Rethinking Our Centralized Monetary System

The Case for a System of Local Currencies

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Legal Aspects of Local Currency

A basic need of a society is money, the form of which adapts contextually. History, replete with examples, confirms that the evolution (or devolution) of monetary systems hinges upon the varying needs of society. Local currency systems, prevalent before ratification of the United States Constitution, have existed throughout American history and have reappeared today. Most of the earlier local currency schemes passed away because they were prohibited by law or were no longer necessary given the circumstances. The question remains whether today's local currency systems are consistent with the law. This chapter begins with a discussion of federal and state law relating to local currency before analyzing federal and state banking laws, federal and state securities laws, and federal income tax aspects of local scrip.

FEDERAL LAWS RELATING TO LOCAL CURRENCY

The federal laws relating to a local currency program consist of the constitutional framework, prohibition on private coinage, and anticounterfeiting legislation. This discussion will demonstrate that no federal barriers exists to the issuance of local paper currency. However, local coinage cannot be minted.

United States Constitutional Framework

The U.S. Constitution does not prohibit private issuance of money. The Framers were concerned primarily with restricting the states from influ-

encing monetary policy,[1] and averting "embarrassments of a perpetually fluctuating and variable currency"[2] caused by "[t]he floods of depreciated paper-money, with which most of the States . . . were inundated."[3] Consequently, the framing document forbids the states to "coin Money,"[4] to "emit Bills of Credit,"[5] and to "make any Thing but gold and silver Coin a Tender in Payment of Debts."[6] The U.S. Constitution also grants to the U.S. Congress the powers "[t]o borrow Money on the credit of the United States,"[7] "[t]o coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures,"[8] and "[t]o provide for the Punishment of counterfeiting the Securities and current Coin of the United States."[9]

Consistent with the hostility felt toward paper money at the time of the Constitutional Convention,[10] the Framers defined "Money" of the United States as coin alone.[11] The authority in the U.S. Constitution "[t]o coin Money,"[12] lifted from the Articles of Confederation,[13] represents the lone constitutional grant of power to create "Money" and limits specifically the means of generation to "coin[ing]."[14]

While the U.S. Constitution prohibits the states from issuing paper currency by barring them from "emit[ing] Bills of Credit,"[15] it is silent on whether the federal government may issue such bills. Distrusting paper money, the Constitutional Convention deliberately struck a provision from the initial draft of the U.S. Constitution empowering the federal government to emit bills of credit.[16] In *The Legal Tender Cases*,[17] the U.S. Supreme Court, however, later held and affirmed that Congress has the authority to emit bills of credit and declare them legal tender for some categories of public and private debts.

Thus, the U.S. Congress may supply the nation with adequate coinage under its power to coin money,[18] but nothing in the U.S. Constitution prohibits private parties from issuing gold, silver, or metal-based coins or the federal government in permitting or assisting private coinage. Moreover, the U.S. Constitution is silent on private issuance of paper currency.

Recognition of Private Issue

Through the Coinage Act of 1792,[19] "Establishing a Mint and Regulating the Coins of the United States," and subsequent coinage acts into the middle of the nineteenth century, Congress developed the foundations for a national monetary system. The coinage acts codified many of the principles set forth by Secretary of the Treasury Alexander Hamilton's *Report on the Subject of a Mint*,[20] which focused primarily on establishing the unit of the system and bimetallism—where the ideal unit is defined in terms of both gold and silver on the basis of fixed gold-silver

ratio.[21] Like the U.S. Constitution, the coinage acts did not speak to private coinage or currency.

Parallel currencies—two unrelated currencies circulating within the same territory—continued to exist. Money issued privately proceeded to enter circulation, especially under emergency circumstances.[22] Under the societary theory of money—acceptance of money that is current and in circulation in a community at the time it is received or simply to protect bona fide payments made with private issue—the courts upheld the validity of payments made in otherwise illegal currency. For instance, in *Thorington v. Smith*,[23] private parties residing in the same city within Confederate territory during the Civil War entered into a contract where part of the debt was to be paid in Confederate notes. The U.S. Supreme Court held that the contract was enforceable in a court of the United States, despite the fact that the Confederate government had no authority to issue such notes, because at the time of the transaction, Confederate notes had become "almost exclusively the currency of the insurgent States" and they "were used as money in nearly all the business transaction of many millions of people."[24] Consistent with the societary theory of money, private coins, current in California in the 1850s, were not recognized as money in Massachusetts where they were not current.[25]

With the maturation of the national monetary system and the concomitant growth of private currency, Congress passed legislation barring or restricting private issue. Recognizing that Congress intended primarily to prevent competition with the national currency, the U.S. Supreme Court, in *United States v. Van Auken*[26] and *Hollister v. Mercantile Institution*,[27] validated private notes issued in 1874 and 1876, respectively, and payable in merchandise at a business, under the principle that such notes would not circulate beyond a limited neighborhood. In *Van Auken*, where the defendant was charged with violating a statute seeking to provide a monopoly to an experimental national "postage currency," the Court stated:

> Small notes payable in any specific articles, if issued, could have only a neighborhood circulation, and but a limited one there. It could be but little in the way of the stamps or small notes issued for the purposes of circulating change by the United States. Congress could, therefore, have had little or no motive to interfere with respect to the former.[28]

The *Hollister* Court cited *Van Auken* and the same principle.[29]

Federal Law Prohibits Private Coinage

As noted, the U.S. Constitution specifically prohibits the states from coining money. This prohibition extends to every branch, agency, and

instrumentality of state government.[30] The private issuance of money did not become a concern of the federal government until 1860. Between 1830 and 1860, prompted by the "Gold Rush," private manufacturers of gold coins flourished.[31] These coins did not imitate the designs of United States coins.[32] Rather, they bore the names and places of the manufacturer.[33] In Georgia, North Carolina, California, Oregon, Utah, and Colorado, the private coins varied in weight and fineness.[34]

By the Act of June 8, 1864,[35] Congress prohibited private coinage, regardless of whether the coins were similar in appearance to coins of the United States. Congress codified this prohibition on the issuance of private coinage in 1873,[36] 1909,[37] and 1948.[38] No substantive changes in subsequent versions were made.[39] The current statute provides:

> Whoever, except as authorized by law, makes or utters or passes, or attempts to utter or pass, any coins of gold or silver or other metal, or alloys of metals, intended for use as current money, whether in the resemblance of coins of the United States or of foreign countries, or of original design, shall be fined for more than $3,000 or imprisoned not more than five years, or both.[40]

Modern local paper currency described in Chapters 4, 5, and 6, however, is not prohibited by this statute. First, the statute prohibiting private coinage does not address paper money. In other words, the prohibition on the issuance of private coinage does not bar a modern, local paper currency. However, fractional paper currency with a value of less than one dollar is subject to criminal sanctions.[41]

Second, the statute requires that the illegal coins be "for use as current money." Interpreting the predecessor statute to the present provision, the court, in *United States v. Gellman*,[42] held that tokens with inscriptions: "No Cash Value" and "For Amusement Purposes Only" were not used as money because there was "no promise to pay money or anything of value, either impliedly or by reason of any express inscription on the coin."[43] The *Gellman* Court relied on language from *United States v. Roussopulous*:[44]

> It does not purport to be money, or an obligation to pay money, and the obligation expressed is in terms solvable in merchandise. It cannot, therefore, have been intended to circulate as money, or to be received and used in lieu of lawful money.[45]

The term "current money" has also been defined in *State v. Quackenbush*[46] as:

> [W]hatever is lawfully and actually current in buying and selling, of the value and as the equivalent of coin (citations omitted). "Current money" means money which passes from hand to hand and from person to person and circulates

through the community. (citation omitted). It is synonymous with "lawful money" (citation omitted). Whatever is intended to, and does actually, circulate as money (citation omitted).... "Current money," that which is generally used as a medium of exchange.[47]

In *Anchorage Centennial Dev. Co. v. Van Wormer & Rodriguez, Inc.*,[48] the Supreme Court of Alaska, citing *Quackenbush*, held that there was no intention to use the coins in question as "current money" where the coins were to bear the proposed inscription, "Good for One Dollar in Trade at Any Cooperating Business Redeemable at Face Value at the Anchorage Centennial Exposition Site Until December 31, 1967" and actually read, "Redeemable at Face Value at Anchorage the Air Crossroads of the World."[49]

Moreover, the *Gellman* Court concluded that the 1864 Act was "primarily adopted to prevent the coining of money in competition with the United States."[50] In *United States v. Falvey*,[51] the First Circuit reached the same conclusion.

