

# SCHRÖDINGER'S CURRENCY

## HOW VIRTUAL CURRENCIES COMPLICATE THE RIC AND REIT QUALIFICATION REQUIREMENTS

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### *Abstract*

*Bitcoin and other virtual currencies have created new opportunities for individuals to invest in a rapidly appreciating new asset class, but the Internal Revenue Code has been unable to keep pace with this new technology. Because the Code does not suitably define what a virtual currency is in the contexts of Regulated Investment Companies (RICs) or Real Estate Investment Trusts (REITs), the concepts of “good” income and “good” assets in I.R.C. §§ 851 (RICs) and 856 (REITs) are inapplicable to virtual currency. Under the current regime, a RIC or a REIT may not be able to invest directly in virtual currency without compromising the investment entity’s qualification as a tax-favorable pass-through entity.*

*The legislative purposes behind Sections 851 and 856 suggest that digital currency possesses the characteristics of “good” income and “good” assets. Accordingly, RICs and REITs should be able to invest in this potentially lucrative new technology without risking disqualification as a tax-favored entity because virtual currency could constitute a “security” for the purposes of Sections 851 and 856. Yet the Code’s RIC and REIT rules require that any qualifying security be registered under the Investment Company Act of 1940. Virtual currency is not yet regulated under the 1940 Act, and thus cannot qualify as a security for the purposes of the RIC and REIT “good” income and “good” asset tests.*

*The inability of the Code and the '40 Act to adapt to new technology makes virtual currency a nonviable investment for RICs and REITs, but even more so, renders the unyielding nexus between the '40 Act and Code Sections 851 and 856 nonsensical. The I.R.C. must somehow provide for the possibility of RIC or REIT investment in a non-1940 Act security, while avoiding the significant non-tax consequences attendant with a sweeping classification of all virtual currency as securities. The Investment Company Act of 1940 should supplement—not comprise—the tax rules that define the kinds of income and assets that allow an entity to qualify as a RIC or a REIT.*

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\*Columbia Law School, J.D. Candidate 2018. Many thanks to Professor Willard Taylor for his advice and expertise, as well as Aaron Josephson, Jisoo Han, Zhiyuan Zuo, and the editorial staff of the Columbia Journal of Tax Law.

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## I. INTRODUCTION

Internal Revenue Code (hereinafter “I.R.C.” or “the Code”) provisions governing Regulated Investment Companies (RICs) or “mutual funds” predate the internet by nearly half a century.<sup>1</sup> The Investment Company Act of 1940 (hereinafter “the ‘40 Act”) followed four years thereafter.<sup>2</sup> Twenty years later, I.R.C. § 856 was added;<sup>3</sup> it contains very similar qualification requirements to Section 851 but is only applicable to investments in Real Estate Investment Trusts (REITs). Computers were in their infancy when RICs and REITs changed the way individuals invested. At that time, no one could have predicted the impact the internet would have on the world.

Even more recently, virtual currency has emerged as a lucrative new way for individuals to invest their real-world cash, but tax policy has not caught up. In 2014, the Internal Revenue Service (hereinafter “the Service” or “the IRS”) declared that virtual currency will be treated as property—not currency—for federal income tax purposes.<sup>4</sup> Other administrative agencies have taken a markedly different stance, classifying virtual currency as a commodity,<sup>5</sup> or a security,<sup>6</sup> although the Securities and Exchange Commission (SEC) has not yet taken a public position on the regulation of virtual currency.<sup>7</sup> None of these characterizations adequately define virtual currency for the RIC or REIT context. The Code does not yet allow a security which is not regulated by the ‘40 Act to constitute a security for the purposes of the RIC or REIT qualification requirements. To qualify as a tax-favored RIC or REIT, (1) the entity must derive a high percentage of its income from certain enumerated sources (hereinafter “good” income),<sup>8</sup> and (2) a certain percentage of its assets must be represented by cash, securities, and, in the case of REITs, real estate (hereinafter “good” assets).<sup>9</sup>

This paper explores the origin and justification of the “good” income and “good” asset qualification requirements or “tests.” The tests’ complete dependence on the ‘40 Act to classify qualifying securities can hinder the Service’s ability to adjust the tax rules to technological advancements. The paradigm should be driven by the Service’s classification of securities and other income and assets, wherein the ‘40 Act supplements the Code’s RIC and REIT qualification requirements but does not dictate them. As new technologies manifest, the Service will be able to address them quickly, thereby fostering investment in new technologies without the confusion or abuse attendant when technological advancements and the Tax Code collide.<sup>10</sup>

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<sup>1</sup> Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648, 1669 (1936). Oliver Burkeman, *Forty years of the internet: how the world changed for ever*, THE GUARDIAN (Oct. 23, 2009), <https://www.theguardian.com/technology/2009/oct/23/internet-40-history-arpanet> [<https://perma.cc/H94W-K4NH>].

<sup>2</sup> Internal Revenue Code of 1954, Pub. L. No. 83-591, § 851, 68A Stat. 3, 268 (1954).

<sup>3</sup> Act of Sept. 14, 1960, Pub. L. No. 86-779, § 10(a), 74 Stat. 998, 1004 (1960).

<sup>4</sup> I.R.S. Notice 2014-21, 2014-16 C.B. 938, 938.

<sup>5</sup> In re Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015).

<sup>6</sup> SEC v. Shavers, No. 13-416, 2013 U.S. Dist. LEXIS 110018, at \*5 (E.D. Tex. Aug. 6, 2013) (finding that “Bitcoin is a currency or form of money.”).

<sup>7</sup> Jeffrey E. Alberts & Bertrand Fry, *Is Bitcoin a Security?*, 21 B.U. J. SCI. & TECH. L. 1, 2 (2015).

<sup>8</sup> I.R.C. §§ 851(b)(2), 856(c)(2) and (3).

<sup>9</sup> I.R.C. §§ 851(b)(3), 856(c)(4).

<sup>10</sup> See, e.g., Harvey J. Shulman, *Our Low-Tech Tax Code*, THE WALL STREET J., Feb. 21, 2010, at WK8; News Release, Information Technology Industry Council, After E.U. Tax Proposal, Tech Industry Calls for Modernization of U.S. Tax Code (Sept. 21, 2017), <https://www.itic.org/news-events/news->

## II. BACKGROUND

This section describes what virtual currency is and how investors use it. It also provides a brief overview of the RIC and REIT qualification requirements.

### A. Virtual Currency

Virtual currency (also called digital currency or cryptocurrency) is an online token designed to function as a unit of value or vehicle for exchange. Although digital currency has been discussed in anti-regulation circles since the inception of the internet,<sup>11</sup> digital currencies emerged in the mid-2000s as a closed-flow trading mechanism in the context of online, virtual world, role-playing games.<sup>12</sup> The money was not real, but the exchanges had real-world value to serious players in these virtual worlds. Sales of virtual currency for cash emerged as a lucrative (albeit illicit) way for players to gain an in-game advantage, while others seized the opportunity to line their pockets with real currency, tax-free.<sup>13</sup>

As virtual currency and real-world currency mixed, businesses seized the opportunity to accept this highly popular yet unregulated currency.<sup>14</sup> Before long, reality's first standalone, open-flow virtual currency—Bitcoin<sup>15</sup>—became available to the public.<sup>16</sup> Shortly thereafter, multiple new digital currencies emerged. Currently, there are seven different virtual currencies of prominence, including Bitcoin, Litecoin, Ethereum, Zcash, Dash, Ripple, and Monero.<sup>17</sup> As of April 2018, there were over 1,500 virtual currencies available to the public, doubling the number of currencies available one year

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releases/after-e-u-tax-proposal-tech-industry-calls-for-modernization-of-u-s-tax-code [https://perma.cc/223Q-ZPLN].

<sup>11</sup> Nicolas Wenker, *Online Currencies, Real-World Chaos: The Struggle to Regulate the Rise of Bitcoin*, 19 TEX. REV. L. & POL. 145, 147-49 (2016).

<sup>12</sup> See, e.g., GEFORCE, *Description*, <https://www.geforce.com/games-applications/pc-games/world-of-warcraft/description> (last visited Feb. 9, 2018) [https://perma.cc/P8J2-NPKM] (“World of Warcraft® is an online role-playing experience set in the award-winning Warcraft universe.”); LINDEN LABS, *About Linden Lab*, <https://www.lindenlab.com/about> (last visited Feb. 9, 2018) [https://perma.cc/S3WP-YSNG] (Second Life is “the pioneering virtual world that’s been enjoyed by millions of people and seen billions of dollars transacted among users in its economy.”). For a description of how players interact with these games, see Byron M. Huang, *Walking the Thirteenth Floor: The Taxation of Virtual Economies*, 17 YALE J.L. & TECH. 224 (2015).

