whose work focuses on the “administrative practices of tax haven jurisdiction”).

<sup>132</sup> Omri Marian, *Are Cryptocurrencies Super Tax Havens?*, 112 MICH. L. REV. FIRST

mechanisms cannot successfully address Bitcoin-based tax evasion.”<sup>133</sup>

In recognition of the enforcement problem, the IRS has charged a group of agents with “master[ing] Bitcoin and other virtual currencies.”<sup>134</sup> These agents will attempt to find tax evaders by reviewing all of the transactions on the blockchain and then working backwards to determine the public address of the participant in the transaction.<sup>135</sup> From there, the IRS will attempt to match an individual name with a public address.<sup>136</sup> Given the fact that the true identity of the founder of Bitcoin has yet to be discovered, it seems unlikely that attempting to match blockchain transactions to individual people could actually uncover tax evaders.<sup>137</sup>

In addition, the federal tax treatment can discourage employers that wish to pay their employees in virtual currency from doing so.<sup>138</sup> Under the federal tax laws, an employer who pays an employee in virtual currency could also be considered to have received taxable income on payday.<sup>139</sup> An employer would be required to keep track of the price that was paid for the virtual currency and its fair market value on the day the employees are paid.<sup>140</sup> Thus, an employer would have a taxable gain if the fair market value on payday is higher than the amount that the employer paid for the virtual currency.<sup>141</sup> For example,

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IMPRESSIONS 38, 42 (2013).

133. *Id.* at 45.

134. Josh Ungerman, Are Virtual Currencies the Next Offshore Bank Account for Tax Evaders?, FORBES (Oct. 3, 2014, 11:18 AM), <http://www.forbes.com/sites/irswatch/2014/10/03/are-virtual-currencies-the-next-offshore-bank-account-for-tax-evaders/>.

135. *Id.*

136. *Id.*

137. Antonikova, *supra* note 126, at 445 (“Although each Bitcoin has a record of ownership and can be eventually traced to the original miner, it is very difficult to imagine how this information can be used to identify the initial owner or force somebody to file an information return.”); see also Fergus Hodgson, *How the IRS Let Bitcoin Pass it By*, TAX REVOLUTION INSTITUTE (Aug. 9, 2016), <https://taxrevolution.us/how-the-irs-let-bitcoin-pass-it-by/> (explaining that an attorney that specializes in the field has not “seen an audit yet that specifically deals with bitcoin”); see *Who is Satoshi Nakamoto?* COINDESK, <http://www.coindesk.com/information/who-is-satoshi-nakamoto/> (last updated Feb. 19, 2016) (explaining the lengths journalists have gone to try to uncover the man behind the alias Satoshi Nakamoto who started Bitcoin).

138. Theodore W. Reuter, *Pitfalls of Paying Employees in Bitcoin*, ADVOCATE 39, 39 (2015) (highlighting how technology companies may wish to pay employees in bitcoin and that employees have asked to be paid in bitcoin).

139. *Id.* at 40.

140. *Id.*

141. *Id.*; Christine Lane & Gene Magidenko, *The U.S. Fed. Taxation of Bitcoins &*

if the employer paid \$1,000 for bitcoin on Monday and then paid the employees the bitcoin on Friday, when the value was \$1,500 the employer would have a taxable gain of \$500.<sup>142</sup> Further, the fluctuations in the USD value of bitcoin would significantly affect an employer's obligations to the IRS with respect to income tax withholdings and payroll taxes, because the USD value of a set amount of bitcoin would fluctuate from pay period to pay period.<sup>143</sup>

#### IV. STATE TAX TREATMENT

Following the lead of the IRS, some states have considered the sales tax and income tax consequences of virtual currency transactions.<sup>144</sup> Two approaches have been promulgated with regard to sales tax: (1) the barter approach ("Barter Approach") and (2) the advertised price approach ("Advertised Price Approach").<sup>145</sup> As for income tax, the property tax treatment implemented by the IRS has been the only method implemented at the state level.<sup>146</sup>

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*Other Convertible Virtual Currencies*, 2014 INSIDE BASIS 3, 4 (2014).

<sup>142</sup> See Reuter, *supra* note 138, at 40 (explaining that employers must "keep track of its basis (i.e. its buying price) for the Bitcoin and also track the reasonable value of the market price of Bitcoin on pay day").

<sup>143</sup> See Reuter, *supra* note 138, at 40. See generally TREAS. INSPECTOR GEN. REPORT, *supra* note 105, at 12 (calling for a bitcoin classification on Form W-2).

<sup>144</sup> KY. DEP'T OF REV., KY. SALES TAX FACTS (June 2014); TAX POLICY DIV. OF MICH. DEP'T OF TREAS., 1 MICH. TREAS. UPDATE 1, 2 (Nov. 1, 2015) [hereinafter Mich. Dep't of Treas.]; N.J. DEP'T OF TAXATION, TECHNICAL ADVISORY MEMORANDUM TAM-2015-1(R) (July 28, 2015); N.Y. DEP'T OF TAXATION, TECHNICAL MEMORANDUM TSB-M-14(5)C, (7)I, (17)S (Dec. 5, 2014); WIS. DEP'T OF REV., NEWS FOR TAX PROFESSIONALS (Mar. 28, 2014).

<sup>145</sup> KY. DEP'T OF REV., KY. SALES TAX FACTS (June 2014); TAX POLICY DIV. OF MICH. DEP'T OF TREAS., 1 MICH. TREAS. UPDATE 1, 2 (Nov. 1, 2015) [hereinafter Mich. Dep't of Treas.]; N.J. DEP'T OF TAXATION, TECHNICAL ADVISORY MEMORANDUM TAM-2015-1(R) (July 28, 2015); N.Y. DEP'T OF TAXATION, TECHNICAL MEMORANDUM TSB-M-14(5)C, (7)I, (17)S (Dec. 5, 2014); WIS. DEP'T OF REV., NEWS FOR TAX PROFESSIONALS (Mar. 28, 2014).

<sup>146</sup> KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

A. *Sales Tax*

## 1. Barter Approach

Kentucky, New Jersey, New York, and Wisconsin have opted to follow the federal tax regime and treat virtual currency as property.<sup>147</sup> Thus, transactions involving bitcoin are treated like barter transactions, where goods or services are traded for other goods or services.<sup>148</sup> Under this system, a sales tax applies when convertible virtual currency serves as consideration for tangible property or a service, which would ordinarily be subject to a sales tax.<sup>149</sup>

The amount of sales tax due is determined by converting the virtual currency into its USD equivalent value at the time of the purchase, and calculating the sales tax based on the USD amount.<sup>150</sup> In a barter transaction for which taxable goods or services are exchanged for other taxable goods or services, sales tax is calculated based on the value of both sides of the transaction.<sup>151</sup> However, virtual currency is treated as intangible property, which is not subject to sales tax.<sup>152</sup> Thus, barter transactions with virtual currency are *not* taxed on both ends.<sup>153</sup> Rather, only the value of the taxable good or service would be taxed.<sup>154</sup> Similarly, using real currency to purchase virtual currency would not result in sales tax liability given its status as intangible property.<sup>155</sup>

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147. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

148. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

149. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

150. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

151. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

152. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

153. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

154. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

155. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

As with the federal system, the value of the taxable goods or services under the state barter approach is considered to be the fair market value of the virtual currency, which was given as consideration.<sup>156</sup> In accordance with the federal tax treatment, the fair market value of the virtual currency is determined at the time of the purchase.<sup>157</sup> Retailers, therefore, must keep detailed records of the fair market value of virtual currency, in terms of USD, which they accept in exchange for taxable goods or services.<sup>158</sup>

## 2. Advertised Price

California and Washington have also issued guidance regarding the state tax treatment of virtual currency, but neither state explicitly indicated whether virtual currency would be treated as a currency or as property.<sup>159</sup> However, the method of determining the basis to be taxed suggests that both states view virtual currencies as currency because they are treated as traditional forms of payment like credit cards and checks.<sup>160</sup>

When a consumer purchases taxable goods or services with a virtual currency, the basis for sales tax purposes will be determined by the amount (in USD) that the retailer would have received had the customer used a traditional form of payment.<sup>161</sup> Generally speaking, the price of goods and services are not negotiated, so the basis for sales tax purposes will be the advertised price of the goods or services.<sup>162</sup>

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156. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

157. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

158. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144.