Therefore, a local issuer may issue coins so long as it does not intend for the coins to circulate as money of the United States. For example, a private individual or entity may issue coins or tokens that may be used to redeem merchandise at particular businesses in a community. But the local issuer may not issue coins with the intention that the coins will be used in lieu of lawful money to purchase goods or to pay debts on a wide scale where the coins would be competing with lawful money.

Other Federal Anticounterfeiting Legislation

Other modern federal legislation prohibiting private counterfeiting[52] similarly does not bar local currency schemes as described in Chapters 4, 5, and 6. The modern statutory provision with the catchline "Tokens or paper used as money,"[53] generally, prohibits anyone from making or using anything, including paper currency, that is similar to lawful currency or legal tender issued by the federal government in the United States as lawful currency or legal tender.[54]

The anticounterfeiting provision dealing with paper currency requires that the tokens or paper be "similar in size and shape to any of the lawful coins or other currency of the United States" or to be "receive[d] . . . [as] lawful coins of other currency of the United States."[55] In other words, the tokens or paper in question must be used as lawful or "current money." Even though the term "current money"—the same term used in the statute prohibiting private coinage described above—is not used in the anticounterfeiting statute addressing counterfeit paper currency, the courts have required that the tokens or paper in question be used as "current money" to violate the statute. The same definition of "current

money" stated above was used in both *Gellman*, interpreting the predecessor to the modern anticounterfeiting statute dealing with paper currency,[56] and *Van Wormer*, interpreting the anticounterfeiting statute itself.[57]

Similarly, other federal anticounterfeiting statutes fall short of proscribing the local currency systems. In *United States v. Smith*,[58] the Fourth Circuit held that two slips of paper, each the size of a federal reserve note and each bearing a crude, backwards facsimile of one, were not "counterfeit" under a statutory provision which prohibits the uttering of counterfeit obligations or securities. The slips of paper must have been an imitation or "similitude"; otherwise, there is no counterfeit in fact.[59] Moreover, unless the pieces of paper purported to fool an "honest, sensible and unsuspecting person of ordinary observation and care,"[60] there is no counterfeit in law.

In a case involving a provision criminalizing the control, custody, or possession of certain plates, stones, or anything else used to print counterfeit obligations and securities of the United States, the court cited and followed Smith's definition of "counterfeit."[61] Local issuers using tools and other equipment to print their currency would, therefore, not be violating any anticounterfeiting statutes unless their equipment imitated and simulated the plates, stones, or other things used by the Secretary of the Treasury to print obligations or securities of the United States. Finally, the *Federal Jury Practice and Instructions*, used by federal district court judges in civil and criminal cases, also uses the Smith definition:

> An item is "counterfeit" if it bears such likeness or a resemblance to a genuine obligation or security issued under the authority of the United States as is calculated to deceive an honest, sensible and unsuspecting person of ordinary observation and care dealing with a person supposed to be honest and upright.[62]

State Issuance of Bills of Credit

While the U.S. Constitution explicitly prohibits the states from emitting bills of credit, and therefore, from directly issuing their own currency, does the prohibition extend to other public bodies (e.g., municipalities or counties) or the private sector? As defined in *Craig v. State of Missouri*,[63] "'bills of credit' signify a paper medium, intended to circulate between individuals, and between the government and individuals, for the ordinary purposes of society."[64] The *Craig* court further stated:

> The word "emit" is never employed in describing those contracts by which a state binds itself to pay money at a future day for services actually received, or for money borrowed for present use; nor are instruments executed for such purposes, in common language, denominated "bill of credit." To "emit bill of

credit," conveys to the mind the idea of issuing paper intended to circulate through the community for its ordinary purposes, as money, which paper is redeemable at a future day.[65]

In *Briscoe v. Bank of Kentucky*,[66] the court clarified its definition of a "bill of credit":

> The definition, then which does include all classes of bills of credit, emitted by the colonies or states, is a paper issued by the sovereign power, containing a pledge of its faith and designed to circulate as money. . . . To constitute a bill of credit, within the Constitution, it must be issued by a state, on the faith of the state, and be designed to circulate as money. It must be a paper which circulates on the credit of the state, and is so received and used in the ordinary business of life.[67]

Within the definition of a bill of credit, the U.S. Supreme Court has permitted states to issue monetary-like instruments that are not intended to circulate as money. In *Poindexter v. Greenhow*,[68] the Court permitted a state to issue coupons receivable for taxes even though the state issued the coupons, the coupons were promises to pay money, and their payment and redemption were based on the credit of the state because "they were not emitted by the State . . . as a substitute for money. And there is nothing on the face of the instruments, nor in their form or nature, nor in the circumstances of their creation or use . . . that these coupons were designed to circulate, in the common transactions of business, as money, nor that in fact they were so used."[69]

Without running afoul of the constitutional prohibition, the U.S. Supreme Court has also ruled that states may also: (1) execute instruments binding themselves to pay money to individuals at a future day for services rendered or money borrowed,[70] and (2) charter banks which issue notes,[71] regardless of whether the state is the sole stockholder of the bank,[72] the officers of the bank were elected by the state legislature,[73] or that the capital of the bank was raised by the sale of state bonds.[74]

The constitutional bar on emitting bills of credit appears to extend to other public bodies as well. The U.S. Supreme Court has held that "trustees or representative officers of a parish, county, or other local jurisdiction" have no authority, implied or otherwise, to issue negotiable securities or coupons, "payable in the future" and "of such a character as to be unimpeachable in the hands of bona fide holders."[75] Moreover, the Court has also held that a municipal corporation, "a subordinate branch of the domestic government of a State" and with no "purposes of private gain" has no power to issue paper clothed with all the attributes of negotiability.[76]

Because bills of credit must be issued by the state or by an individual

or committee who has the power to bind the state acting as agents thereof without imparting, as individuals, any credit to the paper,[77] non-governmental entities, acting alone, are not subject to the constitutional prohibition on states issuing bills of credit. In his famous dissent in the *Briscoe* decision, Justice Story clarified the applicability of the constitutional prohibition:

> The Constitution does not prohibit the emission of all bills of credit, but only the emission of bills of credit by the State: and when I say, by a State, I mean by or in behalf of a State, in whatever form issued. It does not prohibit private persons, or private partnerships, or private corporations . . . from issuing bills of credit. No evils, or, at least, no permanent evils, have ever flowed from such a source. . . . The mischief was not there. . . . It was the issue of bills of credit, as a currency; authorized by the State on its own funds, and for its own purposes; which constituted the real evil to be provided against.[78]

Prior Tax on Notes Not Issued by National Banks

Another method Congress utilized to limit the circulation of notes other than those of federally chartered national banks was to impose a tax on their circulation. As noted in Chapter 2, the U.S. Congress authorized the federal government to issue "notes for circulation"—popularly known as "greenbacks"—through the National Banking Act of 1863.[79]

In 1863, Congress also passed a statute which required all banks, associations, corporations, and individuals issuing notes or bills for circulation as currency to pay a duty of 1 percent each half year on the average amount of their circulation over a certain sum, and a tax of 5 percent on all notes of bills issued in sums representing any fractional part of a dollar.[80] This use of the federal government's power to tax was followed in 1864 by Congress imposing a tax upon the average amount of circulation issued by any bank, association, corporation, company, or person "including as circulation all certified checks, and all notes and other obligations calculated or intended to circulate, or to be used as money."[81]

In 1865, however, Congress implemented another tax designed to crush the decentralized issuance of paper currency and to further a federal government monopoly with respect to paper money. Congress imposed the "death tax" of 10 percent on every state bank or banking association. The tax was imposed on the amount of notes issued by these institutions.[82] This duty was extended to include persons in 1866.[83] Stating that Congress is authorized to provide "a sound and uniform currency for the country," and to "secure the benefit of it to the people by appropriate legislation," the U.S. Supreme Court in *Veazie Bank v. Fenno*[84] upheld the 1865 and 1866 acts. In the following year, the 10 percent tax included notes issued by any town, city, or municipal corporation.[85] In 1875, Congress combined the 1865, 1866, and 1867 acts, effectively ex-

tending the 1867 act to all persons, firms, associations, and corporations.[86]

The "death tax" effectively outlawed notes except those issued by national banks. Banks under state charters were induced to convert into national banks and the circulation of state bank notes disappeared entirely. Foreign banks[87] and notes issued by municipalities[88] also fell prey.

