

## [Understanding Bitcoin and Virtual Currency](#)

**Go to: [What is Bitcoin?](#) | [Advantages/Risks of Bitcoin](#) | [IP Issues/Concerns with Bitcoin](#) | [Lending Considerations](#) | [Overview – Bitcoin Regulation](#) | [Federal Anti-money Laundering / Bank Secrecy Act](#) | [Securities and Exchange Commission](#) | [Internal Revenue Service Guidance](#) | [Commodity Futures Trading Commission](#) | [State Treatment](#) | [International Treatment](#) | [Enforcement](#)**

*Reviewed on: 05/23/2019*

by [Jim Gatto](#), Sheppard, Mullin, Richter & Hampton LLP

### **What is Bitcoin?**

Bitcoin is the most well-known form of digital currency (also referred to as digital money or virtual currency). It was created by Satoshi Nakamoto, a pseudonymous person whose true identity remains elusive, via software that was released under an open source license. Satoshi Nakamoto also released a [white paper](#) describing bitcoin. Further development is being led by the [Bitcoin Foundation](#). Bitcoin is not legal tender, but in most countries it can be used and accepted in commerce voluntarily by willing participants. The use of bitcoin per se is not illegal, but activities performed using bitcoin may be illegal (e.g., buying illegal drugs or running a Ponzi scheme) or subject to regulation (e.g., operating a bitcoin exchange).

Bitcoin is both a type of currency and a decentralized transaction protocol. Bitcoin as currency is a form of virtual currency that can be transferred using the bitcoin transaction protocol. A key component of the Bitcoin protocol is a public ledger, known as the blockchain, which records the transactions conducted using the protocol. This ledger can be used for transactions other than just transfers of virtual currency. For example, it can be used to record smart contracts, escrow systems, smart property/title systems, and much more (as detailed below). As a result, the bitcoin protocol is much more than just a mechanism to transfer the virtual currency.

The decentralized nature of the protocol means that no single entity issues bitcoin. Rather, bitcoins are “mined” by bitcoin miners. While anyone can mine bitcoin, most miners use sophisticated computers and software to solve complex mathematical problems. Upon achieving a successful solution, a miner is given an amount of bitcoin. People all over the world compete to solve the problems and “mine” the coins. This processing power is also used to validate bitcoin transactions, and once validation occurs, a transaction is written to the blockchain. Currently, about 13 million bitcoins have been mined. The protocol dictates that a maximum of 21 million can ever be minable. Due to the increasing complexity of mining bitcoin, the last bitcoin will not likely be mined until 2140.

However, users of the bitcoin currency can acquire bitcoins without mining. Rather, once mined, bitcoins can be purchased via an exchange or accepted as payment for goods and services. An exchange enables users to exchange dollars (or other fiat currency) for bitcoins and vice versa. Numerous exchanges exist and each lists the current bid/ask price. A sample listing of exchanges can be found [here](#). Due to this exchangeability, bitcoin is referred to as a “convertible” virtual currency.

Bitcoins are “stored” in digital wallets (i.e., software applications that are either downloaded or web-based). Numerous wallets exist from various sources, but all wallets have core functionality that adheres to the bitcoin protocol and enables the peer-to-peer transactions that the bitcoin protocol was designed to enable. A sample listing of various types of wallets can be found [here](#). Each wallet is identified by a unique alphanumeric code, or wallet ID, that acts as a public key. To transfer bitcoin, a user must identify the recipient’s public wallet ID, the amount of bitcoin to be sent, and the user’s own private key, which is used to authorize the transfer.

### **Advantages/Risks of Bitcoin**

## Understanding Bitcoin and Virtual Currency

Bitcoin transactions are peer-to-peer transactions (i.e., no financial intermediaries are necessary). This can reduce the cost of transactions by avoiding fees normally paid to such intermediaries. This can be a huge advantage in various contexts (e.g., retailers can avoid credit card fees, and consumers can avoid fees for sending money internationally).

Bitcoin transactions are also pseudonymous, (i.e., they are neither truly anonymous nor fully public). Rather, information from each transaction—including the sender's and recipient's wallet IDs and the amount of bitcoin transferred via the transaction—is written to the public ledger (the blockchain). One advantage of this, compared with credit and debit card transactions, is that it avoids the impact of data breaches. For instance, if a user pays a retailer with bitcoin, the retailer would only receive the user's wallet ID (public key) during the transaction. Even if the retailer experiences a data breach, the wallet ID alone is not useful without the private key. Thus, as long as the user maintains her private key as confidential, there is little risk of loss due to a wallet or retailer being hacked.

Another advantage of bitcoin is that transactions are generally irreversible. Once bitcoins are sent and a transaction is validated and written to the blockchain, the transaction generally cannot be undone. This avoids charge-back fraud, a common problem with credit card transactions. Charge-back fraud occurs when a consumer makes an online purchase with his or her own credit card, but requests a credit, or "charge-back," from the issuing bank after actually receiving the purchased goods or services. The charge-back cancels the financial transaction, leaving the consumer with both the goods and a refund of the money spent. However, the irreversibility of bitcoin also may make it difficult for consumers to get their money back if they pay for goods but don't receive them or if they are damaged.

There are also various risks associated with bitcoin. For one, the value of bitcoin has fluctuated dramatically. This can present a risk for retailers if they accept bitcoin and the value of the bitcoin decreases shortly after the transaction. To mitigate this risk, a number of companies (e.g., Bitpay, Coinbase) provide services to retailers whereby the companies accept a user's bitcoin payment for a retailer and "immediately" credit the retailer with the dollar value of the bitcoin, thereby removing the volatility risk. Many retailers accepting bitcoins use these services.

Another potential disadvantage of bitcoin is the perception that it lacks value, as it is not issued by a single entity nor backed by a government or commodity. Its value instead derives from the fact that a growing number of users are willing to mine and/or use it, and a finite number of bitcoins can be mined. Many people have a hard time understanding how a "currency" not backed by a government or commodity can have value. It is worth noting, however, that many fiat currencies have not been backed by anything since going off the gold standard, making bitcoin less unusual in this regard.

For further discussion of risks, see [Securities and Exchange Commission](#) and below.

- ["Investor Alert: Bitcoin: More than a Bit Risky" issued by the Financial Industry Regulatory Authority](#)
- ["Risks to Consumers Posed by Virtual Currencies" issued by the Consumer Financial Protection Bureau \(Aug. 2014\)](#)
- ["Model State Consumer and Investor Guidance on Virtual Currency" issued by the Conference of State Bank Supervisors \(Apr. 23, 2014\)](#)

### IP Issues/Concerns with Bitcoin

#### **Patents**

Bitcoin is an open-source virtual currency, but it is also a transaction protocol. This means that people can modify bitcoin to create new virtual currencies and can build applications to leverage the protocol. The alternative currencies are often referred to as "alt-coins," while the applications being built on top of the bitcoin platform are referred to as Bitcoin 2.0.

