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C H A R T E R E D

IPB Insights

***Cryptocurrency as Foreign Currency--Potential Application of Section 988¹

Summary

In 2014, the IRS issued guidance stating that cryptocurrency is property, not currency, for federal tax purposes. Since the IRS made this determination, hundreds of new types of cryptocurrency have risen to prominence. One is cryptocurrency issued by central banks, which may function as legal tender in certain countries and may one day be used as a medium of exchange. Another is stablecoins, which function like a derivative instrument whose value is based off another commodity or currency. As the marketplace continues to evolve, taxpayers may wish to take the position that some of the newer types of cryptocurrency are currency for tax purposes, which could subject transactions in such cryptocurrency to the tax rules applicable to foreign currency (section 988 gain or loss).

What is Currency?

Whether cryptocurrency constitutes "currency" is important because section 988 generally provides that a taxpayer must recognize ordinary gain or loss when engaging in certain transactions involving foreign currency.

Black's Law Dictionary states that currency is "[a]n item (such as a coin, government note, or banknote) that circulates as a medium of exchange," while Ballentine's Law Dictionary notes it is "[p]aper money which passes at par as a circulating medium in the business community; money whether in coin or paper." Currency that is recognized by a government is typically recognized as money or "legal tender" in a given location.² The Supreme

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² To illustrate the difference between currency and money, take the U.S. dollar. The dollar is currency because it is used as a medium of exchange and it is also money because it is recognized and backed by the U.S. government (the dollar is also

Court recently noted that “money was ordinarily understood to mean currency issued by a recognized authority as a medium of exchange.”³

Although there is no statutory or regulatory definition of currency for U.S. federal tax purposes, the IRS has stated that “money in its usual and ordinary acceptance is synonymous with currency.”⁴ In two revenue rulings from the 1970s, the IRS stated that “[c]urrency in its usual and ordinary acceptance means gold, silver, other metals or paper used as a circulating medium of exchange, and does not embrace bonds, evidences of debt, or other personal property or real estate.”⁵

More recently, the Department of the Treasury Financial Crimes Enforcement Network (FinCEN) provided the following definition of currency, which the IRS used as a definition of “real” currency in Notice 2014-21 (which generally defined cryptocurrency as property):

the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance.⁶

Section 988: Ordinary Gain or Loss on Transactions Involving Foreign Currency

Section 988 states that a taxpayer recognizes foreign currency gain or loss when entering into a “section 988 transaction” denominated in a “nonfunctional currency.” The Code provides that a section 988 transaction is one where a taxpayer:

- (1) acquires or becomes an obligor of a debt instrument denominated in a nonfunctional currency;
- (2) accrues any income or expense in a nonfunctional currency;
- (3) enters into a forward contract denominated in a nonfunctional currency; and
- (4) disposes any nonfunctional currency.⁷

A nonfunctional currency is defined for this purpose as currency other than the taxpayer’s functional currency,⁸ and functional currency means the U.S. dollar or the currency used in the economic environment of a “qualified business unit.”⁹ For simplicity, this paper addresses the section 988 issue from the point of view of a U.S. taxpayer whose functional currency is the U.S. dollar.

Consider a U.S. taxpayer who buys 800,000 British Pounds at the exchange rate of 1 USD = .8 GBP. The taxpayer would have a basis of \$1 million in the British Pounds purchased. If the U.S. taxpayer later sells the 800,000 British Pounds when the exchange rate is 1 USD = 1 GBP, the taxpayer would only receive \$800,000. The taxpayer

fiat because its value depends on public confidence and has not pegged to any physical object since President Nixon ended the ability to exchange U.S. dollars for gold in 1973).

³ *Wisconsin Central Ltd. v. United States*, 138 S. Ct. 2067, 2070 (2018).

⁴ Rev. Rul. 76-214, 1976-1 C.B. 218.

⁵ *Id.*; Rev. Rul. 74-218, 1974-1 C.B. 202.

⁶ Department of Treasury Financial Crimes Enforcement Network, Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (Mar. 18, 2013).

⁷ I.R.C. § 988(c)(1).

⁸ Treas. Reg. § 1.988-1(c).