Congress's aim to eliminate state banks altogether almost succeeded. On October 5, 1863, there were only 66 national banks in operation while 1,466 state banks existed.[89] By October 1, 1866, after the tax on state bank circulation became effective (on July 1, 1866), the number of national banks increased to 1,634 while the number of state banks dwindled to 297.[90] State banks survived and later actually became more numerous by becoming banks of deposit rather than banks of issue, aided by the change to checking deposits instead of bank notes as money.

In *Hollister v. Mercantile Institute*,[91] the U.S. Supreme Court defined what "notes" would be subject to the punitive tax scheme:

> ["Notes" include] only such notes as are in law negotiable, so as to carry title in their circulation from hand to hand, are the subjects of taxation under the statute. It was, no doubt, the purpose of Congress, in imposing this tax, to provide against competition with the established national currency for circulation as money, but as it was not likely that obligations payable in anything else than money would pass beyond a limited neighborhood, no attention was given to such issues as affecting the volume of the currency, or its circulating value.[92]

The Court went on to hold that a note stating, "Pay David O. Calder or bearer five dollars in merchandise at retail" was not a note under the 1875 act.[93] Thus, unsigned "clearing-house certificates" issued by state banks were held not to be "notes" under the 1875 tax because the 10 percent tax applied only to promissory notes and not to other negotiable or quasi-negotiable paper, and the bearer could not sue the issuer and recover money damages with the paper alone.[94] Neither were all negotiable promissory notes taxable under the punitive tax.[95] The issuer must intend that its notes be used as currency in competition with national currency.[96]

Under the Tax Reform Act of 1976,[97] the 10 percent "death tax" was repealed as obsolete.[98] According to the Comptroller of the Currency, any issuance of notes under the punitive 10 percent tax "is also illegal under other provisions of Federal law."[99] Regardless of the enigmatical reference to other provisions, the local currency described in Chapters 4, 5, and 6, would not be considered "notes" under the previous statute.

The Gold Clause, Its Repeal, and Reinstatement

Generally, a gold clause is a promise to pay a debt in gold. Promises to pay debts in gold coin are called "gold-coin clauses" while promises

to pay the value of gold coin are "gold-value clauses." In 1879, the United States resumed payments of specie (i.e., gold coin) in redemption of its paper currency.[100] In the Gold Standard Act of 1900, Congress eliminated the remnants of the role of silver as a monetary standard.[101] With the collapse of the gold standard, Congress, in 1933, banned gold clauses from public and private contracts.[102] The Gold Reserve Act of 1934 went further, withdrawing all gold from circulation.[103] As President Franklin D. Roosevelt stated, the Act "abolished gold coin as a component of our monetary system."[104]

The constitutionality of the ban was questioned by the U.S. Supreme Court in the *Gold Clause Cases*.[105] The Court upheld the abrogation of gold clauses involving private obligations[106] and obligations involving the federal government.[107] Congress's power, the Court reasoned, came not only from the coinage power, but also from:

> the aggregate of the powers granted to the Congress, embracing the powers to lay and collect taxes, to borrow money, to regulate commerce with foreign nations and among the several States, to coin money, regulate the value thereof, and of foreign coin, and fix the standards of weights and measures, and the added express power "to make all laws which shall be necessary and proper for carrying into execution" the other enumerated powers.[108]

In 1977, the abrogation of gold clauses was repealed.[109] American citizens may now buy and sell gold freely,[110] and courts can enforce gold clauses.[111] Thus, today contracts can provide for the payment in U.S. dollars, scrip pegged to the U.S. dollar, or an alternative currency.

STATE LAWS RELATING TO LOCAL CURRENCY

State codes may affect the circulation and use of alternative currencies. At least thirteen states either prohibit paying employees in scrip or require employers to pay their workers in U.S. currency.[112] Two states, Florida and Massachusetts, have their own anticounterfeiting statutes. The Florida statute, for example, prohibits the issuance or circulation of scrip "as a substitute in any respect for currency recognized by law."[113]

Most troublesome are the Virginia and Arkansas statutes. The Virginia statute prohibits any "individual or entity unless authorized by law" from (a) issuing, "with intent that the same be circulated as currency, any note, bill, scrip, or other paper or thing," or (b) otherwise dealing, trading or carrying on "business as a bank of circulation."[114] Seemingly, the Virginia statute would permit the issuance of discount notes redeemable for goods or services as well as an Ithaca HOURS barter-type exchange mechanism. These arrangements arguably are not issued with the intent to circulate as "currency." A barter-type exchange mechanism may face a bar in Arkansas which restricts instruments to be used as a

medium of trade in lieu of money. The Virginia statute would, on its face, bar a local currency not pegged to the U.S. dollar because such scrip would be issued with the requisite intent, namely, to circulate as currency. This conclusion also follows in Arkansas, which prohibits the creation or circulation of instruments to be used as money.

Despite the sweep of these two state statutes, planning opportunities exist. The Arkansas statute only applies to persons, not entities. The Virginia statute defines an entity to include "any association, corporation, partnership, firm, company."[115] Thus, the term "association" would encompass a cooperative association. Seemingly, a charitable organization would not, however, fall under any of the more specific definitions of the general term "entity." Therefore, the bar of the Virginia statute would not apply to any type of local currency issued by a nonprofit corporation.

Only Vermont specifically authorizes the formation of a corporation for the sole purpose of issuing scrip.[116] In addition, Vermont prohibits the counterfeiting of such scrip.[117]

FEDERAL AND STATE BANKING LAW RELATING TO LOCAL CURRENCY WHICH TRADES INDEPENDENTLY OF THE U.S. DOLLAR

Dual Banking System

The American banking system operates under a dual system where commercial banks and other depository institutions (savings and loans, savings banks, and credit unions) may be chartered and regulated by either state or federal administrations. The structure of regulation is complex. Generally, the dual banking system functions as two interrelated schemes in which federal laws are applicable, to a varying breadth, to state-chartered banks; and state laws, to varying degrees, are applicable to federally chartered banks.[118]

With respect to commercial banks, there are four classes of banks and the regulation, as well as the competitive position, of any bank hinges upon the class to which it belongs. First, there are "national" banks which are chartered under federal law by the Comptroller of the Currency. "National" banks are required to become members of the Federal Reserve System[119] and are insured by the Federal Deposit Insurance Corporation (FDIC).[120] National banks operate under the regulations of the Comptroller of the Currency, the Federal Reserve Act (FRA),[121] the National Banking Act,[122] and the Federal Deposit Insurance Act (FDIA).[123] Second, there are "state member banks," which are chartered under state law, voluntarily join the Federal Reserve System,[124] and are also insured by the FDIC.[125] State member banks also operate under regulations of the Federal Reserve Act and other federal laws. Third, if a bank, char-

tered under state law, declines to join the Federal Reserve System but voluntarily obtains federal deposit insurance, it is a "nonmember insured state bank" and subject to the FDIA and other federal laws. Finally, "nonmember noninsured state banks" are state chartered banks which elect neither to join the Federal Reserve System nor to obtain federal deposit insurance.[126]

The principle federal banking regulators are the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the FDIC. The Board of Governors has the primary responsibility of regulating banks which are members of the Federal Reserve System. The Comptroller of the Currency is responsible primarily for the administration of the national banking laws and the examination of the national banks. The FDIC, like the Comptroller of the Currency, administers the law and examines those banks which are federally insured. Additionally, the FDIC oversees insured savings institutions.[127]

Each state bank is subject to the laws of its own state—laws which differ in countless respects. State banks in adjoining states may be subject to additional restrictions. Every state has banking departments and state banking supervisors or commissioners who regulate state banks. In a majority of the states, the state banking supervisors or commissioners also charter banks. Banking boards or commissions charter the banks in the remaining jurisdictions.[128]

Transferring Local Currency

To transfer funds within the dual banking system, individuals utilize checks and electronic wire communications. Checks, generally, are orders on a bank (the drawee or payor) by a depositor (the drawer) to pay a certain sum of money to a third party (the payee). The term "check" is defined more specifically by, for example, the Uniform Commercial Code (UCC) and Federal Reserve regulations. In addition to the transfer of paper instruments between banks, electronic wire services participate in the transferring of funds. To facilitate the transfer, a payments system has evolved whereby the government (the Federal Reserve) and the private sector (automated clearinghouses) adjust the balances of banks and other depository institutions many times over the day, reducing the need for bank-to-bank dealings.

Assuming that an alternative currency flourishes and local banks agree to accept deposits not denominated in U.S. dollars, individuals accepting the local scrip would require a system that would transfer the new hand-to-hand currency from one bank to another. Although there are restrictions to transferring such local scrip within the Federal Reserve System, the alternative currency may be transferred through private efforts outside the Federal Reserve System.