## Understanding Bitcoin and Virtual Currency

As with other innovations, these modifications and new functionality can be patented, assuming they meet the requirements for patent eligibility and are novel and not obvious. This is analogous to the internet—the TCP/IP protocol is the foundation of the platform, but many applications have been built on top of the platform and have been patented.

Some examples of bitcoin or virtual currency patents or patent applications include the following:

U.S. Patent No. 8510186 B2 - creation, redemption, and accounting in a virtual currency system (Facebook)

US 20140172633 A1 - payment interchange for use with global shopping cart (MasterCard patent application)

US 20140156497 A1 - alternative value exchange systems and methods (Western Union patent application)

### **Trademarks**

Different entities have filed trademark applications for the BITCOIN mark in various countries, creating a complex situation regarding ownership rights in the term. To date, no enforcement actions have been filed.

In the United States, a number of trademark registrations have been issued that include the word “bitcoin” (e.g., AMERICAN BITCOIN EXCHANGE, EASY BITCOIN, MILLY BITCOIN, INSIDE BITCOINS), though most have disclaimed use of “bitcoin” apart from the overall mark. The term “bitcoin,” by itself, would likely be considered descriptive (subject to protection only upon a showing of secondary meaning) or possibly generic (not subject to protection) under US law.

### **Copyright**

Bitcoin software is licensed under an open-source license. Thus, it implicates the usual copyright issues that arise with open source. Beyond that there have not been many copyright-specific issues relating to bitcoin. For further information, see [Open Source Fundamentals](#).

### **Lending Considerations**

As the bitcoin ecosystem matures, a number of new uses are being found for bitcoin. Each has its own risks and advantages, and requires careful consideration. One prominent example is the use of bitcoin as collateral for a loan.

A major risk of accepting bitcoin as collateral is that, without appropriate safeguards, bitcoin can be transferred or liquidated by the borrower pretty quickly in the event of default. Another practical consideration is how to enforce a lien, given that the private key for the user’s wallet is necessary. These issues can be addressed, however, by using a feature of the bitcoin protocol that enables escrows.

Specifically, the feature can enable an “M of N transaction.” This requires a total of M parties to consent to execute a transaction out of a total of N parties. In the case of a simple loan, three parties may exist—the lender, the borrower, and the escrow entity (thus, N=3). A transaction can be programmed using the bitcoin protocol such that the borrower transfers bitcoin to the escrow account with conditions for release, including a requirement that M(2) of N(3) parties must consent. If the borrower and lender agree that there has been a default, they can both “sign” the transaction with their private key and the bitcoin can be released to the lender (in the event of default) or to the borrower (in the event of satisfaction of the underlying loan). If there is a dispute, then the escrow agent can act, together with the party that the agent deems to be correct regarding the dispute, and provide the necessary second signature. Theoretically, this enables the bitcoin protocol to facilitate the enforcement of a lien and potentially avoids the need for filing liens.

### **Overview – Bitcoin Regulation**

Bitcoin is not legal tender, but it is not necessarily illegal in most countries. Governments around the world are grappling with whether and how to regulate it.

## Understanding Bitcoin and Virtual Currency

The primary regulatory concerns are: (1) consumer protection, (2) anti-money laundering; and (3) tax evasion. These issues implicate federal, state, and international law.

U.S. congressional hearings on bitcoin were held in November 2013. Many witnesses with diverse backgrounds testified, including members of the Obama administration, regulators, law enforcement, CEOs, venture capitalists, and representatives of the Bitcoin Foundation. Some of the common themes discussed were the many legitimate uses of bitcoin, the desire to support innovation but with appropriate regulatory oversight, and the need for law enforcement to weed out the bad apples whose illegal early uses gave bitcoin a bad name. While no new federal legislation has resulted from these hearings, many believe they were quite beneficial in educating Congress on the relevant issues.

Most of the current applicable laws are general statutes not written with bitcoin in mind. However, various agencies and governments have issued guidance on how the existing laws and regulations apply to virtual currencies such as bitcoin.

### **Federal Anti-money Laundering / Bank Secrecy Act**

The primary federal law relevant to money laundering is the Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the Bank Secrecy Act or BSA ([31 USCS § 5311 et seq.](#)). The BSA requires US financial institutions to assist US government agencies in detecting and preventing money laundering. The BSA's implementing regulations (the BSA Regulations) establish extensive customer verification, recordkeeping, reporting, and other anti-money laundering requirements for financial institutions. Certain requirements of the BSA Regulations apply to all entities conducting business in the United States, such as the requirement to report foreign bank accounts in excess of \$10,000 and to report cash or currency transactions in excess of \$10,000 that are conducted in any day by or on behalf of a person in connection with a trade or business.

Under the BSA Regulations, the term "financial institution" includes money services businesses (MSBs), which include, subject to certain exceptions, "[a] person wherever located doing business, whether or not on a regular basis or as an organized or licensed business concern, wholly or in substantial part within the United States," in one or more specified capacities, including in the capacity of a money transmitter. A "money transmitter" is a person or entity that provides "money transmission services" or any other person engaged in the transfer of funds, subject to certain exceptions as more particularly discussed below. Money transmission services means "the acceptance of currency, funds, *or other value that substitutes for currency* from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means. [emphasis added]"

The BSA Regulations' definition of money transmission services does not differentiate between "real" currencies and virtual currencies. Therefore, if a person accepts anything of value that substitutes for currency, such as bitcoin, and transmits that value to another location or person, such person may qualify as a money transmitter under the BSA Regulations, unless the person qualifies for a limitation or exclusion. See [FIN-2013-G001](#), Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (Mar. 18, 2013). Some of the six enumerated limitations or exclusions relate to: (1) natural persons who engage in regulated MSB activity "on an infrequent basis and not for gain or profit"; (2) banks or foreign banks; and (3) persons registered with, and functionally regulated or examined by, the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC), or a foreign financial agency that engages in financial activities that, if conducted in the United States, would require the foreign financial agency to be registered with the SEC or CFTC. See [31 C.F.R. § 1010.100\(ff\)\(5\)\(ii\)\(A\)-\(F\)](#).

The BSA Regulations require money services businesses and their agents to develop, implement, and maintain an effective written anti-money laundering (AML) program that is reasonably designed to prevent the MSB or agent from being used to facilitate money laundering and the financing of terrorist activities. An AML program must "be commensurate with the risks posed by the location and size of, and the nature and volume of the financial services provided by, the [MSB]." At a minimum, an AML program must:

## Understanding Bitcoin and Virtual Currency

- 1 incorporate policies, procedures, and internal controls reasonably designed to assure compliance with the BSA Regulations, including, without limitation and to the extent applicable, provisions for verifying customer identity (also referred to as Know Your Customer, or KYC ), filing reports (including Suspicious Activity Reports, or SARs), creating and retaining records, and responding to law enforcement requests;
- 2 designate a person to assure day-to-day compliance with the AML program and the BSA Regulations, whose responsibilities include assuring that: (a) the MSB properly files reports, and creates and retains records, in accordance with applicable requirements of the BSA Regulations; (b) the AML program is updated as necessary to reflect current requirements of the BSA Regulations and related guidance issued by the Department of the Treasury; and (c) the MSB provides appropriate training and education to its personnel in accordance with the BSA Regulations;
- 3 provide education and/or training of appropriate personnel concerning their responsibilities under the AML program, including training in the detection of suspicious transactions to the extent that the MSB is required to report such transactions under the BSA Regulations; and
- 4 provide for independent review to monitor and maintain an adequate AML program commensurate with the risk of the financial services provided by the MSB.