159. CAL. BD. OF EQUALIZATION, SPECIAL NOTICE: ACCEPTING VIRTUAL CURRENCY AS A PAYMENT METHOD, L-382 (June 2014), <https://www.boe.ca.gov/news/2014/1382.pdf>; WASH. DEP'T OF REV., ACCEPTING VIRTUAL CURRENCY AS PAYMENT FOR GOODS AND SERVICES <http://dor.wa.gov/Content/GetAFormOrPublication/PublicationBySubject/TaxTopics/VirtualCurrency.aspx> (last visited Sept. 30, 2016).

160. CAL. BD. OF EQUALIZATION, *supra* note 159; WASH. DEP'T OF REV., *supra* note 159.

161. CAL. BD. OF EQUALIZATION, *supra* note 159; WASH. DEP'T OF REV., *supra* note 159.

162. *But see* Jodi Helmer, *How to Negotiate the Cost of Anything*, CBS MONEY WATCH (Jan. 28, 2011, 2:24 PM), <http://www.cbsnews.com/news/how-to-negotiate-the-cost-of->

Retailers must keep records detailing the prices (in USD) that they usually charge for an item or similar items.<sup>163</sup>

*B. Corporate and Personal Income Tax*

Although few states have determined how to treat virtual currency for income tax purposes, both New Jersey and New York have addressed the issue.<sup>164</sup> As with sales taxes in these respective states, virtual currency is treated as property, in accordance with the Notice.<sup>165</sup> Consequently, both states follow the federal guideline for taxing gains and deducting losses, requiring virtual currency users to keep track of the fair market value of the virtual currency at the time of acquisition and use.<sup>166</sup>

With respect to wages that are paid in the form of virtual currency, New Jersey's guidance states that virtual currency must be converted into USD, after which it will be subject to New Jersey income tax withholding requirements.<sup>167</sup> However, given the implications of the federal tax treatment, whereby employers could be subject to a taxable gain on payday, there is a disincentive for employers to pay in virtual currency.<sup>168</sup>

V. RECOMMENDATIONS FOR NORTH CAROLINA

Given North Carolina's efforts to provide certainty regarding the applicability of North Carolina's Money Transmitters Act, it logically follows that the General Assembly should address the state tax treatment of virtual currencies.

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anything/ (noting that companies and retailers regularly negotiate with consumers on the price of certain products or services).

163. CAL. BD. OF EQUALIZATION, *supra* note 159; WASH. DEP'T OF REV., *supra* note 159.

164. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

165. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

166. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

167. N.J. DEP'T OF TAXATION, *supra* note 144.

168. Reuter, *supra* note 138, at 40 ("A commitment to pay employees in bitcoins means that the company's withholding obligations and wage related taxes and expenses are likely to fluctuate with each pay period.")

A. *Sales Tax*

North Carolina should adopt the Advertised Price method because: (1) the federal treatment is fundamentally at odds with recent efforts to simplify the tax code in North Carolina;<sup>169</sup> (2) North Carolina should not conform the sales tax treatment of virtual currency to the federal definition of virtual currency to create uniformity, because the federal treatment could change;<sup>170</sup> (3) the Advertised Price Approach is a more accurate determination of the value of the item bought with virtual currency;<sup>171</sup> and (4) the Barter Approach will encourage retailers to only accept bitcoin.<sup>172</sup>

## 1. The Barter Approach Would Be Fundamentally at Odds with North Carolina's Efforts to Simplify the Tax Code.

Starting in 2013, the North Carolina General Assembly began to

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169. See An Act to Simplify the N.C. Tax Structure and to Reduce Individual and Business Tax Rates ("Tax Simplification and Reduction Act") § 3.1(a), N.C. GEN. STAT. § 105-164.4(a) (2016) (highlighting that modular homes will now be taxed and the general sales tax rate).

170. See *infra* note 187.

171. See KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

172. See Bajpai, *supra* note 40 (establishing that Bitcoin is the most popular form of virtual currency); KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

gradually simplify and reform the tax code by (1) opting for a flat tax on income to replace its three-tiered tax bracket approach and (2) repealing the estate tax.<sup>173</sup>

The General Assembly also attempted to simplify North Carolina sales taxes by making sales tax provisions more uniform.<sup>174</sup> For example, the sale of modular homes and admission tickets to entertainment activities are now taxed at the regular sales tax.<sup>175</sup>

Under the Barter Approach, retailers would be required to calculate the USD equivalence of virtual currency, which could greatly vary depending on the day and the type of virtual currency.<sup>176</sup> Thus, this approach would contradict North Carolina's effort to make the collection of sales tax more uniform.<sup>177</sup> While the rates at which the USD amount would be taxed would not be effected, determining the fair market value of each virtual currency, every day that it is accepted as payment, would make determining the basis to apply to the rate burdensome.<sup>178</sup>

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173. Tax Simplification and Reduction Act §§ 1.2(a), 7(a), N.C. GEN. STAT. §§ 105–153.7(a), 105–241.10 (2016).

174. See Mark Binker, *Breaking Down the 2013 Tax Package*, WRAL (July 19, 2013), <http://www.wral.com/breaking-down-the-2013-tax-package/12678653/> (discussing the change to a flat rate income tax and the shift away from preferential sales tax rates on certain goods and services).

175. N.C. GEN. STAT. § 105-164.4(a).

176. See KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a “taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction”); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is “based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars”); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

177. Tax Simplification and Reduction Act § 3.1(a), N.C. GEN. STAT. § 105–164.4(1a) (eliminating the preferential sales tax rate on items such as modular homes and applying the general sales tax rate); see also Binker, *supra* note 174 (discussing the change to a flat rate income tax and the shift away from preferential sales tax rates on certain goods and services).

178. See generally KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a “taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction”); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y.

For most retailers, the Advertised Price Approach would only require the sales price in terms of USD, which the vast majority of retailers already possess.<sup>179</sup> A flaw in the Advertised Price Approach is that it is ill-suited for businesses that do not have an advertised price that is generally accepted in exchange for the good or service, such as automobile sales.<sup>180</sup>

A hybrid system, where retailers who accept prices that are outside of a specified variation of the advertised price would be required to follow the Barter Approach, would allow retailers to choose the option that best suits their needs. For example, retailers could (1) adjust their advertised price to be more in line with the price they are willing to accept or (2) calculate the tax basis by determining the fair market value of virtual currency.<sup>181</sup> Practically speaking, the Advertised Price Approach would address most of the items bought on a daily basis.<sup>182</sup>

In terms of deciding how much virtual currency should be charged for an item, the Advertised Price Approach would allow

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DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is “based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars”); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

179. See CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

180. Ben DeMeter, *The Complete Guide to Buying a New Car: How to Negotiate Prices*, INVESTOPEDIA, <http://www.investopedia.com/university/newcar/negotiate-price.asp> (last visited Sept. 17, 2016); see Martha C. White, *12 Things You Should Always Haggle Over*, TIME (Aug. 6, 2012), <http://business.time.com/2012/08/13/12-things-you-should-always-haggle-over/slide/2-home-and-yard-work-contracts/> (listing automobiles, home and yard-work contracts, furniture, credit-card costs, special-events goods and services, anything bought used or in bulk, jewelry, vacation lodging, health care, insurance rates, phone service, television service, internet service, and subscriptions and memberships as products and services that may not necessarily be sold at the advertised price).