Limitations on the Transfer of Funds in the Federal Reserve System

Within the Federal Reserve System, no national bank may issue any notes which circulate as money other than those authorized by the federal banking statutes.[129] Additionally, a national bank may neither put in circulation the notes of any bank which does not receive those notes at par nor put in circulation any notes of any bank which is not redeeming its circulating currency in lawful money of the United States.[130] The restrictions on circulating notes of other banks include any state bank as well as member banks.[131]

The "notes" that these provisions refer to are Federal Reserve notes[132] or national bank notes which must be in certain denominations in certain proportions,[133] engraved by the Comptroller of the Currency's plates and dies,[134] have the charter numbers of the national bank to be printed on them,[135] and printed on distinctive paper.[136] In short, hand-to-hand currency not denominated in U.S. dollars cannot circulate within the Federal Reserve System. However, these provisions do not bar banks, even national banks, from dealing in the alternative scrip and joining a scrip and clearinghouse system to transfer the currency among participating banks.

With respect to collecting checks, Regulation CC establishes rules designed to speed the collection and return of unpaid checks.[137] The Board of Governors of the Federal Reserve System issued Regulation CC to implement the Expedited Funds Availability Act[138] which creates time limits within which depository institutions are required to make available for withdrawal the proceeds of checks deposited for collection.[139] Subpart C of Regulation CC sets forth the rules to ensure the expeditious return of checks, the responsibilities of paying and returning banks, authorization of direct returns, notification of nonpayment of large-dollar returns by the paying bank, check endorsement standards and other related charges to the check collection system.[140] The term "bank" as used in the regulation includes "any person engaged in the business of banking, including . . . a state or unit of general local government to the extent that the state or unit of general local government acts as a paying bank."[141] A "paying bank" includes the bank by which the check is payable and to which the check is sent for payment or collection.[142] Therefore, the Board of Governors has broad authority to apply its check collection rules to all checks, regardless of whether they were collected through the Federal Reserve System. Moreover, a "check" does not include an item payable in anything other than United States money.[143] However, this definition of the term "check" is limited to Subpart C of Regulation CC which deals with the collection of checks.[144]

Federal Reserve Banks may receive, or solely for the purpose of exchange and collection, the checks of member and nonmember banks

alike, so long as the checks are payable upon presentation within that the Federal Reserve Bank's district.[145] This banking provision is accompanied and interpreted by Regulation J.[146] Regulation J defines "check" as a draft, as defined in the Uniform Commercial Code (UCC).[147] "Draft" is defined by the UCC as "order"[148] which the UCC defines as "a written instruction to pay money signed by the person giving the instruction."[149] The UCC describes "money" as "a medium of exchange authorized or adopted by a domestic or foreign government."[150] Thus, under the UCC, a check may be payable in specific foreign money. The UCC provides:

> Unless the instrument otherwise provides, an instrument that states the amount payable in foreign money may be paid in the foreign money or in an equivalent amount in dollars calculated by using the current bank-offered spot rate at the place of payment for the purchase of dollars on the day on which the instrument is paid.[151]

Thus, the twelve Federal Reserve Banks which comprise the Federal Reserve System, as well as the clearinghouse mechanism provided by the Federal Reserve System, cannot receive for exchange and collection checks denominated in a unit of exchange which is neither the U.S. dollar nor a foreign currency, as defined. However, private clearinghouses may exist and provide for the transfer of checks not denominated in U.S. dollars.

Clearinghouses

A clearinghouse is an institution where representatives of various banks which are members in the clearinghouse meet to exchange checks drawn on each other and to make or receive payment of balances and so clear the transactions of the day for each member bank. Private, automated clearinghouses, such as the New York Automated Clearing House (NYACH) and the Clearing House Interbank Payment System (CHIPS), have flourished. Until 1983, the NYACH was the only privately owned and operated unit in the national clearinghouse network and in 1990, had a total volume of $127.7 billion.[152] CHIPS was formed in 1970 to replace paper checks with electronic signals for the exchange and settlement of international dollar transactions between the United States and foreign banks.[153] CHIPS now handles over 95 percent of all dollar payments that move between countries throughout the world.[154] In light of the absence of federal and state limitations on private clearinghouses, banks participating in the alternative currency program could create a regional or local clearinghouse to exchange checks not denominated in U.S. dollars. Initially, two or three banks could establish an informal clearinghouse between or among the participating financial institutions.

State Banks Acting as Agents for Local Issuers

In addition to transferring local scrip through private clearinghouses and banks acting beyond the Federal Reserve System, state banks in several states, such as Massachusetts, have the power to act as financial agents for the issuers and users of alternative currency. In Massachusetts, state banks have the power "[t]o act as financial or other agent for a person, association, trust, corporation, municipal corporation or government, and in their behalf to negotiate loans and the sale, purchase or other disposition or acquisition of securities or other property."[155] In a letter to the administrator to the SHARE program, the Office of the Commissioner of Banks confirmed that Massachusetts state banks have the power to act as financial agents in SHARE's "Local Stable Currency Experiment."[156] Twenty other states have statutes[157] similar to Massachusetts. In these jurisdictions, state banks can participate in alternative scrip programs, including entering into exchange transactions involving a local currency, accepting checking and other deposits in the scrip, implementing automatic teller transactions and electronic funds transfers in the scrip, issuing credit and debt cards, and making loans repayable in the local currency.

FEDERAL AND STATE REGULATION OF SECURITIES

The laws of securities regulation, both federal and state, constitute a complex and comprehensive scheme to protect both the offerees and purchasers of securities. These laws govern only what are deemed "securities." Once an instrument is determined to be a "security," the registration and disclosure requirements of the Federal Securities Act of 1933[158] and various state securities laws, commonly known as "blue sky" laws, typically restrict their offer and sale, unless they fall into an exemption.

Disclosure Requirements and the Registration Process

The basic purpose of the Securities Act of 1933 is to assure that the investor has adequate information upon which to base his or her investment decision with respect to publicly offered securities. To achieve this objective, the 1933 Act prohibits the sale or offer of a security to the public unless it is registered or falls within a statutory exemption.[159] Anyone who purchases illegally an unregistered security from the issuer (or a financial intermediary) may rescind the transaction and get his or her money back at any time within one year after the sale.[160]

An issuer registers a security by filing a "registration statement" with the Securities and Exchange Commission (SEC). The SEC rules specify

what information the registration statement must contain. Included in the registration statement is the "prospectus" which is provided to every purchaser.

Registration is a costly procedure, both temporally and financially.[161] The registration process is divided into three time periods.[162] The prefiling period is the time prior to completing and filing the registration statement. The time between filing the registration statement and when it becomes effective is known as the waiting period. During the waiting period, offers are permitted using a simplified, preliminary prospectus (a so-called "red herring" because of the legend announcing its preliminary character printed on the cover in red) but sales are prohibited. In the posteffective period, the 1933 Act generally requires that the prospectus be delivered to the purchaser prior to or at the same time as the security.[163] In reality, the purchaser thus receives a "retrospectus," the decision to purchase having been made prior to the receipt of any form of prospectus.

Moreover, the movement of the security from the issuer to the public is very expensive. Because most issuers do not have the necessary expertise in the financial industry to maneuver a public offering, issuers typically employ underwriters and other intermediaries. In addition to underwriting costs, the issuer must pay related expenses including, but not limited to, legal fees, accounting fees, printing fees, an SEC filing fee, state (blue sky) filing fees if applicable, and trustees' fees.[164] The average total underwriting costs as a percentage of proceeds is about 6 percent,[165] and typically, the costs are much higher as the size of issue decreases.[166]

An issuer of a local currency can avoid the registration process and the accompanying disclosure requirements by gaining a statutory exemption, of which there are two types: exempt securities and exempt transactions. Before considering these exemptions, the definition of a security must be considered.

What Is a "Security"?

"Security" is defined in Section 2(1) of the Securities Act of 1933 to include:

> any *note, stock,* treasury stock, bond, debenture, *evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement,* collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract,* voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call straddle, option, or privilege entered into on a national securities exchange re-

lating to foreign currency, or in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[167]

The broad statutory definition of the term "security" encompasses many types of instruments. Because there is no universal definition, the issuer of a local currency needs to focus on: notes and evidences of indebtedness, stocks, and investment contracts.