### ***FinCEN Guidance***

The Financial Crimes Enforcement Network (FinCEN) is the federal regulatory agency responsible for enforcing compliance with the BSA Regulations. On March 18, 2013, FinCEN issued interpretive guidance ([FinCEN Guidance](#)) to clarify the applicability of the BSA Regulations to virtual currencies.

FinCEN considers bitcoin to be a “convertible virtual currency,” which it defines as virtual currency that either has an equivalent value in real currency or acts as a substitute for real currency. Three categories of persons are discussed in the FinCEN Guidance—“users,” “exchangers,” and “administrators,” which are defined as follows:

- A user is a person that obtains virtual currency to purchase goods or services on the user’s own behalf.
- An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.
- An administrator is a person engaged as a business in issuing (putting into circulation) a virtual currency, who also has the authority to redeem (to withdraw from circulation) such virtual currency.

FinCEN treats the three categories of participants differently. A user who obtains convertible virtual currency by, for example, earning, harvesting, mining, creating, auto-generating, manufacturing, or purchasing the currency and uses it solely to purchase real or virtual goods or services is not a money transmitter, and therefore not an MSB, under the BSA Regulations. In contrast, an administrator or exchanger that (1) accepts and transmits convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter and thus an MSB, unless the person qualifies for a limitation to or an exemption from the definition of a money transmitter as explained above.

### ***FinCEN Administrative Rulings***

Subsequent to the FinCEN Guidance, FinCEN issued various administrative rulings relating to bitcoin. In the first of two January 2014 [rulings](#), it found that certain miners of convertible virtual currency are not MSBs. Specifically, a miner of bitcoin is a “user,” and therefore not an MSB, to the extent the miner uses its bitcoins “(a) to pay for the purchase of goods or services, pay debts it has previously incurred (including debts to its owner[s]), or make distributions to owners; or (b) to purchase real currency or another convertible virtual currency, so long as the real currency or other convertible virtual currency is used solely in order to make payments ... or for [the miner]’s own investment purposes.”

FinCEN clarified that the mechanism by which a person obtains the convertible virtual currency (e.g., earning, harvesting, mining, creating, auto-generating, manufacturing, or purchasing) is not the relevant factor, but rather for

## Understanding Bitcoin and Virtual Currency

what the person uses the convertible virtual currency and for whose benefit. The ruling refines the definition of “user” from the FinCEN Guidance to emphasize that a user is a person who obtains virtual currency to purchase goods or services on the user’s own behalf. According to the ruling, “[t]o the extent that a user mines bitcoin and uses the bitcoin solely for the user’s own purposes and not for the benefit of another, the user is not an MSB under [the BSA], because these activities involve neither ‘acceptance’ nor ‘transmission’ of the convertible virtual currency and are not the transmission of funds within the meaning of the [BSA Regulations].”

Additionally, FinCEN indicated that a user who converts bitcoin into real currency or another convertible virtual currency will not be deemed to be an “exchanger” of convertible virtual currency based upon such conversion as long as the conversion is “solely for the user’s own purposes and not as a business service performed for the benefit of another.” In contrast, FinCEN stated that any transfer of convertible virtual currency to third parties at the request of a seller, creditor, owner, or counterparty to a transaction may constitute “money transmission services” under the BSA Regulations.

In the second [ruling](#), FinCEN addressed: (1) the production and distribution of software to facilitate the purchase of virtual currency and (2) periodic investment in convertible virtual currency. As to the software issue, the ruling stated: “[t]he production and distribution of software, in and of itself, does not constitute acceptance and transmission of value, even if the purpose of the software is to facilitate the sale of virtual currency.” However, if a software provider engages in other activities in addition to producing and distributing software, such as exchanging convertible virtual currency for real currency, the software provider may be deemed to be a money transmitter, and therefore an MSB, under the BSA Regulations unless an exemption applies.

The ruling also confirmed that “to the extent that [a person] limits its activities strictly to investing in virtual currency for its own account, it is not acting as a money transmitter and is not an MSB under [the BSA].” This reemphasized that what is material to the inquiry is not the mechanism by which a person obtains the convertible virtual currency, but for what the person uses the convertible virtual currency, and for whose benefit.

In an April 2014 [ruling](#), FinCEN clarified that renting to others computer systems for mining virtual currency would not make a person an “administrator” or a money transmitter under the BSA. It reasoned that the BSA Regulations specifically exempt persons that only “[provide] the delivery, communication, or network access services used by a money transmitter to support money transmission services” from the definition of a money transmitter.

In an October 2014 [ruling](#), FinCEN found that a company would be a money transmitter if the company: (1) establishes a system to provide payments to merchants who wish to receive customer payments in bitcoin, (2) receives payment from the customer in currency of legal tender (“real currency”), and (3) transfers the equivalent in bitcoin to the merchant, minus a transaction fee.

In an August 2015 [ruling](#), FinCEN declared that a commodity-backed token service is a money transmitter. The facts upon which this ruling is based are as follows: a company engaged in three complementary but distinct types of activities: a) The company provides Internet-based brokerage services between buyers and sellers of precious metals. Buyers pay sellers directly by check, wire transfer, or bitcoin. b) The company buys and sells precious metals on its own account. c) The company holds precious metals in custody for buyers that purchase this service (“customers”), opening a digital wallet for the Customer and issuing a digital proof of custody (a “digital certificate”) that can be linked to the customer’s wallet on the bitcoin blockchain ledger. The customer then can trade or exchange its precious metals holdings at the company by any means that it could trade or exchange bitcoin via the rails of the blockchain ledger. The company derives its income from charging a transaction fee on transfers of digital certificates by customers and a custody fee for precious metals held in custody.

FinCEN levied a \$700,000 [fine](#) against Ripple Labs Inc. for an alleged willful violation of the anti-money laundering laws. Ripple issues its own digital currency, and according to FinCEN: “Ripple Labs willfully violated several requirements of the Bank Secrecy Act (BSA) by acting as a money services business (MSB) and selling its virtual currency, known as XRP, without registering with FinCEN, and by failing to implement and maintain an adequate anti-money laundering (AML) program designed to protect its products from use by money launderers or terrorist financiers.” Additional information can be found [here](#).