<sup>13</sup> Adam Chodorow, *Rethinking Basis in the Age of Virtual Currencies*, 36 VA. TAX REV. 371, 376 (2017). For a description of how “virtual worlds” work, see Leandra Lederman, “Stranger than Fiction”: *Taxing Virtual Worlds*, 82 N.Y.U. L. REV. 1620, 1621-23 (2007).

<sup>14</sup> Lederman, *supra* note 13, at 1667 n.235; Stephen Totilo, *Finally, You Can Buy Something Real with Play Money*, MTV (Jan. 19, 2006), <http://www.mtv.com/news/1521239/finally-you-can-buy-something-real-with-play-money/> [https://perma.cc/DT6D-VV5S]; Joshua Davis, *The Crypto-Currency*, THE NEW YORKER (Oct. 10, 2011), at 68 (the author was the first person to pay in bitcoins at a Howard Johnson Hotel in Fullerton, California).

<sup>15</sup> Bitcoin (with a capital “B”) denotes the Bitcoin network that generates bitcoins (the currency, denoted by a lower-case “b”) and facilitates transactions. See Alyson, *Drawing the distinction between the uppercase “B” and lowercase “b” in Bitcoin*, BLOCKCHAIN BLOG (Dec. 29, 2014), <https://blog.blockchain.com/2014/12/29/drawing-the-distinction-between-the-uppercase-b-and-lowercase-b-in-bitcoin/> [https://perma.cc/HNK3-MVDJ].

<sup>16</sup> Wenker, *supra* note 11, at 146, 149.

<sup>17</sup> Prableen Bajpai, *The 6 Most Important Cryptocurrencies Other Than Bitcoin*, INVESTOPEDIA (Dec. 7, 2017), <http://www.investopedia.com/tech/6-most-important-cryptocurrencies-other-bitcoin/> [https://perma.cc/9X46-798H].

prior.<sup>18</sup> As of the time of publication in April 2018, Bitcoin holds the lion's share of the market at around 42.2% followed by Ethereum with 15.7%.<sup>19</sup>

### 1. *Virtual Currency User Considerations*

A functional open-flow digital currency must (1) tightly regulate the supply available to the public, and (2) ensure that the same coin is not double-spent.<sup>20</sup> Accordingly, all virtual currency consists of proprietary systems that simultaneously verify coin ownership and monitor transactions while retaining complete anonymity of ownership.<sup>21</sup> Beyond their operations, there are features universal to virtual currencies that may make them appealing to individuals:

- Transacting with virtual currency is simple, fast, and free. It takes minutes to create an account. In most cases, there are no transaction fees because there is no intermediary in the transactions.<sup>22</sup>
- International transactions take only a few minutes, whereas banks may take several weeks.<sup>23</sup>
- Transactions are simultaneously secret and public. Anonymized transactions are meticulously recorded in a publicly available ledger.<sup>24</sup>

But there are also very real risks of investing in or using virtual currency. Because Bitcoin is the oldest and most widely used of the virtual currencies, its fraught history best illustrates these risks. First, virtual currency has been unstable since its inception.<sup>25</sup> For much of 2010, bitcoins were valued around 6¢ each.<sup>26</sup> Three years later, bitcoins were trading at \$1,200. Three years after that, in 2016, the value decreased to around \$600. On December 7, 2017, the value skyrocketed to \$17,000 before dropping

<sup>18</sup> Elena Eyber, *The Rise and Regulation of Virtual Currency*, WOLTERS KLUWER: TAX & ACCOUNTING BLOG (Jan. 23, 2017), <http://news.cchgroup.com/2017/01/23/rise-regulation-virtual-currency/> [<https://perma.cc/R6UX-X9ZH>]; *Cryptocurrency Market Capitalizations*, <https://coinmarketcap.com/all/views/all/> [<https://perma.cc/9AWA-VZNB>] (last visited Apr. 13, 2018).

<sup>19</sup> *Cryptocurrency Market Capitalizations*, *supra* note 18 (last visited Apr. 13, 2018).

<sup>20</sup> Chodorow, *supra* note 13, at 376; Alberts & Fry, *supra* note 7, at 3.

<sup>21</sup> Chodorow, *supra* note 13, at 376. R. Joseph Cook, *Bitcoins: Technological Innovation or Emerging Threat?*, 30 J. MARSHALL J. INFO. TECH. & PRIVACY L. 535, 538 (2014) (“[a]lthough other types of DVCs [decentralized virtual currencies] exist, Bitcoin was the pioneer for decentralized currency, and many other DVCs are modeled on the same or similar principles.”).

<sup>22</sup> At a 2014 hearing before the House Committee on Small Business, Jerry Brito, a Senior Research Fellow with the Mercatus Center at George Mason University, testified that the “decentralized nature [of Bitcoin] results in lower transaction costs...because there is no central intermediary in Bitcoin transactions, fees associated with those transactions are relatively small” as compared with credit card fees. Jerry Brito, *Benefits and Risks of Bitcoin for Small Business*, HOUSE OF REP. SMALL BUS. COMM., 1-2 (Apr. 2, 2014), [https://smallbusiness.house.gov/uploadedfiles/4-2-2014\\_brito\\_total\\_final\\_testimony.pdf](https://smallbusiness.house.gov/uploadedfiles/4-2-2014_brito_total_final_testimony.pdf) [<https://perma.cc/V7FA-EQX2>].

<sup>23</sup> Eyber, *supra* note 18.

<sup>24</sup> Chodorow, *supra* note 13, at 377.

<sup>25</sup> See, e.g., SEC. & EXCH. COMM'N (SEC), OFFICE OF INVESTOR EDUC. & ADVOCACY (SEC), *Investor Alert: Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014), [https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia\\_bitcoin.html](https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html) [<https://perma.cc/574Z-7MRG>]; FIN. INDUS. REGULATORY AUTH. (FINRA), *Investor Alerts – Bitcoin: More than a Bit Risky*, <http://www.finra.org/investors/alerts/bitcoin-more-bit-risky> [<https://perma.cc/L7JV-FSD9>].

<sup>26</sup> Damian Davila, *If You Had Purchased \$100 of Bitcoin in 2011*, INVESTOPEDIA, <https://www.investopedia.com/articles/investing/123015/if-you-had-purchased-100-bitcoins-2011.asp> [<http://perma.cc/6ED7-4CM7>] (last updated May 2, 2017, 9:25 AM).

below \$14,000 48 hours later.<sup>27</sup> Some think that the value is volatile because the technology is new and still exchanged in low volumes. As more businesses and individuals adopt it and the technology becomes more ubiquitous, the instability is expected to subside.<sup>28</sup> Still, some prominent financial experts believe that Bitcoin is currently experiencing a bubble, and its value will plummet.<sup>29</sup>

In addition, the anonymity that makes virtual currency appealing to some can also support its use for illegal activity.<sup>30</sup> For example, patrons of the Silk Road, a now-shuttered secret online marketplace for drugs, illegal services, and forged documents, could only conduct their illegal transactions using bitcoin.<sup>31</sup> Virtual currency is also associated with tax evasion.<sup>32</sup> Libertarian bitcoin user Roger Ver (a.k.a. “Bitcoin Jesus”) purchased St. Kitts citizenship, transferred his fortune to the tax haven via bitcoin (thereby evading the Foreign Account Tax Compliance Act) and then renounced his American citizenship.<sup>33</sup> He and others have succeeded in this scheme because the regulations that limit money transfers to foreign jurisdictions do not yet apply to virtual currency.<sup>34</sup> If the government decides to regulate virtual currency transactions more closely in the future, such transactions may be subject to greater scrutiny than standard cash or securities transactions.<sup>35</sup>

<sup>27</sup> Renae Merle, *Bitcoin soars above \$17,000, boosting worries and a worldwide frenzy*, WASH. POST (Dec. 7, 2017), [http://wapo.st/2iEuh7q?tid=ss\\_mail&utm\\_term=.eecd3bb4605](http://wapo.st/2iEuh7q?tid=ss_mail&utm_term=.eecd3bb4605) [<http://perma.cc/K7WJ-WLVD>]; Will Martin, *Bitcoin is getting pounded after a wild week of gains*, BUS. INSIDER (Dec. 8, 2017), <http://www.businessinsider.com/bitcoin-is-finally-falling-friday-december-8-2017-12> [<https://perma.cc/5JV7-M4EB>].

<sup>28</sup> E.g. Brito, *supra* note 22, at 3 (“[T]here is nothing inherent in Bitcoin’s design that makes it naturally volatile. Its volatility is likely attributable to the fact that it is a new currency, still in the process of discovering its stable price.”).