181. See generally KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a “taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction”); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is “based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars”); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale).

182. See generally Helmer, *supra* note 162 (noting that companies and retailers regularly negotiate with consumers on the price of certain products or services).

retailers the freedom to decide for themselves how often they wish to consult exchange rates.<sup>183</sup>

In setting prices for virtual currency, some retailers will determine the price they will charge by using the “current market rate” at the time of the price quote.<sup>184</sup> Retailers may decide to consult the average fair market value on multiple exchanges or rely on a single exchange.<sup>185</sup> Given the volatility in the fair market value of virtual currency, it is reasonable to assume that merchants would want to consult virtual currency exchanges daily, before setting the price, in terms of virtual currency.<sup>186</sup> However, not all retailers may deem it necessary to consult the exchanges this frequently.<sup>187</sup> For example, Tom Barber of Wilmington, North Carolina, decided to accept bitcoin because he sees it as a good investment, thus he may not be as concerned with the variation of bitcoin on a day-to-day basis.<sup>188</sup> Yet, under the Barter Approach he would be required to consult virtual currency exchanges each day he accepted virtual anyway.<sup>189</sup>

It could be argued that the Barter Approach is not burdensome because it only requires information which retailers would already be obligated to collect, regarding the daily fair market value of virtual currency, under federal income tax requirements.<sup>190</sup> However, North

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183. See generally KY. DEP’T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP’T OF TREAS., *supra* note 144, at 2 (stating that a “taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction”); N.J. DEP’T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP’T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is “based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars”); WIS. DEP’T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale).

184. *How to Accept Bitcoin for Small Businesses*, BITCOIN WIKI, [https://en.bitcoin.it/wiki/How\\_to\\_accept\\_Bitcoin\\_for\\_small\\_businesses](https://en.bitcoin.it/wiki/How_to_accept_Bitcoin_for_small_businesses) (last visited Sept. 13, 2016) [hereinafter BITCOIN WIKI].

185. *Id.*

186. See Selkis, *supra* note 112 (stating that the value of Bitcoin has varied as much as 20% among different exchanges).

187. See generally Dineen, *supra* note 54 (interviewing a small business owner who believes that accepting bitcoin will be a “good investment”).

188. *Id.*

189. KY. DEP’T OF REV., *supra* note 144, at 1; MICH. DEP’T OF TREAS., *supra* note 144, at 2; N.J. DEP’T OF TAXATION, *supra* note 144; N.Y. DEP’T OF TAXATION, *supra* note 144, at 2; WIS. DEP’T OF REV., *supra* note 144.

190. I.R.S. Notice, *supra* note 22.

Carolina should not implement an unduly burdensome approach in reliance on the federal treatment because it is possible that the federal treatment could change due to the pressure of public opinion.<sup>191</sup> Some individuals are pushing for such a change by seeking to legislatively override the IRS's determination.<sup>192</sup> For example, a House Bill, which did not come out of committee, was introduced to change the federal tax treatment of virtual currency so that it would be treated as currency instead of property.<sup>193</sup> In addition to treating virtual currency as foreign currency, the bill would have taxed virtual currency only after the virtual currency was exchanged for USD or a foreign currency.<sup>194</sup>

Further, the American Institute of Certified Public Accountants ("AICPA") sent a letter to the IRS in which it highlighted "major issues" with the IRS Notice.<sup>195</sup> The group sought clarification on (1) valuing "alternative currencies," (2) calculating gains and losses, (3) and classifying gains and losses "among many types of property."<sup>196</sup> Additionally, the letter requested a de minimis exclusion similar to foreign currency transactions where small gains would not be required

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191. See Jeffrey K. Berns & Emmanuel Rayes, BERNs WEISS LLP, VIRTUAL CURRENCY LEGISLATION ON THE HORIZON (July 14, 2016, 7:35 PM), <http://www.law11.com/virtual-currency-legislation-on-the-horizon> (describing former Congressman Stockman's efforts to change the tax treatment and calling on individuals to encourage their representatives to change the classification in the wake of the request for clarification by the American Institute of Certified Public Accountants); see also TREAS. INSPECTOR GEN. REPORT, *supra* note 106, at 11 (expressing concerns over the current IRS guidance) ("With questions that the public has about recordkeeping, mining, and tax compliance reporting for virtual currencies, some potential for noncompliance exists because the detailed guidance needed by taxpayers to properly comply with their virtual currency tax obligations was not provided by the IRS."); Hodgson, *supra* note 137 ("To verify the depth the problem, even the authors themselves struggled to explain the meaning of their 2014 notice. Simple questions, such as how one would go about computing gains and reporting them for every transaction, had them deflecting to other coauthors and finally to media relations — even though they listed themselves as the contacts on the notice.").

192. Berns & Rayes, *supra* note 191.

193. Online Market Protection Act of 2014, H.R. 5892, 113th Cong. § 5(c) (2015). While the bill did not make it out of committee, President Trump's goal of simplifying the tax code may make a change more likely going forward. See generally Jim Nunns et al., TAX POLICY CENTER, AN ANALYSIS OF DONALD TRUMP'S TAX PLAN 2 (Dec. 22, 2015), <http://www.taxpolicycenter.org/sites/default/files/publication/128726/2000560-an-analysis-of-donald-trumps-tax-plan.pdf> (stating that President Trump has expressed the goal of "simplifying the tax code").

194. Online Market Protection Act of 2014, H.R. 5892, 113th Cong. § 5(c)(2015).

195. AICPA Comment Letter, *supra* note 113, at 3 (seeking clarification as to when virtual currency transactions would be considered like kind transactions); Hodgson, *supra* note 137, at 2.

196. AICPA Comment Letter, *supra* note 113; Hodgson, *supra* note 137, at 2.

to be reported.<sup>197</sup> While the IRS confirmed that there were no plans to update the Notice, it did not respond to the request for clarification.<sup>198</sup> This failure to respond to the largest accounting trade association in the world may be due to the fact that the IRS does not have the answers on how to clarify the Notice.<sup>199</sup> Regardless of the reasons why the IRS did not respond to the request for clarification, the notoriety of the AICPA may lead others to seek clarification or a change in the guidelines.<sup>200</sup>

While Singapore also follows the property classification,<sup>201</sup> the European Union,<sup>202</sup> Russia,<sup>203</sup> and Japan<sup>204</sup> have opted to treat virtual currency as currency for tax purposes. Given that this trend occurred after the Notice was issued, it could influence the IRS to rethink its position.<sup>205</sup> Australia, on the other hand, took an approach that is a hybrid of the property treatment of the United States and the currency treatment of other countries stating that, “Bitcoin is neither money nor a foreign currency, and the supply of bitcoin is not a financial supply for goods and services tax (GST) purposes.”<sup>206</sup> However, Australia does treat bitcoin as property for purposes of capital gains taxes on businesses.<sup>207</sup>

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197. AICPA Comment Letter, *supra* note 113, at 4–5; Mike Godfrey, *US Accountants Seek Virtual Currency Tax Guidance*, TAX-NEWS (June 16, 2016), [http://www.tax-news.com/news/US\\_Accountants\\_Seek\\_Virtual\\_Currency\\_Tax\\_Guidance\\_\\_\\_71466.html](http://www.tax-news.com/news/US_Accountants_Seek_Virtual_Currency_Tax_Guidance___71466.html).