## Understanding Bitcoin and Virtual Currency

In May 2015, FinCEN began its first set of Bank Secrecy Act audits for entities that had registered as money transmitters for digital currencies.

### Securities and Exchange Commission

The Securities and Exchange Commission, which protects investors; maintains fair, orderly, and efficient markets; and facilitates capital formation, has indicated that bitcoin and other virtual currency investment schemes may present unique and heightened risks for fraud, and has issued alerts to inform investors of the potential risks:

- [“Investor Alert: Ponzi Schemes Using Virtual Currencies” issued by the SEC \(July 2013\)](#)
- [“Investor Alert: Bitcoin and Other Virtual Currency-Related Investments” issued by the SEC \(May 7, 2014\)](#)

Specifically, the SEC warns investors to consider the following risks when evaluating investments involving bitcoin:

- Such investments are not insured, unlike many securities accounts and bank accounts that are often insured by the Securities Investor Protection Corporation and the Federal Deposit Insurance Corporation (FDIC), respectively.
- Such investments have a history of volatility.
- Federal, state, or foreign governments may restrict the use and exchange of bitcoin.
- Bitcoin may be stolen by hackers and bitcoin exchanges may stop operating or permanently shut down due to fraud, technical glitches, hackers, or malware.
- Bitcoin does not have an established track record of credibility and trust.

One of the first SEC enforcement actions in this area was against a bitcoin-based Ponzi scheme. SEC v. Shavers, No. 4:13-cv-416 (E.D. Texas filed July 23, 2013). An interesting legal issue was whether bitcoin should be considered a security and thus subject to SEC jurisdiction. Shavers moved to dismiss the complaint, arguing that the SEC had no authority to bring the action and that bitcoin is neither money nor subject to regulation. The Eastern District of Texas disagreed with Shavers’ arguments, finding that bitcoin can be used as money and that the investments at issue met the definition of “investment contract” and, as such, were securities. So at least for SEC enforcement purposes, certain bitcoin uses may be deemed to be activities involving a security.

Additionally, many investors are exploring legitimate investment vehicles. The Winkelvoss brothers (of Facebook fame), for instance, [filed a registration statement to establish the Winkelvoss Bitcoin Trust as an investment vehicle](#). Others are rumored to be in the works.

### Internal Revenue Service Guidance

The Internal Revenue Service (IRS) issued a major ruling in 2014 that relates to bitcoin. See [“IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply,” IR-2014-36 \(Mar. 25, 2014\)](#). This ruling addressed the US federal tax implications of transactions in, or transactions that use, bitcoin and other convertible virtual currencies.

A key aspect of the ruling was the IRS’s classification of convertible virtual currency as “property” for US federal tax purposes. This means that the general tax principles that apply to property transactions apply to transactions using virtual currency. Many stakeholders in the bitcoin community were shocked by this, assuming that bitcoin would more likely be treated as a currency. In fact, soon after this ruling, Rep. Steve Stockman (R-TX) introduced the Virtual Currency Tax Reform Act ([113 H.R. 4602](#)) to overturn the IRS classification and have bitcoin declared a currency. No further action has been taken on the bill since it was introduced.

The IRS ruling has an impact on employment and other reporting issues including that:

## Understanding Bitcoin and Virtual Currency

- wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes;
- payments using virtual currency made to independent contractors and other service providers are taxable, and self-employment tax rules generally apply (normally, payers must issue Form 1099);
- the sale or exchange of virtual currency may be treated as a capital gain or loss, depending on whether the virtual currency is a capital asset in the hands of the taxpayer; and
- a payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.

The ruling thus has an impact on bitcoin miners due to the immediate tax liability upon earning bitcoin, a tax impact on consumers who use appreciated bitcoin to buy everyday goods and reporting obligations on employers who pay wages in bitcoin.

The IRS ruling also includes the following pronouncements:

- 1 Convertible virtual currency is a virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, such as bitcoin.
- 2 The sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability.
- 3 Virtual currency is not treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under US federal tax laws.
- 4 For purposes of computing gross income, a taxpayer who receives virtual currency as payment for goods or services must include the fair market value of virtual currency received as measured in US dollars, as of the date that the virtual currency was received.
- 5 The basis of virtual currency received as payment for goods or services is the fair market value of the virtual currency in US. dollars as of the date of receipt.
- 6 For US tax purposes, transactions using virtual currency must be reported in US dollars using the fair market value of virtual currency as of the date of payment or receipt.
- 7 If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.
- 8 A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer and realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer (e.g., inventory and other property held mainly for sale to customers in a trade or business).
- 9 Mining virtual currency triggers gross income at the fair market value of the virtual currency as of the date of receipt.
- 10 If a mining of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax.
- 11 Payments in virtual currency received for services performed as an independent contractor constitute gross income if related to any trade or business carried on by the individual as other than an employee, at the fair market value (in US dollars) as of the date of receipt, and such payments are subject to the self-employment tax.



## Understanding Bitcoin and Virtual Currency

- 12 The fair market value of virtual currency paid as wages is subject to federal income tax withholding, the Federal Insurance Contributions Act (FICA) tax, and the Federal Unemployment Tax Act (FUTA) tax, and must be reported on Form W-2, Wage and Tax Statement.
- 13 Payments made using virtual currency are subject to information reporting to the same extent as any other payment made in property (e.g., payments in virtual currency with a value of \$600 or more for fixed and determinable income, including rent, salaries, wages, premiums, annuities, and compensation).
- 14 A person who in the course of a trade or business makes a payment of \$600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, Miscellaneous Income.
- 15 Third party settlement organizations are required to report payments made to a merchant on a Form 1099-K, Payment Card and Third Party Network Transactions, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200 and (2) the gross amount of payments made to the merchant exceeds \$20,000.
- 16 Taxpayers may be subject to penalties for failure to comply with tax laws (e.g., underpayments attributable to virtual currency transactions such as accuracy-related penalties under section 6662, or failure to timely or correctly report virtual currency transactions when required to do so under sections 6721 and 6722). However, penalty relief may be available to taxpayers and persons required to file information returns who are able to establish that the underpayment or failure to properly file the information return is due to reasonable cause.

### Commodity Futures Trading Commission

The Commodity Futures Trading Commission (CFTC) protects market participants and the public from fraud, manipulation, abusive practices, and systemic risk related to derivatives – both futures and swaps – and seeks to foster transparent, open, competitive, and financially sound markets. The CFTC has not issued any formal guidance on bitcoin. The CFTC has informally indicated in press interviews that bitcoin could come under CFTC jurisdiction as a commodity for future delivery and that the CFTC could regulate derivative products of bitcoins (e.g., Bitcoin futures, swaps, and rolling spot bitcoin transactions). The CFTC held a two-hour hearing in October 2014 on bitcoins and virtual currencies. Panelists for the CFTC event included Coin Center executive director Jerry Brito, New York Law School professor Houman Shadab, BitPay chief compliance officer Tim Byun, and TeraExchange president and co-founder Leonard Nuara. The hearings mostly covered bitcoin basics, not the larger issue of whether bitcoin should be classified as a commodity.