<sup>29</sup> See, e.g., John Wasik, *Why Buffett Sees Bitcoin Bubble*, FORBES (Nov. 6, 2017), <https://www.forbes.com/sites/johnwasik/2017/11/06/why-buffett-sees-bitcoin-bubble/#25f0bcc662a8> [<http://perma.cc/UPJ8-SXHJ>]; Jeremy G. Phillips, *What Jamie Dimon Is Missing About Bitcoin*, N.Y. TIMES DEALBOOK (Sept. 18, 2017), <https://nyti.ms/2y8MkrU>; Kevin Roose, *Such Currency. Much Risk.*, N.Y. TIMES, Sept. 16, 2017, at B1.

<sup>30</sup> FINRA, *supra* note 25. See also Omri Marian, *A Conceptual Framework for the Regulation of Cryptocurrencies*, 82 U. CHI. L. REV. 53 (2017); Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 206 (2011).

<sup>31</sup> See *United States v. Ulbricht*, 31 F. Supp. 3d 540, 547 (S.D.N.Y. 2013) (No. 13–6919); Joseph Goldstein, *Arrest in U.S. Shuts Down a Black Market for Narcotics*, N.Y. TIMES, Oct. 3, 2013, at A3; Cook, *supra* note 21, at 557.

<sup>32</sup> Craig W. Smalley, *Cryptocurrency and taxes*, THE TAX ADVISER (Apr. 20, 2017), <https://www.thetaxadviser.com/newsletters/2017/apr/cryptocurrency-taxes.html> [<http://perma.cc/LU5D-8SWG>] (“[i]n response to the possibility that cryptocurrency users could be using their accounts for illicit activities or to evade tax, the IRS issued a John Doe summons to Coinbase [a Bitcoin exchange] asking for information about all of its customers from Jan. 1, 2013, to Dec. 31, 2015. According to the IRS, in a filing in support of the summons request, an IRS agent attested to the fact that he had uncovered two taxpayers who admitted that they disguised the amounts they spent purchasing bitcoins as deductible technology expenses.”); Kelly Phillips Erb, *IRS Wants Court Authority To Identify Bitcoin Users & Transactions At Coinbase*, FORBES (Nov. 21, 2016), <https://www.forbes.com/sites/kellyphillipserb/2016/11/21/irs-wants-court-authority-to-identify-bitcoin-users-transactions-at-coinbase/#4830db7d5979> [<http://perma.cc/FR47-XGWC>]; Richard Holden & Anup Malani, *Why the I.R.S. Fears Bitcoin*, N.Y. TIMES, Jan. 23, 2018, at A25.

<sup>33</sup> Jason Clenfield & Pavel Alpeyev, *‘Bitcoin Jesus’ promises a virtual paradise*, WASH. POST (June 20, 2014), [http://wapo.st/1lGo6wF?tid=ss\\_mail&utm\\_term=.87df80bf493e](http://wapo.st/1lGo6wF?tid=ss_mail&utm_term=.87df80bf493e) [<http://perma.cc/39PJ-GLGL>]; Eyber, *supra* note 18.

<sup>34</sup> Eyber, *supra* note 18.

<sup>35</sup> The SEC monitors “for potential securities law violations related to virtual currencies.” *Id.*

Finally, investments in Bitcoin are risky because the system can be hacked.<sup>36</sup> In 2014, Mt. Gox, a Japanese Bitcoin exchange, collapsed when hackers absconded with \$460 million of bitcoin.<sup>37</sup> Because there was no financial institution backing the currency, users were unable to recover those losses.<sup>38</sup> Such hacks cause the trading value of Bitcoin to plummet, which impacts users who were not direct victims of the hack.<sup>39</sup>

Despite these risks, financial mavericks have used virtual currency to create new investment opportunities. For example, in 2014, twin entrepreneurs Cameron and Tyler Winklevoss sought SEC approval to create a Bitcoin Exchange-Traded Fund (ETF).<sup>40</sup> In 2017, however, the SEC thwarted two new attempts to create Bitcoin ETFs, citing the threat to investors inherent in the unregulated currency.<sup>41</sup> Hedge funds that primarily operate in bitcoin have also embraced the volatility of virtual currency.<sup>42</sup>

## 2. Bitcoin Transactions

A bitcoin is a virtual token with a fair market cash value that can be transmitted from one user to another via the internet. Bitcoins were first made publicly available in 2009 as an “alternative currency” that needs neither a bank nor governmental regulation to operate.<sup>43</sup> In fact, former chair of the Federal Reserve System Janet Yellen called digital currency “entirely outside the banking industry” in a 2014 Senate Banking Committee hearing.<sup>44</sup> According to Yellen, the Federal Reserve cannot and will not regulate virtual currency.<sup>45</sup>

There are three ways for an individual to get bitcoins. First, they can be purchased for cash, either directly from Bitcoin or through a company that sells bitcoins to users through a specialized account (similar to a traditional bank account).<sup>46</sup> Bitcoin also has ATMs throughout the United States and abroad, where a user can exchange cash for bitcoins. As of April 13, 2018, there are 2,743 Bitcoin ATMs globally, including

<sup>36</sup> FINRA, *supra* note 25.

<sup>37</sup> Eyber, *supra* note 18; SEC, *supra* note 25.

<sup>38</sup> Anthony Volastro, *CNBC Explains: How to mine bitcoins on your own*, CNBC (Jan. 23, 2014), <https://www.cnbc.com/2014/01/23/cnbc-explains-how-to-mine-bitcoins-on-your-own.html> [<http://perma.cc/2APP-RH7N>].

<sup>39</sup> E.g. “A major Bitcoin exchange, Bitfinex, was hacked and nearly 120,000 Bitcoins, worth \$65 million, were stolen in August 2016. Bitcoin value crashed, and Bitfinex was forced to temporarily suspend its trading.” Eyber, *supra* note 18.

<sup>40</sup> Wenker, *supra* note 11, at 180.

<sup>41</sup> Allan Eberhart, *SEC Rejects Bitcoin ETFs: Should You Reject Bitcoin Investments?*, FORBES (Apr. 6, 2017), <https://www.forbes.com/sites/allaneberhart/2017/04/06/sec-rejects-bitcoin-etfs-should-you-reject-bitcoin-investments/#e5eacab79bd4> [<http://perma.cc/WA5D-B9RH>]; Paul Vigna & Alexander Osipovich, *ETFs: SEC Gives Second Bitcoin Fund a Thumbs-Down*, THE WALL STREET J., Mar. 29, 2017, at B15.

<sup>42</sup> Wenker, *supra* note 11, at 180; Andrew Osterland, *As bitcoin soars and ICOs spread, advisors urge caution*, CNBC (Nov. 13, 2017), <https://www.cnbc.com/2017/11/13/as-bitcoin-soars-and-icos-spread-advisors-urge-caution.html> [<http://perma.cc/M5LN-ERY6>].

<sup>43</sup> Grinberg, *supra* note 30, at 206; Chodorow, *supra* note 13, at 378.

<sup>44</sup> Eyber, *supra* note 18; Paul Davidson, *Yellen: Fed can't regulate Bitcoin*, USA TODAY (Feb. 27, 2014), <http://usat.ly/1fusExe> [<http://perma.cc/29FK-DCJ7>].

<sup>45</sup> Eyber, *supra* note 18.

<sup>46</sup> Nathaniel Popper, *Bitcoin Basics: Why Hackers Demand It and How It Works*, N.Y. TIMES, May 16, 2017, at A8.

1,760 in the United States.<sup>47</sup> Second, like cash, bitcoins can be exchanged for goods and services. Third, a user can generate new bitcoins via a “mining” process—akin to striking virtual gold.

A Bitcoin transaction has three components: (1) “the input”—the Bitcoin address that originally transmitted the bitcoins to the transferor; (2) the number of bitcoins being transferred in the transaction at-issue; and (3) “the output”—the transferee’s individual Bitcoin address.<sup>48</sup> Because bitcoins are solely “entries on [the Bitcoin ledger] and do not exist outside of it,” each bitcoin transfer depends on the transfer that preceded it, the one that resulted in the transferor’s ownership of the bitcoin that it now seeks to transfer.<sup>49</sup> When a user undertakes a bitcoin transaction, the network must verify that the transferor actually owns the transferred bitcoins, and that the same coin is not “double-spent” by being transferred to multiple transferees.<sup>50</sup> Accordingly, Bitcoin has developed a proprietary transaction verification system called “the block chain.” Multiple transactions are grouped into “blocks.” When grouped together, these blocks create the block chain, a decentralized,<sup>51</sup> permanent public ledger.<sup>52</sup> This block chain records the details of every transfer that has ever been completed on the Bitcoin network. Users on the Bitcoin network run software to solve complex algorithms associated with a block of transactions to verify new bitcoin transactions that enter the network. This verification process ensures that the transferor has enough bitcoins in his or her wallet to complete the transaction, and that none of those coins are double-spent. The first miner to solve the algorithm receives a reward in bitcoins, which are generated specifically to reward that user for verifying the transaction. Once the transaction has been verified and consummated, the transferee owns the received bitcoins, and the miners receive their bitcoin reward. The new bitcoins are affiliated with the user who solved the algorithm, the verified transactions are recorded on the block chain, and the process repeats as new transactions enter the network.