198. Hodgson, *supra* note 137, at 2–3.

199. Hodgson, *supra* note 137, at 3.

200. *See generally* Hodgson, *supra* note 137, at 2 (highlighting the “clout of the Institute of CPAs”).

201. *Income Tax Treatment of Virtual Currencies*, INLAND REVENUE AUTHORITY OF SING., <https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Specific-topics/Income-Tax-Treatment-of-Virtual-Currencies/> (Sing.) (last visited Sept. 17, 2016).

202. Case C-264/14, *Skatteverket v. Hedqvist*, 2015 E.C.R. 614CJ0264 (2015).

203. Stan Higgins, *Bitcoin Sales are Foreign Currency Transactions, Russia’s Tax Office Says*, COIN DESK (Aug. 10, 2016, 12:47 PM), <http://www.coindesk.com/bitcoin-currency-russia-ministry-finance-tax/>.

204. *Japan Bitcoin a Currency but Still Taxable*, AVALARA VAT LIVE (Mar. 10, 2016), <http://www.vatlive.com/asia-pacific/japan-bitcoin-a-currency-but-still-taxable/>.

205. *See generally* I.R.S. Notice, *supra* note 22 (establishing that the I.R.S. Notice was promulgated in 2014).

206. TAX TREATMENT OF CRYPTO-CURRENCIES IN AUSTRALIA –SPECIFICALLY BITCOIN, AUSTRAL. TAX OFFICE (last modified Dec. 18, 2014), <https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia—specifically-bitcoin/> (Austl.).

207. *See id.* (noting that individuals who use Bitcoin for personal transactions that do not exceed \$10,000 will not be subject to GST or income taxes in Australia).

## 2. The Advertised Price Approach Would Be a More Accurate Method for Determining the Value of a Good or Service

Given the inherent value volatility in virtual currency, the basis for the sales tax under the Barter Approach could vary substantially.<sup>208</sup> Retailers could consult exchange rates to convert the price in USD to a price in virtual currency, based on its value in terms of USD on the day of the transaction, so that the tax basis would stay constant from day to day.<sup>209</sup> However, as previously mentioned, it is not clear that all businesses would be inclined to do so, nor is it clear that it would be practical.<sup>210</sup>

Under the federal system, on which the Barter Approach relies,<sup>211</sup> the fair market value must be calculated as of the day of the transaction, in a manner that is consistent.<sup>212</sup> Thus, a business where customers make purchases in and around the midnight hour, such as a bar, would technically have to tax a beer sold at 11:59:59 P.M. differently from a beer sold at 12:00:00 A.M.<sup>213</sup> The beer sold at 11:59:59 P.M. would be taxed based on the fair market value of virtual currency in terms of USD for Day A, while the beer sold at 12:00:00 A.M. would be taxed based on the fair market value for Day B.<sup>214</sup> On

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208. See Online Market Protection Act of 2014, H.R. 5892, 113th Cong. § 5(c) (2015) (“At present, a taxpayer accepting cryptocurrency for goods or services will be taxed on the fair market value of the cryptocurrency despite the fact that exchange rates (from cryptocurrency to conventional currency) are both highly volatile and published or available only on a small number of proto-exchanges in the early stages of development, acceptance and awareness by cryptocurrency users.”); see also AICPA Comment Letter, *supra* note 113, at 1–2 (illustrating the variability of bitcoin).

209. BITCOIN WIKI, *supra* note 184.

210. Dineen, *supra* note 54.

211. KY. DEP’T OF REV., *supra* note 144, at 1; MICH. DEP’T OF TREAS., *supra* note 144, at 2; N.J. DEP’T OF TAXATION, *supra* note 144; N.Y. DEP’T OF TAXATION, *supra* note 144, at 2; WIS. DEP’T OF REV., *supra* note 144.

212. I.R.S. Notice, *supra* note 22.

213. See I.R.S. Notice, *supra* note 22 (stating that the tax basis is the “fair market value of the virtual currency in U.S. dollars as of the date of receipt”).

214. See generally KY. DEP’T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP’T OF TREAS., *supra* note 144, at 2 (stating that a “taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction”); N.J. DEP’T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP’T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is “based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars”); WIS. DEP’T OF REV., *supra* note 144 (stating that the sales tax basis is the fair

the other hand, if the Advertised Price Approach was applied, the same beers sold a second apart would result in equal tax liabilities.<sup>215</sup> Therefore, relying on the advertised price in terms of USD would be a more accurate picture of the true value of the item being bought.<sup>216</sup>

### 3. The Barter Approach Would Encourage Businesses to Only Accept Bitcoin

Requiring retailers to comply with the Barter Approach, and determine the daily fair market value of every virtual currency accepted, would unfairly disadvantage virtual currency providers other than Bitcoin.<sup>217</sup> As previously discussed with regard to Bitcoin, retailers who accept virtual currency may wish to determine the fair market value of virtual currency before setting a price in terms of virtual currency, but they may not wish to do so on a daily basis.<sup>218</sup> Because

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market value on the day of the sale).

215. See generally CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

216. See generally KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

217. See Bajpai, *supra* note 40 (establishing that Bitcoin is the most popular form of virtual currency); KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale).

218. Cf. Selkis, *supra* note 112 (stating that the value of bitcoin has varied as much as 20% among different exchanges); Dineen, *supra* note 54 (discussing how the bar owner sees Bitcoin as an investment).

Bitcoin is the most popular virtual currency,<sup>219</sup> retailers would have an incentive to only accept bitcoin in order to avoid the hassle of converting other virtual currencies into USD.<sup>220</sup> Under the Advertised Price Approach, retailers would not need to keep separate records of the daily fair market value of every virtual currency that they accept,<sup>221</sup> and thus would not be burdened if they decided to accept less popular virtual currencies,<sup>222</sup> particularly ones that are not traded on an exchange.<sup>223</sup> Some companies have opted to use third-party processors, whereby the processor accepts bitcoin converts bitcoin to USD, and sends the retailer USD the next day.<sup>224</sup> This allows the retailer to avoid the hassle of calculating the tax liability of receiving bitcoin because the retailer never possesses bitcoin.<sup>225</sup> Aside from indirectly increasing costs for businesses by incentivizing the use of payment processors,<sup>226</sup> this preference to avoid complicating their tax liability can prevent other forms of virtual currency from gaining popularity.<sup>227</sup>

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219. Bajpai, *supra* note 40.

220. *See generally* KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale);

221. CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

222. *See Rizzo, supra* note 55 (stating that Reeds Jewelers "isn't ruling out one day accepting altcoins").

223. Selkis, *supra* note 112.

224. *Accepting Virtual Currency: The Basics for Brick-and-Mortar Retailers*, VIRTUAL CURRENCY TODAY (Dec. 15, 2014), <http://www.virtualcurrencytoday.com/articles/accepting-virtual-currency-the-basics-for-brick-and-mortar-retailers/>.

225. *See id.* (quoting TigerDirect's Director of Marketing, Steve Leads, "We never touch bitcoins, so we don't have a tax liability.").

226. *Id.*

227. *See generally How to Accept Bitcoin Payments for Your Store*, COINDESK, <http://www.coindesk.com/information/bitcoin-retail-pos-systems/> (last updated Oct. 14, 2015) (highlighting different options for payment processors for retailers who wish to accept bitcoin).