In September 2014, TeraExchange launched the first bitcoin derivative after a lengthy review and approval by the CFTC. This derivative locks in a dollar value for bitcoin and offers a form of insurance against bitcoin price volatility. Other companies have also proposed issuing virtual currencies backed by gold or some other commodity. If implemented, the CFTC may have jurisdiction over them.

Recently, however, the CFTC [ordered](#) a bitcoin options trading platform operator and its CEO to cease illegally offering bitcoin options and to cease operating a facility for trading or processing of swaps without registering. In this action, the CFTC opined that bitcoin and other virtual currencies are a commodity covered by the Commodity Exchange Act. In September 2015, the CFTC settled charges against the small and now-defunct company.

### State Treatment

All but three states regulate money transmission. Montana, New Mexico, and South Carolina do not.

Most states impose strict licensing and other requirements on money transmitters when any element of the regulated activity occurs within the state, unless an exemption applies. Massachusetts only requires licensure for

## Understanding Bitcoin and Virtual Currency

money transmission to foreign countries, but has pending bills to govern both foreign and domestic money transmission (2013 Bill Text MA H.B. 4329 and 2013 Bill Text MA H.B. 4246).

In most states, licensure requirements are triggered if an entity conducts money transmission on behalf of residents of the state or on behalf of businesses in the state, regardless of whether such entity has a physical location in the state. While most state laws do not specifically address virtual currency, they generally broadly define “money transmission” and “money transmitter” to include receiving money *or monetary value* from one person for transmission to another person or location by electronic or other means.

Several states have issued proposed regulations and/or formal regulatory guidance relating to convertible virtual currencies, including:

- *New York*. On July 17, 2014, the New York Department of Financial Services issued [proposed regulations](#) that would govern New York virtual currency businesses. It subsequently implemented a set of [regulations](#) that are now in effect. In September 2015, it [issued](#) its first bitcoin license, and shortly thereafter, it [issued](#) charters to three virtual currency firms to operate virtual currency-based trusts.
- *Texas*. “[Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act](#),” issued by the Texas Department of Banking (Apr. 3, 2014).
- *Kansas*. “[Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act](#),” issued by the Office of the State Bank Commissioner of Kansas (June 6, 2014).

Other states are evaluating the regulation of virtual currencies and, in the meantime, have issued advisories to residents concerning the use of virtual currencies, such as:

- *California*. “[What You Should Know About Virtual Currencies](#),” issued by the California Department of Business Oversight (Apr. 2014). An effort to pass a bill to license virtual currencies failed in 2016.
- *Maryland*. “[Virtual Currencies: Risks for Buying, Selling, Transacting, and Investing](#),” issued by the Office of the Commissioner of Financial Regulation of Maryland.

Several other states have issued alerts to warn investors of the risks associated with virtual currencies, including:

- *Alabama*. “[Investor Alert - Use of Bitcoins are HIGH RISK with Minimal Protection for Consumers - Largest Bitcoin Exchange Experiences Significant Rise in Complaints](#),” issued by the Alabama Securities Commission (Feb. 25, 2014).
- *Texas*. “[Texas Securities Commissioner Warns About Risks Associated with Investments Tied to Digital Currencies](#),” issued by the Texas State Securities Board (Feb. 25, 2014). Additionally, on March 10, 2014, the Texas Securities Commissioner entered an emergency cease and desist order against a Texas oil and gas exploration company that offered working interests in wells for sale to the public in exchange for bitcoins. The commissioner concluded, among other things, that such investments are “securities” under the Texas Securities Act that had not been registered and that the company made offers containing a statement that is materially misleading or otherwise likely to deceive the public. [2014 Tex. Sec. LEXIS 3](#).

Other states are working on legislation to amend existing money services laws or to clarify that they address virtual currency, such as:

- *Illinois*. A pending bill (2013 Bill Text IL H.B. 5886) seeks to amend the Illinois Transmitters of Money Act to define virtual currency as “a medium of exchange that operates like currency in some environments, but does not have all the attributes of real currency.”
- *New York*. New York has proposed similar legislation to that in Illinois. See [Proposed Regulations, N.Y. Comp. Codes R. & Regs. tit. 23, Part 200](#) (discussed below in more detail).

Finally, some states have indicated that certain persons engaging in virtual currency transactions may be subject to their money services laws, while others have indicated that their money services laws do not apply to certain virtual currency transactions.

## Understanding Bitcoin and Virtual Currency

Ultimately, a state-by-state analysis and monitoring is necessary given the many divergent approaches and the likelihood of future bitcoin-related legislation, guidance, and/or regulatory enforcement.

In September 2015, The Conference of State Bank Supervisors (“CSBS”) issued a [Model Regulatory Framework](#) after finding that activities involving third party control of virtual currency, including for the purposes of transmitting, exchanging, holding, or otherwise controlling virtual currency, should be subject to state licensure and supervision.

A more detailed look at California, Texas, Kansas, Idaho, and New York is below.

**California**

The California Department of Business Oversight (DBO), which oversees state-licensed financial institutions, has not issued any guidance on virtual currency activities. However, it has issued an advisory regarding the risks associated with virtual currencies. See “[What You Should Know About Virtual Currencies](#),” issued by the DBO (Apr. 2014).

California has also amended the California Corporations Code to accommodate the issuance and use of virtual currencies. Specifically, Assembly Bill 129 repealed section 107 of the Code, which prohibited persons from issuing or putting in circulation, as money, anything but the lawful money of the United States. The new law ensures the legality of various forms of alternative currency such as digital currency, points, coupons, or other objects of monetary value when those methods are used for the purchase of goods and services or the transmission of payments.

**Texas**

On April 3, 2014, the Texas Department of Banking (DOB), the state agency that enforces the Texas Money Services Act, [Tex. Fin. Code §§ 151.001 et seq.](#) (Texas Act), issued a supervisory memorandum outlining its interpretation and application of the Texas Act to certain activities involving decentralized virtual currency. See “[Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act](#),” issued by the Texas Department of Banking (Apr. 3, 2014). The DOB memo focuses on whether virtual currency should be considered “‘money or monetary value’ under the [Texas Act].”

Under the Texas Act, “[a] person may not engage in the business of money transmission or advertise, solicit, or hold itself out as a person that engages in the business of money transmission unless the person: (1) is licensed under [the Texas Act]; (2) is an authorized delegate of a person licensed under [the Texas Act]; (3) is excluded from licensure under Section 151.003 [of the Texas Act]; or (4) has been granted an exemption [from the Banking Commissioner of Texas].” The term “money transmission” means “the receipt of money *or monetary value* by any means in exchange for a promise to make the money or monetary value available at a later time or different location.” The terms “money” and “monetary value” mean “currency or a claim that can be converted into currency through a financial institution, electronic payments network, or other formal or informal payment system.” Based upon these definitions, the DOB concluded that bitcoin (and other digital currencies) cannot be considered “money” or “monetary value” under the Texas Act. Thus, receiving cryptocurrency (digital currency in which encryption techniques are used to obtain and transfer units) in exchange for a promise to make it available at a later time or different location is not money transmission under the Texas Act. See “[Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act](#),” issued by the Texas Department of Banking (Apr. 3, 2014).