⁹ I.R.C. § 985(b)(1).

therefore recognizes a \$200,000 ordinary loss because the amount received (\$800,000) is less than the basis (\$1 million).

Section 988 provides a de minimis exception for taxpayers who disposed of a nonfunctional currency in a “personal transaction” where the section 988 gain or loss is less than \$200. For example, a U.S. person traveling to London who purchased British Pounds for the trip would not need to recognize any gain or loss if, at the end of her trip, she exchanged British Pounds back for dollars and had less than \$200 of foreign currency gain or loss.

Notice 2014-21: Cryptocurrency is property, not currency

In Notice 2014-21, the IRS said that “virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.” The IRS adopted FinCEN’s definition of virtual currency and noted that although virtual currency “operates like ‘real’ currency” in some environments, “it does not have legal tender status in any jurisdiction.” It also said that some virtual currency, like Bitcoin, are “convertible” virtual currency that have “an equivalent value in real currency” and “act as a substitute for real currency.”¹⁰

Although the IRS did not specifically address section 988, the Notice said that convertible virtual currencies are “treated as property” for federal tax purposes and are “not treated as currency that could generate foreign currency gain or loss.” There’s an argument that under the logic of Notice 2014-21, cryptocurrency *could* be treated as foreign currency for tax purposes if used as a medium of exchange and recognized as legal tender in a given jurisdiction.¹¹ A FAQ released by the IRS in 2019 similarly suggests that the guidance to date only address cryptocurrency not considered “real currency” (which the FAQ defines as “*the U.S. dollar or a foreign currency*”).¹² Put differently, it’s possible that cryptocurrency is not considered virtual currency within the IRS current guidance if it is “real currency” because it is used as a medium of exchange and recognized as legal tender.

Are any Cryptocurrencies “Currency”?

Given the tremendous number of new cryptocurrencies that have developed since the IRS released Notice 2014-21, it no longer seems logical to conclude that *no* cryptocurrencies are *real currency*. Specifically, at least two types of cryptocurrencies might be considered “real currency” in which case they could be considered foreign currency covered under section 988: cryptocurrency issued by central governments and stablecoins denominated in foreign currencies.

Cryptocurrency issued by central governments

¹⁰ The IRS specifically mentioned that the notice did not apply to other virtual currencies that were not convertible, like airline miles or videogame currencies.

¹¹ BNA Portfolio 190-1st: Taxation of Cryptocurrencies, II.B.2.c. (last accessed March 1, 2020).

¹² *Id.* (citing IRS, *Frequently Asked Questions on Virtual Currency Transactions*, FAQ #29

<https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> (last accessed January 17, 2020)).

In 2014, no country recognized any form of cryptocurrency as valid legal tender. Now, at least four countries have issued some form of virtual currency and seven are testing a digital version that incorporates aspects of cryptocurrency.¹³ For example, the Marshall Islands government declared in February 2018 that it would “issue a digital decentralized currency based on blockchain technology as legal tender of the Republic of Marshall Islands.”¹⁴ Government officials have said that the government would launch an initial coin offering as soon regulatory and compliance issues are resolved.¹⁵ Note that not all cryptocurrencies issued by governments are issued as legal tender. For example, Venezuela has issued a cryptocurrency which purports to be backed by the country’s oil and mineral reserves and which is not legal tender.¹⁶

In order to be currency under the IRS’s definition, cryptocurrency has to be legal tender *and* used as a medium of exchange. Guidance issued in other contexts may be relevant here. In Rev. Rul. 76-214, the IRS concluded that two types of bullion gold coins were not currency. Although the gold coins were issued by foreign governments, both coins derived their value on the basis of gold content and did not derive any value from being used as a medium of exchange. Likewise, in 2018, the Supreme Court held that stock options were not “money” because stock options were not used as a medium of exchange on the date when the relevant statute was enacted.¹⁷ In his dissent, Justice Breyer hinted at the possibility that cryptocurrency could be a medium of exchange someday:

What we view as money has changed over time. Cowrie shells once were such a medium but no longer are; our currency originally included gold coins and bullion, but, after 1934, gold could not be used as a medium of exchange; perhaps one day employees will be paid in Bitcoin or some other type of cryptocurrency.¹⁸

An argument to the contrary is that cryptocurrencies have generally been used as vehicles for speculation rather than mediums of exchange. Even if the Marshall Islands were to issue a cryptocurrency used on the islands as a medium of exchange, it could be seen as sufficiently speculative of an investment to render its customary use as other than as a medium of exchange.