By verifying and recording bitcoin transfers on the block chain, members of the public generate more bitcoins. At the same time, public maintenance of the block chain protects it from fraud and corruption, and “obviates the need for third party intermediaries, such as banks.”<sup>53</sup> Despite this very public verification, monitoring, and recording system, bitcoin transfers are completely anonymous. Each bitcoin user has a file called a digital wallet, which contains public keys and private keys. A public key is

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<sup>47</sup> COIN ATM RADAR, *Bitcoin ATM Industry Statistics / Charts*, <https://coinatmradar.com/charts> [<https://perma.cc/L3EX-PT2D>] (last visited Apr. 13, 2018); COIN ATM RADAR, *Bitcoin ATMs in the United States*, <https://coinatmradar.com/country/226/bitcoin-atm-united-states> [<https://perma.cc/2EQL-NJS4>] (last visited Apr. 13, 2018).

<sup>48</sup> Eyber, *supra* note 18.

<sup>49</sup> *Id.*

<sup>50</sup> Wenker, *supra* note 11, at 149 (“[b]ecause any digital currency is essentially just computer code, it is easy to reproduce via mechanisms such as copying and pasting”) (citing Morgen E. Peck, *Bitcoin: The Cryptoanarchists’ Answer to Cash*, IEEE SPECTRUM (May 30, 2012), <http://spectrtrm.ieee.org/computing/software/bitcoin-the-cryptoanarchiss-answer-to-cash> [<https://perma.cc/L2AT-52AP>]).

<sup>51</sup> “It is decentralized because it is powered by its users rather than any central authority.” Alberts & Fry, *supra* note 7, at 2-3.

<sup>52</sup> Kevin Petrasic & Matthew Bornfreund, *Beyond Bitcoin: The blockchain revolution in financial services*, WHITE & CASE LLP (Mar. 7, 2016), <https://www.whitecase.com/publications/insight/beyond-bitcoin-blockchain-revolution-financial-services> [<http://perma.cc/FGT9-TVFQ>].

<sup>53</sup> Chodorow, *supra* note 13, at 377.



recorded on the block chain whenever the user associated with that public key receives a bitcoin transfer, although it does not identify the owner of the wallet. The private key is used to make transfers from the digital wallet. Each Bitcoin user has both a public and a private key to control the transfer of bitcoins in and out of the digital wallet.<sup>54</sup>

Each transaction associates a certain number of bitcoins with at least one public key. To the recipient, those bitcoins are bundled in the amounts in which they came into the wallet. In other words, unlike in a regular wallet where all the cash is assembled in one pocket, transactions in a Bitcoin wallet remain separate transactions and are assembled in the wallet in the bundles in which they were received. For example, when someone receives a \$10 bill in one transaction, and \$1 in another transaction, and puts both bills in their wallet, they have \$11 dollars. If someone receives 10 bitcoins in one transaction and 1 bitcoin in another transaction, they do not have 11 bitcoins, they have one bundle of 10 bitcoins in their wallet, and another bundle of 1 bitcoin. When the owner wants to send bitcoins, the wallet will recruit those bundles of bitcoins in the wallet that add up to or exceed the amount being transferred. If the transaction bundles in the wallet do not add up exactly to the amount being sent, the sender must send more bitcoins than necessary and collect the difference as change.<sup>55</sup> These bundled bitcoins which are recruited to fulfill a new transfer are collectively called the “Bitcoin address.”

### 3. *The Value of Bitcoin*

Although it takes nearly two million attempts to solve the algorithm and unlock new bitcoins, a reward of 12.5 bitcoins is issued approximately every ten minutes.<sup>56</sup> To control bitcoin production, the reward is halved every four years, and the algorithm to create them becomes increasingly complex. This process was created “to mimic the production rate of a commodity such as gold.”<sup>57</sup> As of April 2018, there are nearly 17 million bitcoins in circulation.<sup>58</sup> Bitcoin will stop issuing new currency when it has issued exactly 21 million bitcoins. It is estimated that the final bitcoin will be generated around the year 2140.<sup>59</sup> As of the time of publication in April 2018, bitcoins were valued at around \$8,117 each, for a total valuation of nearly \$138 billion.<sup>60</sup>

### 4. *How Bitcoin Is Used*

As major retailers begin to accept bitcoin, some users treat bitcoin like cash to purchase goods and services. Businesses typically “convert the bitcoins to U.S. dollars upon receipt.”<sup>61</sup> Other users purchase bitcoins as an investment. Bitcoin has been publicly

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<sup>54</sup> Eyber, *supra* note 18.

<sup>55</sup> *Id.*

<sup>56</sup> Volastro, *supra* note 38.

<sup>57</sup> Eyber, *supra* note 18.

<sup>58</sup> *Bitcoin Price Index Chart*, COINDESK, <http://www.coindesk.com/price/> [https://perma.cc/7NN6-NNPV] (last visited Apr. 13, 2018).

<sup>59</sup> Volastro, *supra* note 38.

<sup>60</sup> For the current Bitcoin valuation, see *Bitcoin Price Index Chart*, *supra* note 58.

<sup>61</sup> Chodorow, *supra* note 13, at 378.

traded since the first Bitcoin exchange opened in Canada in 2015.<sup>62</sup> Other countries, including the United States' New York Stock Exchange, quickly followed suit.<sup>63</sup>

Beyond currency, other institutions have considered using Bitcoin's underlying blockchain technology in different ways. The online retailer Overstock.com plans to use blockchain technology to record and track company stock ownership.<sup>64</sup> Goldman Sachs is developing a "virtual transfer system" based on the block chain which "could be used to record all kinds of transfers of financial assets."<sup>65</sup> Other financial institutions are exploring alternative uses for a block chain to cheaply, efficiently, accurately, and securely "document the transfer of any digital asset, record the ownership of physical and intellectual property, and establish rights through smart contracts, among other applications."<sup>66</sup>

### 5. Tax Treatment

Although virtual currency is becoming increasingly popular, whether it ultimately ends up as a favored currency may depend on the extent to which the government regulates its uses and scrutinizes transactions, as well as how the Internal Revenue Service decides to treat it for tax purposes. Based on the way digital currency is used, and the way the American tax system taxes accessions to wealth, those who receive virtual currency in exchange for goods or services should pay income tax on the value of the currency received. Similarly, those who invest in virtual currency like securities should be taxed on any gains in the value of that currency when it is sold and converted to cash.

The Service has been grappling with virtual currency since as early as 2007 when its Electronic Business and Emerging Issues group made efforts to understand possible compliance issues inherent in the use of virtual currency.<sup>67</sup> It concluded that digital currency may enable malicious users to underreport their income from virtual transactions. It developed "a potential compliance strategy" and a plan of action, both of which necessitated further study of the industry and compliance trends.<sup>68</sup> The resource-strapped Service ultimately dropped the action plan in favor of "other higher priority needs," but continued to study compliance trends.<sup>69</sup> It concluded that the risk of tax

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<sup>62</sup> Diana Ngo, *QuadrigaCX to Become World's First Publicly Traded Bitcoin Exchange*, COINTELEGRAPH (Mar. 4, 2015), <https://cointelegraph.com/news/quadrigacx-to-become-worlds-first-publicly-traded-bitcoin-exchange> [http://perma.cc/4T5E-VKG9].

<sup>63</sup> Michael J. Casey, *Bitcoin Swaps Exchange Gets Public Listing Via Reverse Merger*, THE WALL STREET J. (Feb. 27, 2015, 7:18 PM), <https://blogs.wsj.com/moneybeat/2015/02/27/bitcoin-swaps-exchange-gets-public-listing-via-reverse-merger/>; Yessi Bello Perez, *New York Stock Exchange Launches Bitcoin Price Index*, COINDESK (May 19, 2015), <https://www.coindesk.com/new-york-stock-exchange-launches-bitcoin-price-index/> [http://perma.cc/SE33-RK8F].

<sup>64</sup> Cade Metz, *Overstock Files to Offer Stock That Works Like Bitcoin*, WIRED (Apr. 27, 2015), <https://www.wired.com/2015/04/overstock-files-offer-stock-works-like-Bitcoin/> [http://perma.cc/C3WW-6FDW].