The DOB cautioned, however, that when a cryptocurrency transaction includes sovereign currency, that transaction may be a money transmission depending on how the sovereign currency is handled. The department provided several examples of the types of transactions that would or would not constitute a “money transmission” subject to licensure under the Texas Act. The following activities are not money transmissions: (1) the exchange of cryptocurrency for sovereign currency between two parties; (2) the exchange of one cryptocurrency for another cryptocurrency, regardless of how many parties are involved; and (3) the transfer of cryptocurrency by itself. In contrast, the exchange of cryptocurrency for sovereign currency through a third-party exchanger is generally

## Understanding Bitcoin and Virtual Currency

deemed a money transmission, and the exchange of cryptocurrency for sovereign currency through an automated machine usually, but not always, constitutes a money transmission.

**Kansas**

On June 6, 2014, the Kansas Office of the State Bank Commissioner (the OSBC), the state agency that enforces the Kansas Money Transmitter Act, [Kan. Stat. §§ 9-508 et seq.](#) (Kansas Act), issued guidance modeled after that of Texas. See "[Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act](#)," issued by the Office of the State Bank Commissioner of Kansas (June 6, 2014).

Like the Texas guidance, the OSBC emphasized that "[w]hether or not a Kansas money transmitter license is required for an entity to engage in the transmission of cryptocurrency turns on the question of whether cryptocurrency is considered 'money' or 'monetary value' under the [Kansas Act]."

The Kansas Act provides that "[n]o person shall engage in the business of selling, issuing or delivering its payment instrument, check, draft, money order, personal money order, bill of exchange, evidence of indebtedness or other instrument for the transmission or payment of money or otherwise engage in the business of money transmission with a resident of [Kansas], or ... act as agent for another in the transmission of money as a service or for a fee or other consideration, unless such person files an application and obtains a license from the commissioner [of the OSBC]." Under the Kansas Act, "money transmission" means "to engage in the business of ... receiving money or monetary value for transmission to a location within or outside the United States by wire, facsimile, electronic means or any other means."

The Kansas Act does not define "money." The OSBC thus relies on Black's Law Dictionary's definition of "money" (the "medium of exchange authorized or adopted by a government as part of its currency") to conclude that cryptocurrency is not "money" for purposes of the Kansas Act, as no cryptocurrency is currently authorized or adopted by any governmental entity as its currency.

"Monetary value" is defined by the Kansas Act as "a medium of exchange, whether or not redeemable in money." [Kan. Stat. § 9-508\(g\)](#). The Kansas Act does not define "medium of exchange," however, and the OSBC again relies on Black's Law Dictionary, which defines "medium of exchange" as "anything generally accepted as payment in a transaction and recognized as a standard of value." Because cryptocurrency is not generally accepted throughout the entire economy and does not have a recognized standard of value, the OSBC found that cryptocurrency is not "monetary value" under the Kansas Act.

Based on its conclusions that cryptocurrency is neither "money" nor "monetary value" under the Kansas Act, the OSBC, like the DOB, determines that "an entity engaged solely in the transmission of such currency would not be required to obtain a license in the State of Kansas." And again, like the DOB, the OSBC cautions that if a transmission of cryptocurrency also involves sovereign currency, it may be considered money transmission under the Kansas Act, depending on the facts and circumstances.

**Idaho**

The Idaho Department of Financial Services (the DFS), the state agency that administers and enforces the Idaho Money Transmitters Act, [Idaho Code §§ 26-2902 et seq.](#) (Idaho Act), believes that virtual currency may be considered a type of "stored value" subject to regulation. The Idaho Act provides that, subject to certain exceptions, "no person ... shall engage in the business of money transmission without a license." Under the Idaho Act, "money transmission" means "the sale or issuance of payment instruments or engaging in the business of receiving money for transmission or the business of transmitting money within the United States or to locations outside the United States by any and all means including, but not limited to, payment instrument, wire, facsimile or electronic transfer." The term "payment instrument" means "any check, draft, money order, traveler's check or other instrument or written order for the transmission or payment of money, sold or issued to one (1) or more persons, whether or not such instrument is negotiable." Unlike other state money services laws, the Idaho Act does define "money."

## Understanding Bitcoin and Virtual Currency

In an e-mail response provided on August 21, 2013, to an inquiry regarding whether a digital currency exchange is subject to the Idaho Act, the DFS stated “that [virtual currencies] are perceived and used as stores of value. They may be purchased, held, transferred and used in commercial/consumer transactions ... not unlike old-school money orders, travelers checks, and in some respect money remittances. As such, [the DFS’s] present view is that they are a form of payment instrument and fall within the ambit of the [Idaho Act]. We also believe that deferred currency delivery mechanisms (exchangers) might also fall under the [Idaho Act]... We expect that a money transmitters license would be necessary ... to engage in digital currency transactions on behalf of Idaho residents.” [Opinion Email issued by the Idaho Department of Financial Services \(Aug. 21, 2013\)](#). Accordingly, it is possible that the DFS may consider bitcoin and other virtual currencies to be “payment instruments” under the Idaho Act and that their issuance, sale, or exchange requires a money transmitter license, unless an exclusion or exemption applies.

**New York**

New York is the state that has most actively pursued efforts to regulate virtual currency activities. The New York Department of Financial Services (the NYDFS), the state agency that supervises money transmitters in New York and enforces the New York transmitters of money law, N.Y. Banking Law §§ 640 et seq., held hearings on virtual currency licenses on January 28-29, 2014. Based, in part, on the issues discussed at these hearings, the NYDFS concluded that simply applying its existing money transmission regulations to virtual currency firms is not sufficient. See [“Remarks of Benjamin M. Lawsky, Superintendent of Financial Services for the State of New York, on the Regulation of Virtual Currencies at the New America Foundation in Washington, DC”](#) (Feb. 11, 2014).

On July 17, 2014, the NYDFS issued a proposed “BitLicense” regulatory framework (the [Proposed Regulations](#)) for public comment. The stated purpose of the Proposed Regulations is “[t]o regulate retail-facing virtual currency business activity in order to protect New York consumers and users and ensure the safety and soundness of New York licensed providers of virtual currency products and services.” Notice of Rule Making Activities, [“Regulation of the Conduct of Virtual Currency Businesses.”](#) The Proposed Regulations provide that, subject to certain exceptions, “[n]o Person shall, without a license obtained from the superintendent as provided in [the Proposed Regulations], engage in any Virtual Currency Business Activity.” An exemption would apply to: (1) persons that are chartered under the New York Banking Law to conduct exchange services and are approved by the superintendent to engage in virtual currency business activity and (2) merchants and consumers that use virtual currency solely for the purchase or sale of goods or services.