B. *Income Tax*

For the same reasons why it would be ill-advised to follow the federal tax classification for sales tax purposes (complications in determining the taxable basis), it would also be difficult to treat virtual currency as income for North Carolina income taxes.<sup>228</sup> Further, enforcement against tax evasion would not be practical at the state level given that even the IRS is unsure about how to track down virtual currency tax evaders.<sup>229</sup> Given this obstacle to enforcement, the likelihood that one would be audited even at the federal level is very low.<sup>230</sup> In fact, legal specialists in the field of virtual currency have yet to come across bitcoin related audits.<sup>231</sup>

New Jersey and New York are the only states that have addressed the applicability of state income taxes to virtual currency.<sup>232</sup> However, failing to address income taxes could result in a loss of tax revenue from retailers who receive payment in virtual currency and employees who are paid in virtual currency.<sup>233</sup>

1. Alternatives for State Income Tax Treatment

A. FOREIGN CURRENCY

As highlighted in the House Bill proposing to change the tax

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228. See N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); I.R.S. Notice, *supra* note 22 (describing the reporting requirements for income tax based on the property classification).

229. TREAS. INSPECTOR GEN. REPORT, *supra* note 106, at 7; Ungerman, *supra* note 134 (noting that the I.R.S. has tasked special agents with trying to figure out how to trace tax evasion).

230. Ungerman, *supra* note 134; see Bill Bischoff, *Worried About Being Audited by the IRS? Here are your Chances*, MARKETWATCH (Jan. 29, 2016, 2:57 PM), <http://www.marketwatch.com/story/what-are-your-chances-of-getting-audited-2015-12-15> (discussing the low likelihood of being audited, 0.9% for individuals without business income).

231. Hodgson, *supra* note 137; see TREAS. INSPECTOR GEN. REPORT, *supra* note 129, at 7 (noting that steps have not been taken to ferret out tax dodgers).

232. N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144.

233. See generally I.R.S. Notice, *supra* note 22 (describing how the I.R.S. treats income in virtual currency).

classification of virtual currency, virtual currency tends to be used to engage in everyday transactions.<sup>234</sup> This characteristic makes virtual currency transactions more analogous to foreign currency transactions than barter transactions.<sup>235</sup> Thus, for state income tax purposes, it would make sense to apply features of the federal tax treatment of foreign currency to virtual currency transactions.<sup>236</sup>

One such feature is the de minimis exception for foreign currency transactions, which allows individuals to realize up to \$200 in gains before reporting.<sup>237</sup> This feature would address one of the concerns that the AICPA highlighted in its letter to the IRS—that very small gains would be too burdensome to report.<sup>238</sup> While it is unclear if the result would occur, enacting a de minimis exception could have the added benefit of encouraging individuals to comply with reporting for larger gains because compliance would not seem so burdensome.<sup>239</sup>

Foreign currency treatment would also simplify the reporting process for businesses.<sup>240</sup> Businesses who regularly transact using virtual currency could seek to be classified as a Qualified Business Unit (“QBU”), which would ease their reporting requirements.<sup>241</sup> In order to become a QBU, a business would have to have a separate unit with its own books and records.<sup>242</sup> Further, the QBU must be deemed to have a functional currency that is a foreign currency.<sup>243</sup> If these requirements are met, the QBU can qualify for a reporting system that does not mandate determining gains and losses on every virtual currency

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234. Online Market Protection Act of 2014, H.R. 5892, 113th Cong. (2015); Sam Hampton, *Undermining Bitcoin*, 11 WASH. J.L. TECH. & ARTS 331, 348 (2016).

235. Hampton, *supra* note 234, at 248.

236. Cf. Hampton, *supra* note 234, at 348–49; Antonikova, *supra* note 126, at 450.

237. I.R.C. § 988(e) (2015).

238. Godfrey, *supra* note 197.

239. Elizabeth E. Lambert, *The Internal Revenue Serv. & Bitcoin: A Taxing Relationship*, 35 VA. TAX REV. 88, 114 (2015); see Marco Santori, *supra* note 125 (referring to the current reporting requirements as “unnecessarily cumbersome”).

240. See Antonikova, *supra* note 126, at 450 (stating that treating virtual currency as foreign currency would be “immensely more convenient than income taxation under property rules”).

241. I.R.C. §§ 987, 989(a); Antonikova, *supra* note 126, at 450–51 (“[QBUs] may use a simplified profit and loss method to calculate income and exchange gains and losses under Subpart J section 987.”).

242. I.R.C. § 989(a).

243. I.R.C. § 985(b)(1)(B) (defining functional currency as “currency of the economic environment in which a significant part of such unit’s activities are conducted and which is used by such unit in keeping its books and records”).

transaction.<sup>244</sup> Rather, the QBU would only be required to:

(1) compute the taxable income or loss of the branch separately in its functional currency; (2) translate the income or loss from the functional currency to U.S. dollars using the weighted average exchange rate for the taxable year; and (3) make proper adjustments for transfers of property between QBUs having different functional currencies.<sup>245</sup>

While the IRS has not deemed virtual currency to be currency,<sup>246</sup> the North Carolina Department of Revenue has not issued a similar statement.<sup>247</sup> The amendment to the North Carolina Money Transmitter Statute further signals the State's willingness to treat virtual currency as currency.<sup>248</sup> In addition to easing reporting requirements, treating virtual currencies in this manner would eliminate the need to differentiate between ordinary gains or losses and capital gains or losses because any gains or losses from transferring the functional currency into USD would be treated as ordinary income.<sup>249</sup>

The historical background of foreign currency treatment also lends credence to the argument that a unit of value that is treated as currency should be taxed as currency.<sup>250</sup> Before 1986, foreign currency was treated as property for tax purposes.<sup>251</sup> Because it was being used as a currency, however, the tax treatment resulted in "inconsistent judicial decisions."<sup>252</sup> Further, taxpayers and auditors alike have had difficulty complying with and overseeing the cumbersome reporting requirements.<sup>253</sup> Thus, Subpart J was added to the tax code to address the inefficiencies resulting in treating a unit of exchange that functions

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244. I.R.C. § 987; Antonikova, *supra* note 126, at 451.

245. I.R.C. § 987; Antonikova, *supra* note 126, at 451.

246. I.R.S. Notice, *supra* note 22.

247. *Tax Navigator*, *supra* note 3 ("North Carolina does not address the tax treatment of Bitcoin or other virtual currency.").

248. N.C. GEN. STAT. §§ 53-208.41-.64 (2016).

249. I.R.C. § 987(3)(b); Antonikova, *supra* note 126, at 451.

250. Antonikova, *supra* note 126, at 449-50.

251. Antonikova, *supra* note 126, at 449-50.

252. Antonikova, *supra* note 126, at 450.

253. Antonikova, *supra* note 126, at 450.

like currency under a property classification without any adjustments.<sup>254</sup>

#### B. REPEAL THE INCOME TAX AND RAISE THE SALES TAX

Alternatively, North Carolina could choose to address shortfalls from virtual currency income, not falling under the current state income tax system, by eliminating the personal income tax in favor of a sales tax increase.<sup>255</sup> Such a shift would compensate for virtual currency use by taxing consumption, which could be enforced without relying on the honesty of taxpayers<sup>256</sup> or on special agents skilled in tracing virtual currency transactions.<sup>257</sup> This option would be viable for North Carolina's needs because: (1) the General Assembly has been gradually focusing on increasing revenues through taxes on goods and services while decreasing income tax rates<sup>258</sup> and (2) the progressivity of the income tax, which is one of the principal reasons for relying on an income tax, is not as pertinent to North Carolina.<sup>259</sup> Further, as a tourist destination,<sup>260</sup> North Carolina could also capitalize on sales tax revenues gained from tourist spending, as Florida has done.<sup>261</sup> While increasing sales taxes poses a risk that tourists will go elsewhere, people (other

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254. Antonikova, *supra* note 126, at 450 (citing Steven Chung, *Real Taxation of Virtual Commerce*, 28 VA. TAX REV. 733, 766 (2009)).