<sup>65</sup> Chodorow, *supra* note 13, at 379 (citing Ian Kar, *Goldman Sachs wants to create its own version of bitcoin*, QUARTZ (Dec. 2, 2015), <https://qz.com/563967/goldman-sachs-wants-to-create-its-own-version-of-bitcoin/> [http://perma.cc/8HM9-798K]); Petrasic & Bornfreund, *supra* note 52.

<sup>66</sup> Petrasic & Bornfreund, *supra* note 52.

<sup>67</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES – ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS 15 (2013) [hereinafter GAO Report].

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

evasion or non-compliance was minimal given the very few U.S. taxpayers using virtual currency at that time.<sup>70</sup>

In 2009—the year that Bitcoin became publicly available—the Service first published taxpayer guidance concerning the tax consequences of transactions in virtual currency.<sup>71</sup> The guidance maintains that taxpayers may be required to report gains from transactions in virtual currency as taxable income. It equated such transactions with “bartering, gambling, business, and hobby income,” and provided information about prior IRS guidance on those issues.<sup>72</sup> As Bitcoin gained popularity, the Service’s regime became unworkable and the Government Accountability Office (GAO) weighed in. In 2013, it issued a report discussing the tax compliance risks attendant with virtual currencies, including: taxpayer ignorance that accessions to wealth are taxable, the ambiguous character of income or basis for gains from digital currency, third-party reporting requirements, and outright evasion.<sup>73</sup> It called on the Service to issue new, informal guidance to address the risks it identified.

The IRS satisfied the GAO’s recommendation the following year. In Notice 2014-21 the IRS issued its public position on the taxation of any kind of virtual currency that can be converted into cash. It noted that virtual currency “does not have legal tender status in any jurisdiction” in spite of its similarities to “‘real’ currency,” which it defines as “the coin and paper money of the United States or of any other country that is designated as legal tender.”<sup>74</sup> Accordingly, the Service declined to treat virtual currency as a foreign currency for tax purposes.<sup>75</sup> Instead, it would be treated as property.<sup>76</sup> Upon sale or exchange of virtual currency, the “character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.”<sup>77</sup> This definition prevents whipsaw wherein taxpayers would treat virtual currency like an asset when it appreciates by claiming a capital gain, but claiming an ordinary loss when it depreciates.<sup>78</sup>

Pro-virtual currency commentators balked at the Service’s stance. They believed that taxing the currency based on its fair market value on the date of receipt destroyed the fungibility that made it an appealing alternative to cash.<sup>79</sup> In addition, suddenly virtual

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*; INTERNAL REVENUE SERVICE, *Tax Consequences of Virtual World Transactions*, <https://www.irs.gov/businesses/small-businesses-self-employed/tax-consequences-of-virtual-world-transactions> [<https://perma.cc/7FCC-X453>] (last updated Mar. 21, 2018).

<sup>72</sup> GAO Report, *supra* note 67, at 15.

<sup>73</sup> *Id.* at 12-15.

<sup>74</sup> I.R.S. Notice 2014-21, *supra* note 4, at 938.

<sup>75</sup> *But see* U.S. DEP’T OF TREASURY FIN. CRIMES ENFORCEMENT NETWORK, FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (Mar. 18, 2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf> [<http://perma.cc/JNZ9-ZR77>] (classifying virtual currency as a currency); Cook, *supra* note 21, at 545.

<sup>76</sup> I.R.S. Notice 2014-21, *supra* note 4, at 938.

<sup>77</sup> *Id.* at 939.

<sup>78</sup> Victor Fleischer, *Taxes Won’t Kill Bitcoin, but Tax Reporting Might*, N.Y. TIMES DEALBOOK (Mar. 26, 2014), <https://nyti.ms/2kpf8uF> [<https://perma.cc/EAQ8-DFMS>].

<sup>79</sup> Chodorow, *supra* note 13, at 380. Under a capital gains tax, users must record when different coins were acquired in order to determine whether its basis made the new transaction tax-efficient. If the fair market value of the goods, services, or face value of cash exchanged for virtual currency exceeds the coin’s basis in the transferor’s hands, the transferor has taxable gain. If the basis exceeds the fair market value, the transferor has a loss. Under the Service’s rule, a transferor would be incentivized to exchange high basis coins in order to minimize the taxable gain or maximize the deductible loss, thereby reducing their taxable

currency users could be subject to tax every time they conducted a transaction. Because of the potential tax consequences of inattentive virtual currency usage, virtual currency would lose its appeal to taxpayers.<sup>80</sup> More optimistic commentators view this preference as a business opportunity: “developers may provide ‘instant conversion’ tools, which would enable a person to buy Bitcoins at the moment needed for a transaction; thus effectively eliminating taxable gain or loss.”<sup>81</sup>

#### 6. *Regulators’ Characterization of Virtual Currency*

The Service’s position that virtual currency is treated as property is inconsistent with the stance taken by other regulators or judicial authorities, which have characterized virtual currency as cash,<sup>82</sup> a commodity,<sup>83</sup> or a security.<sup>84</sup> Its fragmented regulatory state stems from agencies’ eagerness to regulate this complex, dynamic, and unfamiliar creature “through the prism of what they understand,” according to Edmund Moy, former Director of the U.S. Mint.<sup>85</sup> Moy explains that:

Every agency has to look at bitcoin from the perspective of what their agency does. So the Commodities Futures Trading Commission looks at bitcoin as a commodity, because it complies with all the issues that commodities applies with. The Federal Trade Commission looks at this as a bartering issue, as a trading issue; the FEC looks at it from an investment perspective; the IRS looks at it as a taxable event.<sup>86</sup>

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income. This is starkly different from cash, where every bill has an unchanging value that is equal to the value of bills in the same denomination. A purchaser need not decide which bill to use in a transaction because the basis of cash always equals its unchanging face value; there is no tax benefit to using different bills to purchase a good. In the context of virtual currency, like cash, the basis of each coin would be the same if the coins all had the same value, regardless of its fair market value on the date of receipt. Transferors would not have a preference for certain high basis coins if they all had the same value. Eyber, *supra* note 18.

<sup>80</sup> Chodorow, *supra* note 13, at 381.

<sup>81</sup> Eyber, *supra* note 18.

<sup>82</sup> SEC v. Shavers, No. 13-416, 2013 U.S. Dist. LEXIS 110018, at \*5 (E.D. Tex. Aug. 6, 2013) (“Bitcoin is a currency or form of money.”).

<sup>83</sup> In re Coinflip, Inc., CFTC No. 15-29, 2015 WL 5535736 (Sept. 17, 2015).

<sup>84</sup> *Shavers*, 2013 U.S. Dist. LEXIS 110018, at \*6 (finding with the SEC, “[t]he Court finds that [investments in a Bitcoin hedge fund] meet the definition of investment contract, and as such, are securities.”). Some commentators believe that this holding means that bitcoins themselves are securities. See Dan Stroh, *Secure Currency or Security? The SEC and Bitcoin Regulation*, U. CIN. L. REV. BLOG (Nov. 18, 2014), <https://uclawreview.org/2014/11/18/secure-currency-or-security-the-sec-and-bitcoin-regulation/> [<https://perma.cc/MM4H-LJWR>]. *But cf.* Alberts & Fry, *supra* note 7, at 14 (“This is incorrect. The court limited its holding to whether shares of the hedge fund were investment contracts and did not consider whether Bitcoin itself is an investment contract.”).

<sup>85</sup> Wenker, *supra* note 11, at 184 (citing Stan Higgins, *Former US Mint Director: How to Save Bitcoin From the Regulators*, COINDESK (July 9, 2014), <https://www.coindesk.com/former-us-mint-director-save-bitcoin-regulators/> [<http://perma.cc/EAP4-ZVLF>]). For a discussion of possible regulatory coordination among agencies, see generally Viktor Mayer-Schönberger, *Virtual Heisenberg: The Limits of Virtual World Regulability*, 66 WASH. & LEE L. REV. 1245 (2009).

<sup>86</sup> Wenker, *supra* note 11, at 184-85 (citing Higgins, *supra* note 85).

The tax uncertainty that continues to surround bitcoin most recently manifested in a 2016 report from the Treasury Inspector General for Tax Administration.<sup>87</sup> Echoing the GAO Report from 2013, the Service acknowledged that it had taken steps to understand the unique tax character of virtual currency by creating a Virtual Currency Issue Team, but that it had not developed guidelines for taxpayer compliance. While the report was full of optimism and recommendations for further action, including “developing a coordinated virtual currency strategy, providing updated guidance for requirements and tax treatments, and revising third-party reporting requirements,” it is not clear that such steps have yet been taken.<sup>88</sup> For now, the increasingly popular system of currency is left with no clear classification or regulation.