Notes and Evidences of Indebtedness

Contrary to what the statutory definition may lead one to believe, "any note" is not considered a "security." Prior to the U.S. Supreme Court's decision in *Reves v. Ernst & Young*,[168] the lower federal courts were sharply divided on the applicable criteria in determining whether a note was a "security." Four approaches predominated: (1) the commercial/investment test; (2) the family resemblance test; (3) the risk capital test; and (4) the *Howey* test. First, under the commercial/investment standard, courts look to whether the note can be characterized as commercial or investment in nature. If the note is a commercial instrument, then it is not deemed a "security." Conversely, if the note is an investment instrument, then it is a "security."[169] Second, under the family resemblance test, courts presume that a note is a "security" unless the presumption is rebutted by showing a strong family resemblance to a judicially crafted list of nonsecurities.[170] Third, under the risk-capital test, courts determine whether risk capital was subject to the efforts of others. If the purchaser invested risk capital, then the note would be a "security."[171] Finally, under the *Howey* criteria, courts ask whether the note involves an investment of money in a common enterprise with the expectation of profits arising solely from the efforts of others.[172]

In *Reves*, the U.S. Supreme Court sought to establish the definitive approach to be taken in determining the federal securities law status of notes in contrast to the prevailing uncertainty. The *Reves* Court adopted and modified the "family resemblance" test employed by the Second Circuit in *Exchange National Bank v. Touche Ross & Co.*[173] which presumes that a note is a "security" unless it resembles a note on a list of categories of notes that are not considered "securities." That list includes:

[T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).[174]

The *Reves* Court's modified "family resemblance" test involves two parts. First, it begins with the Second Circuit's test where "[a] note is presumed to be a 'security,' and that presumption may be rebutted only by showing that the note bears a strong resemblance"[175] to one of the notes on the list of exceptions in terms of four factors: (1) the motivations of a reasonable seller and buyer in entering into the transaction;[176] (2) whether the note is an instrument in which there is "common trading for speculation or investment"; (3) what are the "reasonable expectations" of the public; and (4) whether the transaction is governed by another regulatory scheme which "significantly reduces the risk of the instrument," making the application of federal securities laws unnecessary.[177] But "[i]f an instrument is not sufficiently similar to an item on the list," a second step involves whether another category should be added by considering the same four factors.[178]

Under two of the four *Reves* factors, local scrip (e.g., Deli Dollars) cast in the form of notes should not be a security. When examining the motives of the seller and buyer under *Reves'* first consideration, a note would be a "security" if the seller sought "to raise money for the general use of a business enterprise or to finance substantial investments and the buyer "is interested primarily in the profit the note is expected to generate."[179] "Profit," in the context of notes, is the return on the investment "which undoubtedly includes interest."[180] Arguably, the issuers of discount notes were not seeking to finance a business venture and the note purchasers were not interested primarily in the profit (the interest) the notes were expected to return. The issuers were not motivated by profit and the notes did not purport to yield interest. Rather, community and human empowerment were the leading motivators. Thus, the local currency described in Chapter 5 (e.g., Deli Dollars) does not satisfy the second criterion under *Reves*.

Under the third *Reves* factor, the public could reasonably perceive local scrip as a mere currency, providing a medium of exchange and store of value. Thus, an alternative currency would not be considered a "security" under the reasonable expectations of the public.

More troublesome are the two other *Reves* factors. The existence of a "risk reducing" factor, as the U.S. Supreme Court stated, would make application of the federal securities laws "unnecessary."[181] Like the demand notes in *Reves*, notes such as Deli Dollars are uncollateralized. Thus, such notes do not sufficiently decrease risk to distinguish them from the notes in *Reves*.

A local scrip cast in the form of a note such as Deli Dollars may also satisfy the "common trading for speculation" which is defined narrowly to include as a "security" notes "sold to a broad segment of the population" and not traded on an exchange.[182] Similar to the notes in *Reves* which were offered to more than 23,000 individuals and held by more

than 1,600 people, Deli Dollars were and continue to be offered and sold to a broad segment of the public.

The statutory definition of a "security" also encompasses an "evidence of indebtedness."[183] Obviously, the phrase is so broad that a literal reading is impossible. The criteria developed by courts in dealing with notes will likely guide the judiciary in interpreting the phrase "evidence of indebtedness."[184] What can be stated with assurance is that SEC staff declined administrative no-action protection, that is, assurance that the Commission would not take administrative action against the issuer with respect to retail incentive programs rebating 50 percent of the purchase price of certain merchandise in case ten years after purchase.[185]

Investment Contracts

Investments in money-raising schemes may be deemed an "investment contract," a "certificate of interest," or a "profit-sharing agreement" and thus fall in the category of "security" subject to the reach of the 1933 Securities Act, particularly the registration requirement. In *SEC v. W.J. Howey,*[186] the U.S. Supreme Court laid out the basic test: "An investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party."[187]

The U.S. Supreme Court has implied that an investment of money must have an affirmative, voluntary nature.[188] For instance, interests in a noncontributory pension plan are not "securities" because the contributions by employers could not be considered an "investment of money."[189] Courts have divided on whether, under the "common enterprise" requirement, investors must share in a single pool of assets ("horizontal commonality") or whether a profit-sharing arrangement between the promoter and each investor ("vertical commonality") is sufficient. The requirement that profits be secured "solely" from the efforts of others has been diluted to one that the profits come "primarily" or "substantially" from the efforts of others.[190]

The *Howey* definition of an investment contract may, thus, raise concerns for certain alternative currencies. A for-profit issuer of local currency, which floats independently of the U.S. dollar (e.g., the Constant), may face scrutiny by the SEC. The Commission may view an investment in such an instrument as a common enterprise in which the purchaser expects profits (a rise in the value of the alternative scrip in relation to the U.S. dollar) primarily from the promoter's efforts. In other words, the SEC might view the scrip issuance as a means of financing the issuer's operation. The issuer, relying on the *Forman* case, discussed next, could counter that the purchaser of an alternative currency does not

possess an expectation of substantial profits from the transaction. The main purpose, arguably, was to promote the local economy in a sustainable manner. Using a reasonable expectations test may enable an issuer to remove its scrip from the definition of a "security" under the *Howey* test.

Stocks

As with notes, the words "any . . . stock," contained in the statutory definition of a "security," are not always interpreted literally. In *United Housing Foundation v. Forman*,[191] the U.S. Supreme Court held that while most instruments bearing the label of "stock" are likely to be covered by the definition,[192] that fact alone is not sufficient to invoke coverage of the federal securities laws. Instead, the *Forman* Court concluded that it would also determine whether the instrument possessed the traditional indicia of stock, that is, the right to receive dividends, the conferring of voting rights apportioned according to the number of shares owned, and the possibility of appreciating in value.[193] Thus, the Court in *Forman* held that shares of stock in a cooperative housing corporation were not "securities" where "the inducement to purchase was solely to acquire low-cost subsidized living space" and the shares bore none of the characteristics typically associated with stock.[194] Moreover, the purchasers were not misled into believing that federal securities laws applied to their purchase.[195]

Under the "sale of business doctrine," courts once held that the transfer of all outstanding stock in the sale of a business was not a sale of "securities" because the sale was merely a transfer of the ownership and management of the corporation's assets.[196] However, the U.S. Supreme Court rejected the "sale of business" doctrine in *Landreth v. Landreth*,[197] affirming *Forman*, holding that the sale of shares having traditional indicia of stock was a sale of "securities" regardless of the purpose of the transaction or the percentage of shares sold.

Exempt Securities—Short-Term Notes

Even if an instrument meets the definition of a "security," it may be exempt from federal registration requirements. Section 3(a) of the 1933 Securities Act lists several "exempted securities." Generally, an "exempted security" is not subject to the federal registration requirements but may be subject to the federal antifraud and civil liability provisions for the sale of a "security" by misleading statements or omissions.[198]

Section 3(a) (3) exempts "any note . . . which has a maturity at the time of issuance of not exceeding nine months."[199] A broad, literal interpretation of this exemption would include any note with a maturity of less than nine months. However, many courts have limited the short-term

note exemption to high-grade commercial paper issued by large corporations to finance their current operations.[200]

In *Reves*, the U.S. Supreme Court declined to answer which interpretation would control because the demand notes in question were not short-term notes under either approach. Four of the five justices in the majority, led by Justice Thurgood Marshall, found that the notes in question were not short-term notes even under the literal interpretation.[201] Justice Marshall wrote that a note payable on demand under state law did not make the "maturity" of the demand note less than nine months because the term "maturity" is defined by federal law and Congress could not have intended that the exemptions be applied differently to the same transactions, depending upon which state law happened to apply.[202] Justice John Paul Stevens, writing in concurrence, adopted the commercial paper interpretation and found the notes to be "securities" under the majority test.[203] Four Justices in dissent, led by Justice William H. Rehnquist, declared that the notes in question did have a maturity of nine months or less and embraced the literal approach.[204]

Thus, the local scrip described in Chapter 5 (e.g., Deli Dollars) would probably fall under the exemption for short-term notes. In dictum, the *Reves* Court stated a demand note may be an "exempted security" if "the design of the transaction suggested that both parties contemplated that demand would be made within [the nine-month] period."[205] Properly structured, the maturity of the discount or bargain purchase-type local currency must not exceed nine months. Additionally, unlike *Reves*, there are no laws that vary from state to state that would affect the "maturity" of local scrip.