255. See generally I.R.S. Notice, *supra* note 22 (describing how the I.R.S. treats income in virtual currency). "If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain." *Id.* "The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency." *Id.*

256. See Pagliery, *supra* note 129 (emphasizing how the property classification will be difficult to enforce); see also TREAS. INSPECTOR GEN. REPORT, *supra* note 106, at 7 (discussing the inadequacy of enforcement procedures).

257. Ungerman, *supra* note 134.

258. See Binker, *supra* note 174 (providing a summary of the 2013 North Carolina tax reforms); Dan Way, *Rucho: Lawmakers Not Done with Tax Reform*, CAROLINA JOURNAL (Dec. 9, 2015, 12:00 AM), <https://www.carolinajournal.com/news-article/rucho-lawmakers-not-done-with-tax-reform/> (quoting Representative Lewis, who said "[w]e believe that what someone truly consumes is what should be taxed," when asked about switching to a consumption based tax system).

259. N.C. GEN. STAT. § 105-153.7 (2016) (imposing a flat tax on income); Joseph R. Santoro & Caleb S. Fuller, *Reassessing the Fair Tax*, 77 U. PITT. L. REV. 385, 393 n.57 (2016) (explaining that sales taxes are "inherently regressive").

260. See *Tourism Statistics for North Carolina*, VISIT NC (Dec. 7, 2016), <https://media.visitnc.com/news/tourism-statistics-for-north-carolina> ("Tourism is one of North Carolina's largest industries.").

261. See Lyle Moran, *How Nine States Without Income Taxes Pay the Bills*, BOS. U. (Nov. 4, 2008), <http://www.bu.edu/phpbin/news-cms/news/?dept=1368&id=51338> (explaining how Florida and other states rely on sales taxes for a majority of state revenue).

than large groups such as ones hosting conventions) are not always deterred by higher taxes.<sup>262</sup>

Over the past few years, North Carolina has decreased its reliance on the personal and corporate income tax, lowering the rate for the highest bracket for individuals from 7.75% to a flat tax rate of 5.75%, which will decrease to 5.499% in 2017.<sup>263</sup> The corporate income tax rate has also been reduced from 6% in 2014,<sup>264</sup> to 4% in 2016.<sup>265</sup> Beginning in 2017, the corporate income tax rate will also be lowered to 3%.<sup>266</sup> On the other hand, while the general rate of sales tax has not increased, exemptions have been reduced and items which were previously taxed at preferential rates are now taxed at the general rate.<sup>267</sup> For example, the sales tax holiday<sup>268</sup> and the exemption for “meals sold at higher educational facilities, such as college cafeterias” were eliminated.<sup>269</sup> Further, sales taxes (at the general rate) were applied to services which had not previously been taxed before, such as

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262. See Elaine Povich, *States Lure Tourists Then Tax Them*, PEW CHARITABLE TRUST (June 15, 2015), <http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2015/6/15/states-lure-tourists-then-tax-them> (stating that Ga.’s tourism industry increased by 6.7% and set a record despite adding a hotel tax) (highlighting that in the fifty most traveled cities tourists pay 58% more in their combined tax bill than residents pay on state taxes); see also Carl Bialik, *Greece Hopes Foreign Tourists Will Help Pay Its Debts*, FIVE THIRTY EIGHT (July 15, 2016), <http://fivethirtyeight.com/datalab/greece-hopes-foreign-tourists-will-help-pay-its-debts/> (stating that economic health in visitors’ home effects tourism more than sales taxes); Nishaal Gooroochurn & Chris Milner, *Assessing Indirect Tax Reform in Tourism Dependent Developing Country*, 33 WORLD DEV., No. 7, 1183, 1194 (2005) (calling for an increase in sales taxes on items that tourists typically buy in Mauritius). The amount that sales taxes would have to be raised to be revenue neutral, which is beyond the scope of this Note. However, as a baseline, Tennessee has a 5% state sales tax on food and a 7% tax on other items to compensate for not having an income tax. TENN. CODE ANN. § 67-6-202 and 228 (West 2016).

263. Tax Simplification and Reduction Act § 1.2(a), N.C. GEN. STAT. § 105-153.7; Binker, *supra* note 174.

264. *Corporate Income Tax Information, Tax Rate*, N.C. DEP’T OF REV., <http://www.dor.state.nc.us/taxes/corporate/rate.html> (last visited Sept. 18, 2016).

265. Tax Simplification and Reduction Act § 2.1(a), N.C. GEN. STAT. § 105-130.3.

266. N.C. DEP’T OF REV. INCOME TAX DIV., IMPORTANT NOTICE: THE SECRETARY OF REVENUE CONFIRMS THAT NET GENERAL FUND TAX COLLECTIONS FOR FISCAL YEAR 2015-2016 EXCEEDED THE TARGETED AMOUNT OF \$20,975,000,000. THE CORPORATE TAX RATE FOR YEARS BEGINNING ON OR AFTER JANUARY 1, 2017 WILL BE REDUCED BY 1% (Aug. 4, 2016), [http://www.dornrc.com/taxes/income/impnotice080416\\_triggerratereduction.pdf](http://www.dornrc.com/taxes/income/impnotice080416_triggerratereduction.pdf).

267. Tax Simplification and Reduction Act § 3.1(a), N.C. GEN. STAT. § 105-164.4; Binker, *supra* note 174.

268. Tax Simplification and Reduction Act § 3.4(c), N.C. GEN. STAT. § 105-467(b).

269. Tax Simplification and Reduction Act § 3.2(b), N.C. GEN. STAT. § 105-164.13(26); Binker, *supra* note 174.

automobile repair services.<sup>270</sup> Thus, based on past tax bills, the General Assembly is amenable to focusing more heavily on sales taxes.<sup>271</sup> Lieutenant Governor Dan Forest has said that the “ultimate goal” is to abolish the income tax.<sup>272</sup>

A principal reason for having an income tax, rather than solely relying on sales taxes, is that income taxes are progressive when rates are broken into tax brackets.<sup>273</sup> For example, if the federal government or states that follow the federal government, in having progressive tax brackets, abolished income taxes in favor of sales taxes, the tax rate would shift from being based on one’s income to the same rate for everyone.<sup>274</sup> However, the North Carolina income tax is based on a flat rate, which applies at the same rate regardless of income.<sup>275</sup> Thus, if North Carolina were to abolish the flat income tax in favor of a sales tax, the predominant tax would still apply at the same rate to every individual.<sup>276</sup>

Sales taxes are generally classified as regressive because the “poor, on average, spend a higher percentage of their income on consumer goods” and thus, sales taxes disproportionately affect the poor.<sup>277</sup> Yet, some sales taxes are more regressive than others.<sup>278</sup> If

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270. Tax Simplification and Reduction Act § 3.2(c), N.C. GEN. STAT. §105-164.15A; Colin Campbell, *Sales Taxes on Auto Repairs, Dozens of Other Services Start Tuesday*, NEWS AND OBSERVER (Feb. 27, 2016, 4:28 PM), <http://www.newsobserver.com/news/politics-government/state-politics/article62898522.html>.