## B. RIC and REIT Qualification Rules

RICs and REITs are pass-through entities through which individuals might make tax-efficient investments. RICs are the longest standing statutory pass-through entity in the American tax system. They were originally enacted as a legislative response to the Morrissey case, which classified managed investment trusts as C corporations and subjected them to a corporate-level tax. Interest groups successfully lobbied for tax-favorable treatment for those investment entities. A RIC allows small investors to invest in the stocks and securities of operating companies by pooling their funds to buy shares in investment companies without subjecting those funds to corporate-level taxes. Those investment companies then invest those aggregated funds in the stocks and securities of operating companies. A REIT uses a similar pooling mechanism, but primarily invests in interests in real property, broadly defined, and interests in the mortgages attached to real property.<sup>89</sup> To stimulate investments in real estate, Congress afforded REITs “substantially the same” favorable tax treatment “since in both cases the methods of investment constitute pooling arrangements.”<sup>90</sup> As pass-through entities, RICs and REITs are not required to pay tax at the corporate level on distributed earnings as long as they meet the stringent qualification requirements imposed by the Code. Two such requirements include the “good” income and “good” asset tests.

### I. “Good” Income

#### a. RICs

Under I.R.C. § 851(b)(2), a RIC must derive at least 90% of its yearly gross income from dividends; interest; payments with respect to securities loans; gains from the sale of stock, securities, or foreign currencies; income from publicly traded partnerships; or other income derived from its business of investing in stocks and securities. This rule is intended to distinguish between income from passive investments and income resulting from conducting an active business. When a RIC’s (or a REIT’s, as discussed below)

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<sup>87</sup> TREASURY INSPECTOR GEN. FOR TAX ADMIN., AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE (Sept. 21, 2016), <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf> [<http://perma.cc/AZF9-8X3G>].

<sup>88</sup> Smalley, *supra* note 32.

<sup>89</sup> See Treas. Reg. § 1.856-10.

<sup>90</sup> H.R. REP. NO. 86-2020, 1960-2 C.B. 819, 820 (1960).

income is derived from passive investments, the entity can qualify for favorable tax treatment if it so elects.<sup>91</sup>

b. REITs

Under I.R.C. § 856(c)(2), at least 95% of a REIT's gross income at the end of a taxable year must be derived from dividends; interest; rents from real property; gains from the sale of stock, securities, and real property; or certain other income. Under I.R.C. § 856(c)(3), at least 75% of a REIT's gross income must come from rents from real property, interest on mortgages secured by real property, gain from sale or other disposition of real property, dividends from the sale of transferable shares in other REITs, and certain other real estate income. In other words, three-quarters of the REIT's income must be derived from real property. Up to an additional 15% of the REIT's income can come from sources from which a RIC would derive the vast majority of its income.<sup>92</sup> Thus, while the same passive investment rule applies to both RICs and REITs, the additional 75% rule on REIT income is designed to ensure that the majority of the passive investments made by a REIT are in real property or in mortgages on real property.<sup>93</sup>

2. "Good" Assets

a. RICs

The RIC "good" asset test is intended to mirror the asset diversification requirement in the '40 Act for certain investment companies. The "good" asset test, when satisfied, may afford tax-favored treatment to certain diversified investment companies. Under I.R.C. § 851(b)(3)(A), at the end of each quarter, 50% or more in value of the total assets of the RIC must be cash or cash items (including receivables), Government securities (e.g. Treasury securities), securities of other RICs, and certain other types of securities. This tax requirement parrots the definition of "diversified management company" in Section 5(b)(1) of the '40 Act. Section 5(b) provides that a diversified company is a management company,<sup>94</sup> at least 75% of the total assets of which are invested in cash, government securities, securities of other investment companies, and certain other securities. Section 5(b) also provides that no more than 5% of the value of the total assets invested by the diversified company may be invested in the securities of any one issuer, and no more than 10% (by vote or value) of the outstanding voting securities of one issuer.<sup>95</sup> In the Internal Revenue Code, that 75% threshold from the '40

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<sup>91</sup> *Id.* at 821 (Congress "has...taken care to draw a sharp line between passive investments and the active operation of business...").

<sup>92</sup> *Id.* at 822.

<sup>93</sup> *Id.* at 819, 822.

<sup>94</sup> "'Management company' means any investment company other than a face-amount certificate company or a unit investment trust." Investment Company Act of 1940, Pub. L. No. 76-768, § 4(3), 54 Stat. 789, 799 (1940).

<sup>95</sup> "'Diversified company' means a management company which meets the following requirements: At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per

Act is decreased to 50% for RIC tax qualification purposes. The legislative purpose for the RIC “good” asset test and its nexus with Section 5(b) of the ‘40 Act are somewhat of a mystery. One commentator hypothesizes that diversified investment companies must satisfy the asset diversification requirement under the ‘40 Act “to inform stockholders of the character of the portfolio of the company in which they have invested,” thereby enabling the small investors that tend to invest in RICs to make sound investment decisions and to be insulated from the risks of a non-diversified investment.<sup>96</sup>

#### b. REITs

Under I.R.C. § 856(c)(4), at the close of each quarter at least 75% of a REIT’s total assets must be invested in real estate, cash, and government securities. No more than 25% of those assets may consist of securities other than government securities or REIT debt instruments. This requirement echoes the RIC “good” asset requirement because Congress, in crafting a tax regime for REITs, wanted to assure investors that (1) the majority of the REIT’s investments are in real property, and (2) the trust’s assets are sufficiently diversified in investments other than real estate (or cash, or government securities).<sup>97</sup> Thus, the rationale behind the “good” asset test for both RICs and REITs is the same: diversification of investments. According to the Service, “[b]oth sets of rules are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers.”<sup>98</sup>

### III. VIRTUAL CURRENCY & THE ‘40 ACT

Given that investor interest in virtual currency has skyrocketed in recent years,<sup>99</sup> it is likely that RICs and REITs will invest in virtual currency in the future. However, any substantial investment in virtual currency may jeopardize an entity’s ability to qualify as a RIC or REIT, even though the characteristics of virtual currency are consistent with the legislative intent of those qualification requirements. This section discusses how virtual currency should be classified under I.R.C. Subchapter M and proposes a workable regulatory solution in light of that definition.

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centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer.” *Id.* at § 5(b)(1).

<sup>96</sup> Alfred Jaretzki Jr., *The Investment Company Act of 1940*, 26 WASH. U. L. Q. 303, 314 n.34 (1941); H.R. REP. NO. 86-2020, *supra* note 90, at 820 (“Your committee believes that the equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.”).

<sup>97</sup> H.R. REP. NO. 86-2020, *supra* note 90, at 822.

<sup>98</sup> P.L.R. 2005-26-011; Note, *The Investment Company Act of 1940*, 41 COLUM. L. REV. 269 (1941).

<sup>99</sup> Michael J. Casey & Paul Vigna, *Bitcoin and the Digital-Currency Revolution*, THE WALL STREET J. (Jan. 23, 2015), <https://www.wsj.com/articles/the-revolutionary-power-of-digital-currency-1422035061> [<https://perma.cc/9WKY-J428>].

### A. What Is Virtual Currency Under the Current RIC and REIT Rules?

The Service has spoken only once on the classification of virtual currency, in its 2014 Notice.<sup>100</sup> Under this ruling, any substantial investment in virtual currency may jeopardize an entity's ability to qualify as a RIC or REIT because "property" is not enumerated in either the "good" income or "good" asset tests. But an analysis of the legislative history of these qualification requirements reveals that the liquidity that diversification provides and income that is passively-earned are the key features of "good" assets and "good" income, respectively.

Virtual currency possesses those key features; as to assets, virtual currency resembles already-approved "good" assets like cash and securities. In some regards, virtual currency is cash-like; users are able to use it to purchase goods and services from accepting retailers. Some investors also treat an investment in virtual currency like an investment in securities. It might qualify as a "security" under the broad "investment contract" definition in the Securities Act of 1933,<sup>101</sup> although it does not strictly fit the definition and is unlikely to be regulated by the SEC as a security.<sup>102</sup> In addition, virtual currency should qualify as a "good" asset because it satisfies the legislative intent that RICs and REITs invest in liquid assets; as it becomes more widely adopted, virtual currency becomes increasingly liquid.<sup>103</sup> If Congress intended the RIC and REIT "good" asset tests to encourage portfolio diversification, the rules are likely not intended to foreclose entire classes of investments, particularly when those investments closely resemble already-approved "good" assets like cash and securities.