They *Reves* Court also emphasized that the statutory exclusion for short-term notes must be interpreted in accordance with the exemption's legislative purpose.[206] The persuasive argument that the Court adopted hypothetically was that Congress intended to create a bright-line rule exempting from coverage all notes of less than nine months' duration on the ground that short-term notes are sufficiently safe that the protection afforded investors by the federal securities laws is unnecessary.[207] Given this purpose, a discount or bargain purchase–type note would fall into the exemption provided it has the requisite of short term.

State "Blue Sky" Laws

State securities laws—"blue sky" laws—contain some form of one or more of three basic regulatory devices: (1) registration or licensing of securities prior to any dealing in the securities, which frequently involves procedures and standards for an affirmative administrative review of the merits of a particular issue; (2) antifraud provisions which make it unlawful to make a false or misleading statement or to omit a material fact

in connection with the sale of a security; (3) registration or licensing of certain persons engaged in the securities business prior to their trading in securities within a state. Although the details of registration and disclosure requirements of the various state securities laws are beyond the scope of this work, these state statutes define what a "security" is as well as set out various exemptions.

Every U.S. jurisdiction, including Guam[208] and Puerto Rico,[209] defines "security" in terms similar to the federal definition. In their definitions, forty-four states and the District of Columbia explicitly express what is not a "security" in addition to what is.[210] The remaining five states simply list what a "security" is.[211] Additionally, every state, except Ohio and Oregon, exempts short-term notes with maturity of less than nine months.[212]

Exempt Securities—Nonprofit Exemption

Also exempt from the registration and disclosure requirements from the 1933 Act is "[a]ny security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual."[213] Similarly, forty-seven jurisdictions, including the District of Columbia, have a comparable non–profit exemption.[214]

A local scrip, such as Deli Dollars, promoted by a for-profit issuer clearly falls outside this nonprofit exemption. However, a local scrip issued by a nonprofit organization, meeting the statutory definition, should qualify for the exemption even if it otherwise meets the definition of a security. The issuer satisfies the first requirement, namely, that it is exclusively organized for religious, educational, or charitable purposes, by receiving a ruling from the Internal Revenue Service that it qualifies as a tax-exempt organization. Because profit motives may make the exemption unavailable,[215] the issuer should also carefully adhere to and operate as a nonprofit organization.

Exempt Transactions—Intrastate Exemption

Section 3(a) (11) of the 1933 Securities Act[216] establishes the "intrastate offering exemption" which, in theory, may prove useful for a profit-seeking issuer of a local scrip that meets the definition of a "security." This exemption from the federal registration burdens is available only for a securities issue offered and sold exclusively to persons resident within one state by an issuer resident and doing business within the state.[217] Thus, if a potential offeree is domiciled outside the state, the exemption is unavailable not only for that offer but also for the entire

issue (unless another federal securities law exemption is available), therefore opening the seller-issuer to liability to every person who purchased the security—the local scrip—in the offering. In reality, the intrastate exemption may be of little utility.

Exempt Transactions—Limited Offerings

Section 3(b) of the 1933 Securities Act empowers the SEC to exempt, according to such conditions as it sees fit to establish, the issuance of securities of up to $5 million. Rule 504 of the SEC rules provides an exemption for "small" offerings which may be of interest to a for-profit local scrip issuer offering an instrument meeting the definition of a "security" under the 1933 Securities Act. Any nonpublic issuer can sell up to $1,000,000 in securities during a twelve-month period without having to comply with any federal registration requirements.[218] However, state securities laws remain applicable. In addition, there is no limit under federal securities law on the number of offerees to whom the securities can be sold. Rule 504 also allows for the general solicitation of investors and generally provides for the free transferability of securities under the rule.[219] The antifraud provisions of the federal securities laws still apply.

The multiplicity of state blue sky laws complicate the use of Rule 504 as an exemption from the federal registration requirements pursuant to the 1933 Act. Planners should consider using the Small Corporate Offering Registration Form (SCOR), known as Form U-7, which is available in about thirty-five states. The creation of SCOR makes Rule 504 a more viable exemption. SCOR provides a simplified question and answer disclosure document that serves as a uniform registration form for purposes of state securities registration in those jurisdictions which have adopted the SCOR approach.

FEDERAL INCOME TAX ASPECTS OF LOCAL CURRENCY

Taxation of Barter Exchanges

Income Aspects

As a general matter, the income tax aspects of barter transactions—the exchange of one commodity (or service) for another—are quite simple. The fair market value of the commodity (or service) received represents gross income.[220] The income is realized and recognized in the year the commodity (or service) is received.

At the outset, it is also useful to keep in mind that noncash exchanges may (1) take the form of direct transactions or (2) be handled by barter

clubs in which commodities or services may be exchanged for credits which can, in turn, be used to obtain goods or services.

The IRS gives the following example of a two-party bartering transaction that produces taxable income for both parties.[221] A lawyer performed personal legal services for a housepainter who in return painted the attorney's house. In the IRS's example, the lawyer and the painter belonged to a barter club, all of whose members are professional or business persons. The club provided a directory of members who contact each other directly and negotiate for the services to be performed. The IRS concluded that the lawyer and the painter must each include in income the fair market value of the services received from the other.

The IRS has reached similar results in indirect, three-party exchanges accomplished through a barter club. Income tax consequences arose where members of a barter club receive "credit units" as a medium of exchange. For example, a club credits a member's account for goods or services rendered to other members on the basis that one credit unit equals one U.S. dollar of value. Assume the club charges a member a 10 percent commission. The club does not, however, guarantee that a member will be able to use any of his or her credit units. The club does not pay a member cash for any unused credit units. A member can use his or her credit units to purchase goods or services offered by other club members. A member may transfer or sell his or her credit units to another club member.

Under a system involving credit units in a barter club, the members receive taxable income when the credit units are credited to their accounts, up to the U.S. dollar value of the units. Assume that A, B, and C, who use the cash method of accounting, that is, income is realized and recognized for income tax purposes when items are actually or constructively received regardless of when the claims actually arose.[222] The club members agree to provide specific services to any other club member for a specified number of hours while members are entitled to receive services provided by other members. Using a directory provided by the club, members contact each other and request services to be performed. The IRS concluded that the fair market value of the services received by A, B, and C is eligible to be included in their gross incomes in the taxable year in which received, not when the credits are spent. The services received by the taxpayers represent advance compensation for their agreeing to provide future services to other club members.[223]

Information Reporting Requirements

Barter exchanges are also subject to information reporting requirements. A "barter exchange," for purposes of the information reporting requirements, is any organization of members who provide property or services and who jointly either with each other or with the entity contract

to trade or barter such property or services directly or through the entity.[224] The term "barter exchange" does not, however, include arrangements that solely provide for the informal exchange of similar services on a noncommercial basis, such as a carpool for commuters to and from work.[225]

Under the Treasury Regulations,[226] a barter exchange must report information with respect to the calendar year in which exchanges of personal property or services are made through the exchange among its members or between its members and the exchange. For this purpose, property or services are exchanged through a barter exchange if: (1) the barter exchange arranges a direct exchange of property or services among its members or exchanges property or services with a member, or (2) if payment for property or services is made by means of a credit on the books of the barter exchange or scrip issued by the barter exchange.[227] These regulations would appear applicable to a LETS approach or an Ithaca HOUR–type system discussed in Chapter 4. However, this rule does not apply to transactions with exempt foreign persons[228] or a barter exchange through which there are fewer than one hundred exchanges during a calendar year. The IRS may require multiple barter exchanges to be combined for the purposes of the information filing requirement if it determines that a material purpose for the formation or continuation of one or more of the barter exchanges was to receive an exemption.[229]

Barter exchanges required to file information returns with respect to exchanges of property or services must file IRS Form 1096 for each calendar year that they are subject to the reporting requirements.[230] IRS Form 1096 is an annual summary that must accompany the transmittal of the IRS information returns to exchange members.