In short, we do not know how these new forms of cryptocurrency issued by central governments will work in practice. But if they are used as mediums of exchange in the areas where they are recognized as legal tender, it follows that such central bank cryptocurrencies may meet the definition of “currency,” including for federal tax

¹³ Ted R. Stotzer, *Are Central Bank Cryptocurrencies Currency for U.S. Tax Purposes?*, 165 Tax Notes Federal 223 (Oct. 14, 2019); Mike Orcutt, *Sweden Is Now Testing Its Digital Version Of Cash, The E-Krona*, MIT Technology Review (Feb. 20, 2020), <https://www.technologyreview.com/f/615266/sweden-riksbank-ekrona-blockchain/>.

¹⁴ https://rmiparliament.org/cms/images/LEGISLATION/PRINCIPAL/2018/2018-0053/DeclarationandIssuanceoftheSovereignCurrencyAct2018_1.pdf.

¹⁵ <https://sov.foundation/>; Christine Kim, *Why the Marshall Islands is Doing a Pre-Sale for its National Cryptocurrency*, Coindesk (Sep. 12, 2019) <https://www.coindesk.com/why-the-marshall-islands-is-doing-a-pre-sale-for-its-national-cryptocurrency>.

¹⁶ *U.S. Bans Use of Venezuela’s Cryptocurrency*, <https://www.wsj.com/articles/u-s-bans-use-of-venezuelas-cryptocurrency-1521496566>.

¹⁷ *Wisconsin Central Ltd. v. United States*, 138 S. Ct. 2067 (2018).

¹⁸ *Id.* at 2076 (Breyer, J., Dissenting)

purposes. In that case, the rules of section 988 could apply to govern recognition of foreign currency gain or loss.

Stablecoins

Stablecoins are cryptocurrencies designed to peg to another cryptocurrency, fiat money (defined as government-issued currency not backed by a commodity), or a commodity. For example, the highest market cap stablecoin—Tether—is a cryptocurrency which purports to be pegged 1-to-1 to the U.S. dollar.¹⁹ The goal of Tether is to combine blockchain technologies that allow security and transparency for businesses completing transactions with stability achieved by “tethering” the price of the cryptocurrency to the dollar.²⁰ Although less prevalent, some stablecoins are pegged to foreign currencies like the Euro²¹ or Swiss Franc.²² Additionally, it was reported that Facebook’s anticipated cryptocurrency Libra would be pegged to a variety of foreign currencies like the Euro, Yen, British Pound, and Singapore Dollar.²³

Because the value of a stablecoin is anticipated to move in tandem with the foreign currency or commodity to which it is pegged, stablecoins function to some extent like derivative instruments. Under the rules applicable to foreign currency transactions, a taxpayer who holds some types of notional contracts may be subject to section 988 gain or loss as if they held a foreign currency directly. The section 988 regulations provide that a taxpayer that holds certain financial instruments will need to recognize section 988 gain or loss if “the underlying property to which such other instrument (e.g., the futures contract) ultimately relates [to] a nonfunctional currency.”²⁴ For example, a forward contract to purchase British Pounds is subject to section 988, but a contract to settle a wheat contract in British Pounds is not subject to section 988.²⁵

The regulations applicable to derivative instruments under section 988 may provide a basis for the conclusion that transactions in stablecoins are also subject to section 988. In such case, taxpayers holding stablecoins pegged to nonfunctional currencies could be required to recognize section 988 gain or loss after a section 988 event, discussed above.

For questions or additional information, please free to contact us.

¹⁹ <https://tether.to/>.

²⁰ *Id.*

²¹ <https://cryptoslate.com/coins/stasis-euro/>.

²² <https://cryptoslate.com/coins/cryptofranc/>.

²³ *Facebook cryptocurrency: Libra is considering foregoing a currency basket*, <https://financefwd.com/de/libra-wahrungskorb/>.

²⁴ Treas. Reg. § 1.988-1(a)(2)(iii)(A).

²⁵ *Id.*



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