271. See Way, *supra* note 256 (quoting Representative Lewis, saying “[w]e believe that what someone truly consumes is what should be taxed,” when asked about switching to a consumption based tax system). See generally Tax Simplification and Reduction Act § 5(b), N.C. GEN. STAT. §105-164.4 (amending the tax code to eliminate special tax rates for items that were previously taxed at a lower rate and eliminating the special tax rate for modular homes).

272. Patrick Gleason, *Significant State Changes of 2015 & Those on the 2016 Agenda*, FORBES (Dec. 31, 2015, 12:25 PM), <http://www.forbes.com/sites/patrickgleason/2015/12/31/state-tax-changes/#208df4f859ca>.

273. See William G. Gale, *Don’t Buy the Sales Tax*, BROOKINGS INST. (Mar. 1, 1998), <https://www.brookings.edu/research/dont-buy-the-sales-tax/> (“The sales tax would tax consumption at a flat rate compared to the current system, which taxes income at progressive rates.”)

(“If households are classified by annual income, the sales tax is sharply regressive.”) (stating that based on consumption level all households would pay less if the federal income tax was changed to a sales tax).

274. Santoro & Fuller, *supra* note 259, at 393–94.

275. N.C. GEN. STAT. § 105-153.7.

276. See generally N.C. GEN. STAT. § 105-153.7 (establishing the flat income tax in North Carolina with limited deductions from income).

277. See Santoro & Fuller, *supra* note 259, at 393–94 n.57 (discussing the impact of a

goods essential to basic needs were exempt from sales tax, the tax would be less regressive.<sup>279</sup> In North Carolina, prescriptions are exempt from sales tax and only local sales taxes are applied to groceries, which lessens the impact on lower income individuals.<sup>280</sup> North Carolina could consider lowering the tax on electricity and further increasing the sales tax on entertainment admission tickets in order to combat the hardships to lower income individuals.<sup>281</sup>

Another downside to solely relying on a sales tax is that it would negatively impact local retailers in the short term by encouraging savings.<sup>282</sup> Replacing the income tax with a sales tax would incentivize taxpayers to save more because they would only be taxed on their consumption.<sup>283</sup> Yet, with current interest rates being as low as they are,<sup>284</sup> people are incentivized to spend.<sup>285</sup>

A concern with raising state sales taxes is that residents will travel to bordering states to make purchases to avoid sales taxes.<sup>286</sup> The ranking from the highest possible combined state and local taxes among bordering states to the lowest is as follows: Tennessee,<sup>287</sup> South Carolina,<sup>288</sup> Georgia,<sup>289</sup> North Carolina,<sup>290</sup> and Virginia.<sup>291</sup> South

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national sales tax on lower income individuals).

278. Tim Worstall, *A Flat Tax Isn't Regressive, It's Progressive*, FORBES (Nov. 12, 2015, 9:36 AM), <http://www.forbes.com/sites/timworstall/2015/11/12/a-flat-tax-isnt-regressive-its-progressive/#371d92dd2d25>.

279. *Id.*

280. Binker, *supra* note 174.

281. See generally Santoro & Fuller, *supra* note 274, at 394 (discussing another mechanism for lessening the impact of a sales tax on lower income individuals, the probate tax, as envisioned in the Fair Tax proposal).

282. See generally Santoro & Fuller, *supra* note 274, at 404 (noting that income taxes discourage saving).

283. See generally Santoro & Fuller, *supra* note 274, at 404 (noting that income taxes discourage saving).

284. *Consumer Interest Rates*, BLOOMBERG MARKETWATCH, <http://www.bloomberg.com/markets/rates-bonds/consumer-interest-rates> (last visited Sept. 18, 2016).

285. C.W., *Why Negative Interest Rates Have Arrived-and Why They Won't Save the Global Economy*, THE ECONOMIST (Feb. 18, 2015, 11:50 PM), <http://www.economist.com/blogs/economist-explains/2015/02/economist-explains-15>.

286. Scott Drenkard & Nicole Kaeding, *State and Local Tax Rates in 2016*, TAX FOUND. (Mar. 9, 2016), <http://taxfoundation.org/article/state-and-local-sales-tax-rates-2016>.

287. See TENN. DEP'T OF REV. (Dec. 1, 2016), <https://tn.gov/assets/entities/revenue/attachments/taxlist.pdf>; TENN. CODE ANN. § 67-6-202 and 228 (West 2016) (stating that Tennessee allows a local tax of up to 2.75% on top of its state sales tax of 7%).

288. See S.C. DEP'T OF REV., SALES AND USE TAX RATES OF SOUTH CAROLINA (May 26, 2016), [https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427\\_05262016.pdf](https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427_05262016.pdf)

Carolina has the second highest state sales tax, although the lowest tax combined rate is .75 less than the lowest combined rate in North Carolina.<sup>292</sup> North Carolina could lower the maximum permissible local sales tax rate, similar to the 1% local rate in Virginia and, in order to increase the state sales tax without having a drastic effect on the combined rate.<sup>293</sup> Local governments could recoup lost revenue by increasing local property taxes.<sup>294</sup> This approach would lower the likelihood that residents will leave the state to make purchases and lessen the burden on lower income individuals.<sup>295</sup>

Raising the sales tax could cause customers to turn to online retailers instead of brick and mortar stores, but online retailers have been challenged to collect sales taxes.<sup>296</sup> For example, Amazon charges

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(stating that South Carolina has a state sales tax of 6% and allows multiple local taxes which results in a local tax of 2.5% in the counties with the highest sales tax).

289. See GA. DEP'T OF REV., *Ga. Sales and Use Tax Chart Oct. 2016*, [https://dor.georgia.gov/sites/dor.georgia.gov/files/related\\_files/document/LGS/Distributions/LGS\\_2016\\_Oct\\_Rate\\_Chart.pdf](https://dor.georgia.gov/sites/dor.georgia.gov/files/related_files/document/LGS/Distributions/LGS_2016_Oct_Rate_Chart.pdf) (last visited Nov. 5, 2016) (showing that Georgia allows up to an 8% total sales tax, including the 4% state sales tax).

290. N.C. GEN. STAT. § 105-164.4(a) (2016) (stating that the state sales tax is 4.75%); see also N.C. DEP'T OF REV., *Sales and Use Rates Effective Oct. 1, 2016*, [http://dornc.com/taxes/sales/salesrates\\_10-16.html](http://dornc.com/taxes/sales/salesrates_10-16.html) (last visited Nov. 5, 2016) (stating that a 2.75% local sales tax is allowed in addition to the state tax, totaling 7.5%).

291. VA. CODE ANN. § 58.1-603 and 605 (West 2016) (stating that Virginia has a state sales tax of 4.3% and allows a local tax of up to 1%).

292. See S.C. DEP'T OF REV., *SALES AND USE TAX RATES OF SOUTH CAROLINA* (May 26, 2016), [https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427\\_05262016.pdf](https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427_05262016.pdf) (stating that South Carolina has a state sales tax of 6%, which is the combined rate for some counties); see also N.C. GEN. STAT. § 105-164.4(a) (2016) (stating that the state sales tax is 4.75%); N.C. DEP'T OF REV., *Sales and Use Rates Effective Oct. 1, 2016*, [http://dornc.com/taxes/sales/salesrates\\_10-16.html](http://dornc.com/taxes/sales/salesrates_10-16.html) (last visited Nov. 5, 2016) (stating that the lowest combined rate is 6.75%).