Except for exchanges involving corporate members (which are subject to special rules), for each exchange of property or services that is reportable by a barter exchange, the exchange must file an information return showing: the name, address, and identification number of each member providing property or services in the exchange; the property or services provided; the amount received for such property or services; the date on which the exchange occurred; and any other information required by IRS Form 1096.[231]

For each corporate member providing property or services in an exchange for which an information return is required, the barter exchange reports: the name, address, and identification number of the corporate member; the aggregate amount received by the corporate member during the calendar year for property or services provided by such corporate member for which an information return is required; and any other information required by the information return.[232]

The information return required for both noncorporate and corporate

members is IRS Form 1099-B (Statement for Recipients of Proceeds from Broker and Barter Exchange Transactions).[233]

Planners should note the definition of three key terms, "exchange," "amount received," and "fair market value" in connection with the information reporting requirements. An "exchange" occurs with respect to a member of a barter exchange on the date cash, property, services, a credit, or scrip is actually or constructively received by the member as a result of the exchange.[234] The doctrine of constructive receipt deals with when items of income, although not actually received by a taxpayer using the cash method of accounting, should be included in income.

The "amount received" in a barter exchange equals the fair market value of: (1) any credits to the account of the member on the books of the barter exchange; or (2) any issued to the member by the barter exchange. However, the term does not include any amount received in exchange for credits or scrips. The "fair market value" of a credit or scrip equals the value assigned to such credit or scrip by the barter exchange for the purposes of the exchanges unless the IRS requires the use of a different value that the Service determines more accurately reflects fair market value.[235]

If a barter exchange is required to report an exchange pursuant to the information reporting requirements contained in section 6045 of the Internal Revenue Code, it is required to impose backup withholding if: (1) a member of the exchange does not provide a taxpayer identification number (TIN) in the manner referred; or (2) the IRS notified the exchange that the TIN provided by the member is incorrect.[236]

Special Exception from the Information Reporting Requirement

A special exception exists for credits posted to volunteer's accounts in a barter exchange.[237] In the IRS Letter Ruling which gave rise to this exception, the taxpayer in question, a nonprofit organization, supervised a community self-help program. The program, operated by volunteers, maintained a file of individuals with specific skills. The organization linked these skilled individuals with people needing assistance. The assistance provided (e.g., housekeeping, babysitting, house painting) was voluntary. Neither the volunteer service provided nor the service recipient incurred any contractual obligations.

The taxpayer organization kept records of the hours a volunteer spent performing services. When a volunteer performed a service, the taxpayer credited the hours spent to the service provider's account and debited the hours to the service recipient's account. The credits posted to a service provider's account served as a means to motivate the volunteers.

The service providers did not receive a contractual right to receive services when they performed services. The taxpayer organization at-

tempted, however, to link a service provider with other volunteers if a service provider required assistance.

The Service reasoned that the community self-help program in question was not a "barter exchange" under section 6045(c) (3) of the Internal Revenue Code.[238] The Service reasoned that the credits posted to a volunteer service provider's account had no monetary value. The service recipients did not incur a contractual liability on the receipt of services. The service providers did not earn a contractual right to receive services in exchange for performing services. The credits served as a means to motivate volunteers to continue their community service. In other words, the credits provided recognition and a form of bonding. The credits did not serve as a cash substitute.

Deduction Aspects

Commissions paid by a member to a barter exchange are deductible as a business expense if he or she acquires an item for use in his or her trade or business[239] or for investment purposes.[240] Commissions are not deductible if paid to acquire an item for personal purposes.[241]

For tax purposes there are two basic methods of accounting—the cash method and the accrual method. The cash method of tax accounting is used by almost all wage earners and employees. It is also used by taxpayers rendering personal services and other small-scale proprietorships in which inventories are not significant.

The cash method has the merit of simplicity. Under the cash method, the receipt and disbursement of cash, property, or services controls the timing of the realization and recognition of income and deductions. Revenues and expenditures are realized and recognized at the time such items are actually or constructively received or actually paid out, regardless of when the claims or obligations actually arose.[242] The cash method minimizes bookkeeping and accounting duties; indeed for most cash method taxpayers, all "accounting" is done in the family checkbook.

Under the cash method, the disbursement of property or services controls the timing of the deductions. Expenditures, if deductible, are realized and recognized at the time such items are actually paid out, regardless of when the obligations actually arose.[243]

The accrual method of tax accounting was authorized to enable taxpayers to use for their tax books and records the same accounting principles as generally used by the accounting profession. Accountants determine income by (1) "timing" the recognition of revenue and (2) "matching" the related expense items against such revenue. The cash method makes no effort to "time" or to "match" revenue against expenses, because the recognition of revenue or expense only occurs when a receivable or a payable is reduced to cash, property, or services. This simple method is suitable for individuals rendering personal services.

However, a more sophisticated tax accounting method is required to determine more satisfactorily annual income for business taxpayers engaged in the sale of merchandise (such as manufacturers or distributors) who extend credit to customers or who receive credit from suppliers. Almost all businesses of any substantial size use the accrual method of accounting for the recognition of the revenues and expenses. And after 1986, Section 448 of the Internal Revenue Code[244] requires, for income tax purposes, many businesses to be on the accrual method.

In general, under the accrual method, a taxpayer (1) reports income when earned (rather than when actually or constructively received) and (2) takes a deduction when the liability for payment arises, not when an expense item is paid. Thus, accounts receivable (amounts owed to a taxpayer by its customers) and accounts payable (amounts owed by a taxpayer to its suppliers) are generally taken into account when the obligation becomes fixed, even though payment is not received or made until a later period.

In determining when an accrual method taxpayer may deduct expenses, a two-part test must be met. First, the taxpayer must meet an "all events" test, that is, "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."[245] Second, economic performance must occur with respect to an item.[246] The net effect of the "economic performance" provision is to postpone a deduction that meets the "all events" test to a time closer to the actual payment of the liability. The requirement of "economic performance" acts as a time constraint on the deductibility of liabilities that satisfy the "all events" test.

Thus, if, in a barter transaction, the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer (or out of the provision of services or property to the taxpayer by another person), economic performance occurs to the extent of the lesser of: (1) the extent to which the taxpayer incurs costs in connection with its liability to provide services or property, or (2) the extent to which services or property are provided to the taxpayer.[247]

Even if an item is deductible, the Internal Revenue Code generally prohibits a full and immediate deduction for capital expenditures, that is, an item with a useful life extending substantially beyond the close of the taxable year in which it is acquired.[248] Thus, commissions are treated as a capital expenditure if paid in connection with acquiring a capital item, regardless of a taxpayer's accounting method, even if used in the taxpayer's trade or business. The capitalized amount becomes part of the taxpayer's basis in the asset for which the commission is incurred.

Tax Consequences of Bargain Purchase or Discount Notes

Income Aspects

For income tax purposes, there are two ways of looking at notes such as Deli Dollars: (1) a nontaxable purchase discount transaction; or (2) a taxable discounted note.

A Deli Dollars scrip may serve as a tax-free means to provide purchasers of goods and services with a trade discount. Under long-standing judicial precedent, trade discounts are not included in the seller-taxpayer's gross income.[249] Thus, a seller-taxpayer realizes and recognizes $9 of income when scrip with a face value of $10 is sold to a purchaser. When the purchaser turns in the scrip he or she receives $10 worth of goods or services in a tax-free transaction.

Another way of looking at scrip involves viewing the scrip as a discount note. Thus, the $1 difference between the $9 paid for the scrip and $10 in goods or services for which the scrip is redeemed represents interest. For federal income tax purposes, interest is a payment for the use or forbearance of money made in connection with a valid debt.[250] The IRS treats payments that represent compensation for the use or forbearance of money as interest, regardless of how they are designated by the parties.

Indebtedness exists only if both parties intend to establish an enforceable obligation of repayment—in other words, a debt obligation.[251] The presence or absence of an intent to create a debt is normally tested at the time the "debt" is incurred.

In addition to the "intent" test, to be treated as debt, the obligation must be: (1) enforceable; (2) provable (here the scrip evidences the debt's existence); and (3) unconditional.[252] A further word or two is in order with respect to the enforceability prong of the test for indebtedness. According to the case law, to be classified as debt, the instrument must represent a legally enforceable obligation to make payment in money.[253] Does it make a difference that the payment here takes the form of goods or services? Probably what is more significant is that the scrip was given in exchange for consideration ($9 in U.S. cash). According to one commentator, indebtedness is a "present obligation to repay a money debt, which is not a sham or a disguise for some other relationship."[254]

If the difference between the face amount of the scrip ($10) and the amount paid for it ($9) represents interest, then it is included in the gross income of the scrip holder and is deductible by the business owner. A cash method scrip holder realizes and recognizes the interest in gross income in the year in which he or she redeems the scrip and receives goods and services from the business owner.