Under the Proposed Regulations, “virtual currency” means “any type of digital unit that is used as a medium of exchange or a form of digitally stored value or that is incorporated into payment system technology. Virtual Currency shall be broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort. Virtual Currency shall not be construed to include digital units that are used solely within online gaming platforms with no market or application outside of those gaming platforms, nor shall Virtual Currency be construed to include digital units that are used exclusively as part of a customer affinity or rewards program, and can be applied solely as payment for purchases with the issuer and/or other designated merchants, but cannot be converted into, or redeemed for, Fiat Currency.”

“Virtual currency business activity” means “the conduct of any one of the following types of activities involving New York or a New York Resident: (1) receiving Virtual Currency for transmission or transmitting the same; (2) securing, storing, holding, or maintaining custody or control of Virtual Currency on behalf of others; (3) buying and selling Virtual Currency as a customer business; (4) performing retail conversion services, including the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency; or (5) controlling, administering, or issuing a Virtual Currency.”

The breadth of this definition would likely require the licensure of many persons engaged in virtual currency transactions, such as virtual currency exchanges, wallets, and processors. Note, however, that engaging in the same activity with the resident of another state may not require licensure under that state’s money services laws. For example, engaging in the business of exchanging one cryptocurrency for another cryptocurrency for a New

## Understanding Bitcoin and Virtual Currency

York resident would likely be deemed virtual currency business activity under the Proposed Regulations and, thus, require a license from the NYDFS. In contrast, the Texas Department of Banking and the Kansas Office of the State Bank Commissioner have both indicated that the exchange of one cryptocurrency for another cryptocurrency is not money transmission under the Texas and Kansas acts, respectively, regardless of how many parties are involved.

The application process to obtain a license under the Proposed Regulations is similar to the application process for obtaining a money transmitter license from the NYDFS and includes extensive requirements, such as background reports, biographical information, financial statements, and fingerprints of principal officers and stockholders of the applicant. The requirements for holding a license under the Proposed Regulations are also similar to the requirements for holding a money transmitter license issued by the NYDFS. Such requirements include, for example, obligations to implement an anti-money laundering program (including identity verification procedures for account holders that include actual proof of identity, not just wallet IDs), provide certain consumer disclosures, satisfy certain capital requirements, and maintain certain books and records. The Proposed Regulations may likely serve as a model for other states that consider regulating virtual currencies.

### International Treatment

The international treatment of bitcoin varies by country. A research report by the Law Library of Congress's Global Legal Research Center provides a summary of various countries' approaches to bitcoin as of early 2014. See "[Regulation of Bitcoin in Selected Jurisdictions, The Law Library of Congress, Global Legal Research Center.](#)"

A summary of the treatment of bitcoin in notable countries is below.

Country/Jurisdiction	Position on Virtual Currency
Argentina	Bitcoins are not legal currency because they are not issued by the government monetary authority and are not legal tender. Therefore, they may be considered a payment method but not legal currency, since they are not a mandatory means of canceling debts or obligations. According to some experts, a bitcoin may be considered a "good" or a "thing" under the Civil Code, and transactions with bitcoins may be governed by the rules of the sale of goods under the Civil Code.
Belgium	There are no specific laws or regulations regarding bitcoin in Belgium.
Canada	Canada does not have a specific law or regulation that regulates bitcoins.
China	The central bank of China defines bitcoin as a special "virtual commodity" that is not a currency and should not be circulated and used in the market as a currency. Banks and payment institutions in China are prohibited from dealing in bitcoins.
Denmark	Denmark's Financial Supervisory Authority has issued a statement rejecting bitcoin as a currency and stating that it will not regulate bitcoin use. It found that bitcoin does not fall under any of the financial services categories, including the issuance of electronic money, payment for services, currency exchanges, or the issuance of mortgages; thus, bitcoin activity is not covered under current financial regulations.
European Union	The European Union has passed no specific legislation relative to the status of bitcoin as a currency. In October 2012, the European Central Bank issued a report on virtual currency schemes that discusses the bitcoin system and briefly analyzes its legal status under existing EU legislation. On December 13, 2013, the European Banking Authority, the regulatory agency of the EU responsible for advising EU institutions on banking, e-money regulation, and payments,

## Understanding Bitcoin and Virtual Currency

	issued a warning on the dangers associated with transactions such as buying, holding, or trading virtual currencies. The authority noted that because bitcoin is not regulated, consumers are not protected, are at risk of losing their money, and may still be liable for taxes when using virtual currencies. In 2015, the European Court of Justice ruled definitively that sales of bitcoin are exempt from VAT.
Finland	The Finnish Tax Authority has stated: (1) when bitcoin is transferred to another currency, the rules on taxation of capital gains apply; (2) when bitcoin is used as a form of payment for goods and services, it is treated as a trade, and the increase in value that the currency might have gained after it was obtained is taxable; and (3) the sale of bitcoins at a loss in value compared to the original purchase price is not deductible under the Finnish Income Taxation Act, as such a loss in value is not specifically described as deductible in the act.
France	France does not have any specific laws or regulations regarding the bitcoin system.
Germany	Bitcoins are not legal tender. Instead, they are units of value that have the function of private means of payment within private trading exchanges, or they are substitute currencies that are used as a means of payment in multilateral trading transactions on the basis of legal agreements of private law. The manner in which bitcoins are currently given as payment, accepted as payment, or “mined” does not require bank supervisory licensing. However, licensing could become necessary under various circumstances, such as the creation or maintenance of a market in bitcoins.
Iceland	The Central Bank of Iceland reportedly stated that engaging in foreign exchange trading with bitcoins is prohibited, based on the country’s Foreign Exchange Act, which sets forth general restrictions on foreign exchange trading and capital movements between Iceland and other countries. According to the Bank’s statement, “[i]t does not appear that the provisions of the Act that exempt goods and services from the aforementioned restrictions can be applied to trading in the bitcoin or that other exemptions from restrictions of the Act apply to such transactions.”
Japan	There are at present no laws in Japan regulating the use of bitcoins. While not stated in the Global Legal Research Center report, Japan is proposing to back a self-regulatory approach to bitcoin. More information can be found <a href="#">here</a> .
New Zealand	The Reserve Bank of New Zealand states that it “prohibits the issuance of bank notes and coins by any party other than the Reserve Bank. However, the Reserve Bank has no direct power over any form of alternative payments [media]. Non-banks do not need our approval for schemes that involve the storage and/or transfer of value (such as ‘bitcoin’) – so long as they do not involve the issuance of physical circulating currency (notes and coins).”
Russia	While not stated in the research report, Russia has taken a stance against bitcoin. The Central Bank of Russia declared that Article 27 of the Law on Central Bank of Russia prohibits the production of alternative monetary products. The regulator warned the public and the financial industry that virtual currency is not regulated, and due to its anonymous nature, may be used to launder money and finance terrorism. The bank also stated that virtual currency also carries a high risk of loss of value. The notice advised that any legal