293. See N.C. GEN. STAT. § 105-164.4(a) (2016) (stating that the state sales tax is 4.75%); N.C. DEP'T OF REV., *supra* note 288 (stating that a 2.75% local sales tax is allowed in addition to the state tax, totaling 7.5% in N.C.); see also VA. CODE ANN. § 58.1-603 and 605 (West 2016) (stating that Virginia has a state sales tax of 4.3% and allows for a local tax of up to 1%); S.C. DEP'T OF REV., *SALES AND USE TAX RATES OF SOUTH CAROLINA* (May 26, 2016), [https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427\\_05262016.pdf](https://dor.sc.gov/tax-index/sales-and-use/Sales%20Notices/ST427_05262016.pdf) (stating that South Carolina has a state sales tax of 6%, which is the combined rate for some counties).

294. See Thomas Frohlich, *States with No Individual Income Tax*, USA TODAY (Mar. 19, 2016, 8:34 AM), <http://www.usatoday.com/story/money/personalfinance/2016/03/19/states-no-individual-income-tax/81965082/> (discussing how some states with no individual income tax have higher property taxes).

295. See Josh Barro, *The Inevitable, Indispensable Property Tax*, N.Y. TIMES (July 4, 2015), [http://www.nytimes.com/2015/07/05/business/the-inevitable-indispensable-property-tax.html?\\_r=0](http://www.nytimes.com/2015/07/05/business/the-inevitable-indispensable-property-tax.html?_r=0) (explaining that property taxes are “more progressive than sales tax[es]”).

296. See *About Sales Tax*, AMAZON <https://www.amazon.com/gp/help/customer/>

sales tax on items shipped to a majority of states, including North Carolina.<sup>297</sup>

## VI. CONCLUSION

North Carolina's updated Money Transmission Statute treats virtual currency as having monetary value for purposes of the Statute.<sup>298</sup> However, the State's tax code does not reflect this development.<sup>299</sup> Therefore, the state tax code needs to be updated so that individuals cannot use the current uncertainty surrounding virtual currency as a means of avoiding state taxes.

While the majority of states that have issued guidance have followed the Notice's approach and treat virtual currency as property under sales tax laws,<sup>300</sup> North Carolina should not take that approach. Instead, North Carolina should follow the Advertised Price Approach used by California and Washington because: (1) the federal treatment is fundamentally at odds with the recent efforts to simplify the tax code in North Carolina,<sup>301</sup> (2) the Advertised Price Approach would be a more

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display.html?nodeId=468512 (last visited Dec. 16, 2016) ("If an item is subject to sales tax in the state to which the order is shipped, tax is generally calculated on the total selling price of each individual item. In accordance with state tax laws, the total selling price of an item will generally include item-level shipping and handling charges, item-level discounts, gift-wrap charges, and an allocation of order-level shipping and handling charges and order-level discounts."); Leroy Baker, *Amazon Surprises by Starting North Carolina Sales Tax Collection*, TAX-NEWS (Jan. 23, 2014), [http://www.tax-news.com/news/Amazon\\_Surprises\\_By\\_Starting\\_North\\_Carolina\\_Sales\\_Tax\\_Collections\\_\\_\\_63445.html](http://www.tax-news.com/news/Amazon_Surprises_By_Starting_North_Carolina_Sales_Tax_Collections___63445.html) (stating that Amazon had agreed to collect sales taxes on N.C. residents). *See generally Quill Corp. v. North Dakota*, 112 S. Ct. 1904, 1913–14 (1992) (stating that a "corporation may have the "minimum contacts" with a taxing State as required by the Due Process Clause, and yet lack the "substantial nexus" with that State as required by the Commerce Clause") (holding that an online retailer must have a "physical presence" with a state to be required to collect sales taxes).

297. *See About Sales Tax*, AMAZON <https://www.amazon.com/gp/help/customer/display.html?nodeId=468512> (last visited Dec. 16, 2016).

298. N.C. GEN. STAT. § 53-208.41–64 (2016).

299. *Tax Navigator*, *supra* note 3 ("North Carolina does not address the tax treatment of Bitcoin or other virtual currency.").

300. KY. DEP'T OF REV., *supra* note 144; MICH. DEP'T OF TREAS., *supra* note 144; N.J. DEP'T OF TAXATION, *supra* note 144; N.Y. DEP'T OF TAXATION, *supra* note 144; WIS. DEP'T OF REV., *supra* note 144; CAL. BD. OF EQUALIZATION, *supra* note 159; WASH. DEP'T OF REV., *supra* note 159.

301. *See generally*, N.C. GEN. STAT. § 105-153.7 (2016) (highlighting that modular homes will now be taxed and the general sales tax rate); *see also* Binker, *supra* note 174 (discussing the change to a flat rate income tax and the shift away from preferential sales tax rates on certain goods and services).

accurate picture of the value of the item bought with virtual currency,<sup>302</sup> and (3) the Barter Approach would discourage innovation, because retailers would be incentivized to only accept the virtual currency with the greatest market share, which is currently Bitcoin.<sup>303</sup> It is notable that the Advertised Price Approach is used by states that are either home to or neighbors with Silicon Valley,<sup>304</sup> which suggests that the Advertised Price Approach is more attuned to the needs of the technology industry.<sup>305</sup> Given North Carolina's emphasis on technology in Research Triangle Park, it is reasonable for North Carolina to model its sales tax treatment after California.<sup>306</sup>

In addition, North Carolina should address the treatment of virtual currency for income tax purposes. Because of the de minimis

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302. See generally KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

303. See generally KY. DEP'T OF REV., *supra* note 144, at 1 (stating that the fair market value of bitcoin at the time of the transaction is the basis); MICH. DEP'T OF TREAS., *supra* note 144, at 2 (stating that a "taxpayer accepting virtual currency must also maintain documentation demonstrating the value of the virtual currency on the day and at the exact time of the transaction"); N.J. DEP'T OF TAXATION, *supra* note 144 (stating that retailers must record the dollar value amount of virtual currency at the time of the transaction); N.Y. DEP'T OF TAXATION, *supra* note 144, at 2 (stating that sales tax is "based on the market value of the convertible virtual currency at the time of the transaction, converted to U.S. dollars"); WIS. DEP'T OF REV., *supra* note 144 (stating that the sales tax basis is the fair market value on the day of the sale); CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept); Bajpai, *supra* note 40 (establishing that Bitcoin is the most popular form of virtual currency).

304. CAL. BD. OF EQUALIZATION, *supra* note 159 (stating that the advertised price is the basis for sales tax); WASH. DEP'T OF REV., *supra* note 159 (stating that the tax basis is the dollar value that the retailer would accept).

305. See generally *The Birth of Silicon Valley*, NPR (Apr. 4, 2012, 3:57 AM), <http://www.npr.org/2012/03/26/149404846/the-birth-of-silicon-valley> (establishing California's reputation for innovation).

306. See generally David Kroll, *7 Reasons Why It's Finally Time to Live in Research Triangle Park*, FORBES (Feb. 4, 2014, 9:00 AM), <http://www.forbes.com/sites/davidkroll/2014/02/04/7-reasons-its-finally-time-to-live-in-research-triangle-park/#7a35c0821410> (establishing N.C.'s emphasis on technology in Research Triangle Park).

exception<sup>307</sup> and simpler tax treatment for QBUs,<sup>308</sup> treating virtual currency the same as foreign currency for income tax purposes, rather than treating it as property per the Notice, makes sense in North Carolina.<sup>309</sup> Alternatively, repealing the state income tax and raising the state sales tax (with a possible increase in property taxes) would allow the state to prevent retailers and employees who are paid in virtual currency from decreasing their state income tax liability.

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307. I.R.C. § 988(e) (2015).

308. I.R.C. § 987; Antonikova, *supra* note 126, at 451.I

309. See I.R.S. Notice, *supra* note 22 (stating that virtual currency will be treated as property for federal tax purposes).

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