As to "good" income, RICs and REITs could—and perhaps should, given its trajectory over the past year—invest in virtual currency like a security, receiving gains from its sale as "good" income. In addition, if a tenant in a building owned by a REIT pays his rent in virtual currency,<sup>104</sup> and the REIT held that virtual currency and ultimately sold it at a gain, the difference between the value of the currency when it was used to pay the rent and the value for which the currency was ultimately sold should also qualify as "good" income because it is income received as rent as well as a gain from the sale of a security.

Other regulators might disagree that virtual currency should be treated like a security. Some argue that virtual currency is more similar to a commodity than a security. Such a definition may work in other contexts, but it is unworkable for RICs. If virtual

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<sup>100</sup> See I.R.S. Notice 2014-21, *supra* note 4.

<sup>101</sup> See *infra* notes 110-20. See also the argument in Grinberg, *supra* note 30, at 195-98. After much deliberation, the author concluded that bitcoin is not an investment contract because users are not engaged in a common money-making enterprise. See also Alberts & Fry, *supra* note 7, at 20-21. For an analysis of how certain characteristics of a digital token map onto the legal definition of a security, see Lee Schneider et al., *A Securities Law Framework for Blockchain Tokens* (Dec. 7, 2012), <https://www.coinbase.com/legal/securities-law-framework.pdf> [<https://perma.cc/V8VJ-MQRA>].

<sup>102</sup> *But cf.* Kerry Lynn Macintosh, *The New Money*, 14 BERKELEY TECH. L. J. 659, 672 n.78 (1999) ("An argument can be made that 'obligation' was never intended to include electronic money...").

<sup>103</sup> Laura Shin, *4 Reasons Why Bitcoin Represents A New Asset Class*, FORBES (June 2, 2016), <https://www.forbes.com/sites/laurashin/2016/06/02/4-reasons-why-bitcoin-represents-a-new-asset-class/#49cf8b5f3426> [<https://perma.cc/W5J3-FAXF>].

<sup>104</sup> This hypothetical is not divorced from reality. For example, a condominium in Washington, D.C. recently listed for 59 bitcoin. See Michele Lerner, *Four condos in Northwest Washington list for \$569,000 to \$949,000 – and bitcoin*, WASH. POST (Feb. 7, 2018), [http://wapo.st/2Dyk9G9?tid=ss\\_mail&utm\\_term=.66d38cd0cd24](http://wapo.st/2Dyk9G9?tid=ss_mail&utm_term=.66d38cd0cd24) [<https://perma.cc/T5XN-QCDW>].



currency is considered a commodity, it would satisfy the “good” asset test only for REITs; RICs and commodities have a fraught relationship.<sup>105</sup> However defined, virtual currency should mean the same thing for both RICs and REITs for the sake of regulatory simplicity and administrability.<sup>106</sup>

Others have wondered if virtual currency should be treated as a foreign currency for tax purposes, rather than property. Such a classification brings up some issues in the RIC and REIT contexts. The RIC rules allow gains from the sale of foreign currency to qualify as “good” income; the REIT rules do not.<sup>107</sup> The REIT rules also do not allow a REIT to hold foreign currency as a “good” asset (cash) unless that currency is the REIT’s “functional currency.”<sup>108</sup> The regulations do not provide guidance on tax treatment when a virtual currency is a REIT’s functional currency. At the same time, to define virtual currency as any kind of cash would oppose the Service’s current position that such currency is an asset. Such a stark inconsistency will inevitably lead only to further tension in other Code provisions.

Thus, assuming that both RICs and REITs should be able to invest in virtual currency, as argued in Part III(A) above, it is easy to say what virtual currency is not for the purpose of the RIC and REIT qualification rules. But it is not nearly as simple to say exactly what it is. Based on the way it is used,<sup>109</sup> it might fall somewhere between a foreign currency and a security. The Securities Act of 1933 defines a “security” as a number of instruments, including “any note, stock, ... transferable share, investment contract, ... or group or index of securities (including any interest therein or based on the value thereof)...”<sup>110</sup> Although users make investments in virtual currency like a stock, virtual currency lacks the essential characteristics of a stock, including voting rights and the right to receive dividends.<sup>111</sup> Virtual currency could constitute a note if a court were to find that it represents a “written promise by one party to pay money to another party” that bears a “family resemblance” to other kinds of notes.<sup>112</sup> Although the definition of “note” has been broadly construed, it is likely inapplicable to most types of virtual currency.<sup>113</sup> A note represents a continuing obligation between two parties: the note-maker, and the note-holder. When a holder “cashes in” his virtual currency, it is not the note-maker that pays the obligation, it is the third party to whom the holder transfers or sells his currency.

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<sup>105</sup> See Rev. Rul. 2006-1, 2006-1 C.B. 261; Rev. Rul. 2006-31, 2006-1 C.B. 1133 (The Service ruled that a derivative contract on commodities was not a security under I.R.C. § 851(b)(2); a RIC’s income from such a contract is not “good” income).

<sup>106</sup> See generally Willard B. Taylor & Diana Wollman, *Why Can't We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems*, 53 TAX LAW. 95 (1999).

<sup>107</sup> I.R.C. § 851(b)(2)(A); I.R.C. § 856(n).

<sup>108</sup> I.R.C. § 856(c)(5)(K).

<sup>109</sup> See Part II *supra*.

<sup>110</sup> Securities Act of 1933, 15 U.S.C. § 77b(a)(1).

<sup>111</sup> See Grinberg, *supra* note 30, at 195-96 (“A bitcoin is not ‘stock’ ... because it lacks important characteristics of stock, such as conferring the right to receive dividends contingent upon an apportionment of profits.”). Cf. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81,207 at 1, 4 (July 25, 2017) (finding that tokens available for purchase in a “virtual” organization are securities because they “permit the participant to vote and entitle the participant to ‘rewards.’”).

<sup>112</sup> Note, BLACK’S LAW DICTIONARY (10<sup>th</sup> ed. 2014); *Reves v. Ernst & Young*, 494 U.S. 56, 62-63 (1990).

<sup>113</sup> *Reves*, 494 U.S. at 62-63.

Some virtual currencies might meet the broad definition of an investment contract: “a contract, transaction, or scheme whereby a person (1) invests his money in (2) a common enterprise and is led to expect profits (3) solely from the efforts of the promoter or a third party...”<sup>114</sup> Given that most virtual currency investors purchase their currency from exchanges, it satisfies the first element of the definition. At least one federal court has concluded that a bitcoin purchase is an investment under this element.<sup>115</sup> As to the second element, all Bitcoin investors are involved in the common enterprise of maintaining the block chain system and ensuring that the currency’s value is maximized, because “each individual investor’s fortunes [are tied] to the fortunes of the other investors...”<sup>116</sup> Others have argued that because bitcoin is so decentralized, “there is no one money-making business that seeks to raise money through investments,” and thus, there is no common enterprise.<sup>117</sup> But in RICs and REITs, investors rely on investment advisors to manage the portfolio. The court in *Shavers* found that such reliance qualifies such entities as a common enterprise.<sup>118</sup>

The third element, which requires that the “essential managerial efforts which affect the failure or success of the enterprise” “are made by those other than the investor,” is the trickiest.<sup>119</sup> On one hand, investors passively rely on the virtual currency’s network administration to manage their investment vehicle. But those “essential managerial efforts” come from other investors, who guard the network to ensure the value of the currency. Still, bitcoin has value because of the increasing number of people who use it; like other technological advances, the value of the technology grows as the network grows.<sup>120</sup>

On balance, it is difficult to predict what a court would decide based on SEC precedent, so it is unlikely that virtual currency will qualify as a security under existing securities laws in the near future. Regardless of what the SEC decides to call virtual currency, however, the Service affords it the same treatment as a security: much like a stock or a bond, the gains and losses from the sale of virtual currency are treated as capital gains and losses.<sup>121</sup> The characterization of virtual currency as a security thus most closely aligns with the existing IRS guidance; when virtual currency is treated like property, investors are treated like those who invest in stocks.<sup>122</sup> But the fact remains that the Code does not currently describe how non-’40 Act securities are treated for the purpose of the RIC and REIT “good” income or “good” asset qualification requirements. This regulatory no-man’s land may prevent RICs and REITs from investing in virtual currency when legislative history indicates that it should be able to do so.

<sup>114</sup> SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946). For a thorough discussion of how the various qualities of bitcoin satisfy (or do not satisfy) this definition, see Grinberg, *supra* note 30, at 196-99.

<sup>115</sup> SEC v. *Shavers*, No. 13-416, 2013 U.S. Dist. LEXIS 110018, at \*6 (E.D. Tex. Aug. 6, 2013).

<sup>116</sup> *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87 (2d Cir. 1994); Schneider et al., *supra* note 101 at 14-15. For an alternative analysis of “common enterprise” and Bitcoin, see Alberts & Fry, *supra* note 7, at 15-20.