## Understanding Bitcoin and Virtual Currency

	institutions or professionals that provide services to exchange virtual currency to national or foreign currency, including to goods or services, will be treated as if they are potentially involved in suspicious activities, money laundering, or terrorism financing.
Slovenia	The Ministry of Finance of the Republic of Slovenia issued a formal opinion about the status of bitcoin and other virtual currencies in response to a request from the Tax Administration of the Republic of Slovenia. The opinion states that bitcoin is not a monetary means or financial instrument under Slovenian law. According to the Ministry of Finance, the existing legislative framework does not contain provisions applicable to businesses involved in bitcoin trading. However, the ministry stressed that taxation of bitcoin income still warrants review on an individual basis.
Sweden	The Swedish Skatterättsnämnden (Swedish Tax Board) has given a preliminary ruling on value added Tax (VAT) on bitcoins, stating that trade in bitcoins is not subject to Swedish VAT, but is instead subject to the Finansinspektionen (Financial Supervisory Authority) regulations and treated as a currency. The decision has been appealed by the Swedish Tax Authority.
United Kingdom	The United Kingdom has issued no official statement.

## Enforcement

As with many new technologies, early adoption of bitcoin involved some questionable practices. This has resulted in a few enforcements; representative enforcement actions are listed below.

*Dwolla.* Dwolla was an online payment processor that accepted deposits from customers and enabled use of the funds to make purchases of bitcoin from Mt. Gox (at the time one of the largest bitcoin exchanges; see below for further information). These transactions were completed through a subsidiary, Mutum Sigillum LLC, which was engaged in money transmitting but was not registered with FinCEN as required. The US Department of Homeland Security initiated legal action that prompted Dwolla to stop processing bitcoin transactions. In an affidavit in support of a seizure warrant, the department alleged that the Dwolla accounts subject to seizure were used to conduct transactions as part of an unlicensed money service business. The warrant can be found [here](#).

*Silk Road.* Silk Road was an underworld, online marketplace where over \$1.2 billion worth of drugs, guns, hit men, and other contraband was freely bought and sold from 2011 to 2013. The site was operated by an anonymous administrator, it could only be accessed through Tor (software that allows encrypted, anonymous access to hidden websites), and transactions were paid for using the pseudonymous bitcoin. The founder, Ross Ulbricht, is on trial for various criminal charges, primarily related to drugs. He has admitted to creating Silk Road, but alleges that he passed the site on to other administrators. This case may be significant for more than just the drug charges—an emerging issue in the case is the legality of the federal law enforcement tactics used to break through the many layers of anonymity.

US government agents have also arrested Charlie Shrem, the CEO of bitcoin exchange BitInstant, charging him with laundering money for customers who used Silk Road to buy drugs. Shrem (and Robert Faiella, an alleged co-conspirator) pleaded guilty to aiding and abetting an unlicensed money transmitter. Shrem faced up to nearly seven years in prison, but was sentenced to just two years. Both men agreed to forfeit \$950,000 to the government as a condition of their deals, and Faiella is awaiting sentencing. See *United States v. Faiella*, 14-cr-00243, U.S. District Court, Southern District of New York (Manhattan).

*Mt. Gox.* A Tokyo-based company, Mt. Gox—once the largest bitcoin exchange—is now the largest bitcoin-related entity to declare bankruptcy, with a dose of regulatory issues involved. First, its US subsidiary was shut down in 2013 for allegedly being involved in money laundering, resulting in customer funds being frozen. Things spiraled



## Understanding Bitcoin and Virtual Currency

down from there, and soon Mt. Gox stopped processing withdrawal transactions, yet continued to accept deposits. Ultimately, several hundred million dollars in bitcoin allegedly went missing. Also, Mt. Gox did not register as a money transmitter for most of its existence. While the bankruptcy and related regulatory actions are still unfolding, Mt. Gox will likely be known as the largest legal debacle in the early days of bitcoin. This will also likely be a seminal case regarding why money transmitters need to be licensed.

*Shavers Ponzi Scheme.* In the first federal securities fraud case involving a bitcoin-related scheme, the Securities and Exchange Commission filed civil fraud charges against Trendon Shavers in July 2013 for running a bitcoin-based Ponzi scheme, which recently culminated in a federal judge ordering Shavers to pay \$40 million in fines. Shavers unsuccessfully challenged the SEC's charges against him, arguing that the SEC had no jurisdiction under federal securities laws because bitcoin could not be classified as a "security." The court rejected the argument, finding that the bitcoin investments satisfied the Supreme Court test for the meaning of "security" as set forth in [S.E.C. v. W.J. Howey & Co., 328 U.S. 293 \(1946\)](#).

*Espinoza.* In Florida, an enforcement action against a man allegedly engaged in money laundering and unlawfully engaging in business as a money services business was dismissed. See *Florida v. Espinoza*, No. F14-293 (Fla. Cir. Ct. July 22, 2016).

The Florida statute, upon which the money laundering charge was based, makes it illegal for an individual to conduct or attempt to conduct a financial transaction involving property or proceeds that a law enforcement office has represented came from, or are being used to conduct or facilitate a specified unlawful activity, when the person's conduct is undertaken with the intent to: (1) promote the carrying on of specified unlawful illicit activity; (2) to control or disguise the illicit proceeds, or (3) to avoid reporting requirements. § 896.101 (3) (c), Fla. Stat. (2016).

The Defendant argued that the money laundering counts should be dismissed because the sale of Bitcoin does not meet the definition of "financial transaction" or "monetary instruments" under §896.101(2)(d) and (e), Fla. Stat.

"Monetary instrument" is defined as "coin or currency of the United States or any other country, travelers' checks, personal checks, bank checks, money orders, investment securities in bearer form or otherwise in such form that title thereto passes upon delivery, and negotiable instruments in bearer form or otherwise such form that title thereto passes upon delivery." [§ 896.101\(2\)\(e\), Fla. Stat.](#) (2016).

The Court found that virtual currency is not separately included as a category in that definition, nor does Bitcoin fall under any of the existing categories listed. It also found that it was not clear that defendant promoted any illegal activity.

The Court further stated: "This Court is unwilling to punish a man for selling his property to another, when his actions fall under a statute that is so vaguely written that even legal professionals have difficulty finding a singular meaning. Without legislative action geared towards a much needed update to the particular language within this statute, this Court finds that there is insufficient evidence as a matter of law that this Defendant committed any of the crimes as charged, and is, therefore, compelled to grant Defendant's Motion to Dismiss..."

Law enforcement is gaining ground, and the days of bitcoin being the Wild West are likely waning. Anyone involved in the bitcoin ecosystem needs to understand and comply with the plethora of relevant laws.

---

End of Document