Deduction Aspects

Internal Revenue Code Section 163(a) provides a deduction for a taxpayer's adjusted gross income for interest paid or accrued on indebtedness within the taxable year. The terms "paid or accrued" are defined in Section 7701(a) (25) of the Internal Revenue Code.[255] The proper year for the deduction of interest depends mainly on whether the seller-taxpayer uses the cash method or the accrual method for tax accounting purposes. For a cash-method taxpayer–business owner rendering personal services, actual payment is the critical factor.[256] Thus, interest is paid when the scrip holder receives the goods or services from the business owner in exchange for the note.

As discussed earlier, the timing of deductibility of interest for an accrual method taxpayer turns on meeting a two-part test. First, all events must have occurred which determine both the fact of liability and that the amount of such liability can be determined with reasonable accuracy.[257] Second, economic performance must occur. Here, the business owner–taxpayer is to provide goods or services. Economic performance occurs as the taxpayer provides goods or services to the scrip holder.[258]

As discussed in Chapter 6, the scrip issuer may be a nonprofit organization. Thus, the deductibility of interest is not a problem for this type of scrip issuer. However, if the "discount" does not represent a purchase discount, it constitutes taxable interest to a purchaser of the note or scrip.

Special timing rules exist for "original issue discount" instruments. The term "original issue discount" (OID) connotes a debt instrument issued for money where the instrument's "stated redemption price at maturity" exceeds the instrument's "issue price."[259] An instrument's "issue price" is, generally speaking, the amount of money received by the issuer.[260] An instrument's "stated redemption price at maturity" equals the sum of all amounts payable at maturity, however characterized, excluding interest based on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the instrument's entire term.[261] In other words, original issue discount is measured by the difference between the amount paid on redemption and the issue price, that is, the amount the borrower will have to pay the note holder at maturity less the amount the issuer received (borrowed), a difference which is, in effect, compound interest on the issue price during the term of the obligation.

Basically, the Internal Revenue Code: (1) characterizes the OID interest element as ordinary income; (2) requires the holder (the creditor) to include in annual income a portion of the OID allocated to the year at issue;[262] and (3) permits the issuer (the debtor) to take a deduction[263] to the extent that the holder is required to include OID in income.

However, the details of the income tax treatment of OID to a note

holder and issuer need not concern us because IRC sections 1272 and 163(e) do not apply to short-term debt instruments, that is, any debt instrument that has a fixed maturity date not more than one year from the date of its issue.[264]

Despite the absence of any definitive judicial or administrative materials dealing with the income tax consequences of a bargain purchase/discount note, practicality may supply an answer. Because these notes are issued in bearer form, it probably is impossible for the Internal Revenue Service to enforce compliance with the reporting of interest income realized and recognized by a noteholder.

The compliance dilemma stems from bargain purchase/discount notes falling under an exception to Internal Revenue Code requirements for the registration of debt obligations. To improve taxpayer compliance in reporting interest received on debt instruments, the Internal Revenue Code provides registration requirements for debt obligations. Most publicly traded corporate debt obligations having maturities of one year or more must be in registered form.[265] An obligation is in registered form if the right to the principal of and the stated interest on the obligation may be transferred only through a book entry, that is, a system by which the owner of an obligation can be identified.[266] However, the term "registration required obligation," which triggers the registration requirement, encompasses all interest-bearing obligations except those obligations: (1) issued by natural persons (i.e., not a corporation); (2) of a type not offered to the public; or (3) having a maturity at issue of not more than one year. Thus, bargain purchase/discount notes which take the form of short-term debt instruments are not subject to the registration requirements, thereby creating a massive compliance problem for the Internal Revenue Service.

Tax Aspects of Local Currency Not Pegged to the U.S. Dollar

Transactions in local currency not pegged to the U.S. dollar, such as an exchange of local currency for U.S. dollars, may result in taxable gain or deductible losses because of fluctuations in the value of the local currency which result in exchange gains or loss. Of particular concern is the characterization of the exchange gains or losses as capital gains (or ordinary income) or capital loss (or ordinary loss). If the local currency is a capital asset, it may be receive capital gains or loss treatment.

Currently, the maximum tax rate on capital gains for individuals equals 28 percent.[267] In contrast, the top marginal rate on ordinary income for individuals if the local currency is not a capital asset equals 36 percent and reaches 39.6 percent with a 10 percent surtax on high-income taxpayers. The 28 percent maximum rate for capital gains only applies to individuals, not corporations.[268] The rate differential between capital

gains and ordinary income provides an impetus for individuals to engage in transactions involving local currency which create capital gains rather than ordinary income.

A capital gain (or loss) is a gain or loss from the sale or exchange of a capital asset. Once the amount of the gain or loss resulting from the exchange of local currency into U.S. dollars is computed,[269] the resulting gain or loss must be characterized. Characterization turns on the nature of the property sold or exchanged and on the nature of the taxpayer's trade or business.

Local currency generally is treated as property, that is, a capital asset.[270] However, if local currency is bought or received incidentally to a taxpayer's trade or business (e.g., by a currency dealer) it is not a capital asset and its conversion into U.S. currency results in the realization and recognition of ordinary income or loss.[271]

Assuming that the local currency meets the definition of a capital asset, the resulting gain or loss from a sale or exchange into U.S. dollars is characterized as a capital gain or loss. It is then necessary to determine whether the gain or loss is short term or long term. Section 1222 of the Internal Revenue Code defines short-term and long-term capital gains or losses by reference to the length of time the taxpayer held a capital asset prior to its sale or exchange. Generally, if a taxpayer holds the asset for more than the requisite holding period (currently one year), the capital gain or loss is characterized as long-term.[272] Conversely, if the taxpayer holds the asset for less than the requisite holding period (currently one year), any capital gain or loss is characterized as short-term.

A noncorporate taxpayer begins by aggregating all capital asset transactions that occur in a taxable year.[273] If all of these transactions taken together result in a "net capital gain," then the capital gain preference comes into play. If a noncorporate taxpayer has no net long-term capital gain or if her net long-term capital gain does not exceed short-term capital loss,[274] the taxpayer cannot use the special capital gains preference because net short-term capital gains are not included in the term "net capital gain"[275] and are taxed in the same manner as ordinary income.

All taxpayers, both individual and corporate, may be limited in their ability to deduct all of their capital losses in the year incurred. An individual can use capital losses as a deduction, without limitation, to offset capital gains.[276] However, if an individual's capital losses exceed capital gains, then only $3,000 of that excess can be deducted. Thus, the maximum amount of ordinary income that can be offset by capital losses is limited to $3,000 annually.[277] Any capital loss deduction that an individual taxpayer cannot currently use is merely postponed, because it may be carried forward (but not back) indefinitely and treated as a capital loss incurred in a subsequent year.[278]

For a corporate taxpayer, capital losses may be deducted in full to the

extent of capital gains but any excess may not be used to offset ordinary income.[279] Subject to certain limitations, a corporation may carry back and carry forward its unused capital loss deductions to prior and subsequent tax years.[280]

CONCLUSION

In short, a local currency system may raise questions under federal and state securities laws and under the federal Internal Revenue Code. However, with the possible exception of Virginia and Arkansas, federal or state currency laws would not restrain a system of alternative paper scrip.

The federal bar to private coinage and to the issuance of fractional paper currency denominated at less than one U.S. dollar per unit remains. We may appreciate the necessity of fractional coinage and fractional paper currency by envisioning the national monetary system without half dollars, quarters, dimes, nickels, or pennies. Moreover, the ability to set finer prices would aid producers in pricing products of varying quality and consumers in choosing between different products. As F. A. Hayek noted:

> an [issuer] would clearly also have to provide fractional coins; and the availability of convenient fractional coins in that currency might well be an important factor in making it popular. It would also probably be the habitual use of one sort of fractional coins (especially in slot machines, fares, tips, etc.) which would secure the predominance of one currency in the retail trade of one locality.[281]

For local issuers to create some form of fractional coinage, the 1864 Act prohibiting private coinage should, therefore, be repealed, as well as the imposition of criminal sanctions on the issuance of fractional paper currency with a value of less than one U.S. dollar.