<sup>117</sup> Grinberg, *supra* note 30, at 197; Alberts & Fry, *supra* note 7, at 16.

<sup>118</sup> *Shavers*, 2013 U.S. Dist. LEXIS 110018, at \*5.

<sup>119</sup> SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973).

<sup>120</sup> Joe Weisenthal, *Here’s the Answer to Paul Krugman’s Difficult Questions About Bitcoin*, Bus. Insider. (Dec. 30, 2013), <http://www.businessinsider.com/why-bitcoin-has-value-2013-12> [perma.cc/3MZN-WACX] (the author cites the late-90s file-sharing phenomenon Napster as one such example).

<sup>121</sup> Tara Siegel Bernard, *When Trading in Bitcoin, Keep the Tax Man in Mind*, N.Y. TIMES, Jan. 20, 2018, at B2.

<sup>122</sup> Wenker, *supra* note 11, at 186.

### B. RICs, REITs, and the '40 Act

The liquidity and passivity of virtual currency, regardless of whether or not it can properly be classified as a security, suggest that it is a “good” asset. Under the current statutory scheme, it most closely qualifies as a “security” for the RIC and REIT rules, although that characterization is admittedly not without controversy. Yet because the '40 Act does not recognize virtual currency as a security, and because the RIC and REIT rules do not contain any provisions that would otherwise capture virtual currency, it cannot qualify as a “good” asset under the status quo.<sup>123</sup>

There is no contingency in the Code for a non-'40 Act security. This structural limitation at best complicates, and at worst forecloses completely RIC or REIT investment in virtual currencies. While other pass-through entities are able to invest in virtual currency,<sup>124</sup> RICs and REITs are liable to lose their tax-favored status simply by investing in these lucrative technologies. But defining virtual currency as securities has major non-tax consequences; thus, the tether between the '40 Act and the RIC and REIT “good” income and “good” asset tests serves an important purpose.<sup>125</sup> Perhaps instead the RIC and REIT rules too rigidly define “good” income and “good” assets. But this limitation is not just a byproduct of the Internet Age. A similar tension between the RIC qualification requirements and physical commodities has led some experts to believe that RICs cannot invest directly in commodities.<sup>126</sup>

When different regulatory agencies define something in a variety of different ways, the regulatory scheme breaks down where those regulators overlap, like the SEC and the IRS do in the RIC and REIT qualification rules. By effectively deferring to the SEC's definition of a security, the Service connects an otherwise fragmented system. Problems arise, however, when the regulator on which another agency relies is slow to take a position on a unit that tests the bounds of the existing shared regulatory regime.

Virtual currency has been the thorn in regulators' sides since it emerged in 2009 and the IRS has only recently begun to regulate virtual currency. But its current solution is not ideal; the classification of virtual currency as property creates problems in other areas of the Code where such a definition is unsuitable. A tether to the '40 Act places the onus on the SEC to understand the new currency and regulate it accordingly, thereby preventing such a stopgap regulatory scheme from creating problems. In the cryptocurrency context, however, the SEC has not acted quickly enough, even though the Securities Act of 1933 was designed to “create a legal construct that would not be

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<sup>123</sup> In order to constitute a security in the RIC and REIT Code provisions, it must be recognized by the '40 Act. Rev. Proc. 2016-50, 2016-43 I.R.B. 522.

<sup>124</sup> Fixed investment trusts and publicly traded partnerships are two such entities. See VanEck Vectors Bitcoin Strategy ETF, Registration Statement (Form N-1A) (Aug. 11, 2017); REX Bitcoin Strategy ETF, Registration Statement (Form N-1A) (Aug. 23, 2017).

<sup>125</sup> See Alberts & Fry, *supra* note 7, at Part II.

<sup>126</sup> See Rev. Rul. 2006-1, *supra* note 105; Rev. Rul. 2006-31, *supra* note 105 (holding that income from derivative contracts with respect to a commodities index is not “good” income because such contracts do not constitute a security under the RIC qualification rules). See also Rev. Proc. 2016-50, *supra* note 123; Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, 124 Stat. 3537; Ronald E. Creamer, Jr., Willard B. Taylor & Ari M. Zak, *RIC Modernization Act of 2010*, SULLIVAN & CROMWELL LLP 6 (Dec. 23, 2010), [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_RIC\\_Modernization\\_Act\\_of\\_2010.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_RIC_Modernization_Act_of_2010.pdf) [<https://perma.cc/C663-TP7X>].

outpaced by financial innovations.”<sup>127</sup> Although formal problems in the Subchapter M context have not yet come before the IRS, they quite possibly could in due time. For now, however, based on the SEC’s posture towards investments in virtual currencies, RIC and REIT investments in virtual currency are unlikely to gain much popularity any time soon.<sup>128</sup>

Thus, it is either nonsensical that RICs are registered under the ’40 Act, or that there is no contingency in the RIC and REIT qualification rules for technological advances that create appealing investment opportunities in non-’40 Act securities. As shown in the legislative history behind the rules, Congress wants to enable small investors to minimize their investment risk by investing in pooling arrangements. It should not allow the Service’s intransigence to prevent such investors from investing in lucrative technologies. A statutory or regulatory scheme that explicitly determines that virtual currency qualifies as a “good” asset, and that income from the sale of virtual currency can count as “good” income when it is earned from passive investments should solve this problem. Accordingly, something resembling the following language should be added to Sections 851 and 856 or their regulations:

Securities Not Otherwise Defined in the Investment Act of 1940.  
Securities that are not otherwise defined in the Investment Act of 1940 shall be defined by reference to Service determination, taking into account the purposes for which those terms are being applied in the context of Sections 851 and 856 of the Internal Revenue Code.

This language requires the Service to reverse its current position that it will not rule on whether or not an instrument is a “security” under the ’40 Act for RIC qualification purposes.<sup>129</sup> Upon a ruling request, the Service will assess the security for liquidity and its connection with passive investment, as opposed to active business. It may also look to decisions by the SEC or other regulatory agencies to inform its decision, if such decisions or rulings have already been made. It will also look for a sinister intention to flout the tax rules.<sup>130</sup> Without such language, RICs and REITs will be precluded from investing in new technologies until the tether between the ’40 Act and the Code is severed.

Such a severance is more easily fathomed in the REIT context, where the Code’s reliance on ’40 Act definitions is a bastion of its origin as a mutual fund for real estate. In fact, extending the RIC qualification rules to entities not registered under the ’40 Act may facilitate simpler tax structures. For example, if hedge funds could organize as RICs, the complex tiered partnership structures under which they now operate would be eliminated. But completely separating the Code’s and the ’40 Act’s definitions of securities may be inadvisable in the long-run. As agencies’ regulatory expertise is unable to keep pace with new technologies that fall within the purview of multiple agencies which either cannot or

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<sup>127</sup> Alberts & Fry, *supra* note 7, at 8 (citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)).

<sup>128</sup> Eberhart, *supra* note 41.

<sup>129</sup> Rev. Proc. 2016-50, *supra* note 123.

<sup>130</sup> Cf. Owen Davis, *In the World of Cryptocurrencies, The ‘Wolf of Wall Street’ Guy Is a Paragon of Probity and Reason*, ABOVE THE LAW (Oct. 23, 2017, 7:30 PM), <https://abovethelaw.com/2017/10/in-the-world-of-cryptocurrencies-the-wolf-of-wall-street-guy-is-a-paragon-of-probity-and-reason/> [http://perma.cc/2HGS-7ED2].

will not coordinate, the Service may need to defer to the expertise and relative alacrity with which the SEC operates to characterize new technologies, which should be regulable—if not taxable—instruments.

#### IV. CONCLUSION

Consistent with its libertarian origins, cryptocurrency has created chaos among regulatory agencies. The SEC has been slow to regulate virtual currencies, which may create problems for small investors who wish to invest in virtual currency through a RIC or a REIT. The Congressional intent behind the RIC and REIT qualification requirements indicates that virtual currency should qualify as a “good” asset, and gain from the sale thereof should constitute “good” income. But the Service has classified virtual currency as “property,” which cannot qualify for either under the current regime.

Instead, virtual currency may be classifiable as a “security.” Yet that sweeping generalization is a dangerous proposition; such a classification would have great non-tax consequences. For the specific tax purposes of the RIC and REIT qualification requirements, and any other requirements in the Code where such a definition fits, however, it may be practicable to call some digital currencies “securities.” It is up to the Service to generate such a definition; it has not yet and may never come from the SEC. The Service must acknowledge that it serves a purpose distinct from that of the SEC, and that sometimes the Code’s reliance on SEC action may be unworkable.