New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 251—NO. 81

TUESDAY, APRIL 29, 2014

INTERNATIONAL CRIMINAL LAW AND ENFORCEMENT

Expert Analysis

Bitcoins: Will Regulation Drive The New Currency Out of Circulation?

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In our last column, we wrote about the virtual currency known as bitcoins.[1] We described how bitcoins work and the increasing acceptance of bitcoins as an alternative to traditional fiat currency. We cautioned, however, that the global regulatory treatment of bitcoins remained uncertain. Recent regulatory developments throughout the world have in some senses provided greater clarity as to the treatment of bitcoins by regulators, but that treatment and certain revelations involving bitcoin exchanges have raised concerns about the viability of bitcoins and other virtual currencies as an alternative to traditional fiat currency (money declared by a government to be legal tender).

Most significantly, the announcement by the Internal Revenue Service that it considers bitcoins and other virtual currencies to be "property," rather than a currency, for U.S. tax purposes imposes greater reporting obligations on virtual currencies than on fiat currencies. As set forth below, this undermines the very purpose for which bitcoins were originally intended—as a low-cost alternative to fiat currencies.

Revelations

Perhaps the most unexpected development involving bitcoins was an exposé by Newsweek claiming to have identified and located the mysterious purported inventor of bitcoins, Satoshi Nakamoto.[2] According to Newsweek, Nakamoto was quietly living a modest and reclusive lifestyle in California. The international media subsequently descended on Nakamoto's home, and Nakamoto for his part denied being the inventor of bitcoins. The uncertainty surrounding this "revelation" was very much in keeping with the uncertain regulatory landscape for bitcoins.

A more serious blow to the prospects for bitcoins occurred just prior to the purported revelation about Nakamoto. On Feb. 25, 2014, Mt. Gox—based in Japan and formerly the largest bitcoin exchange—filed for bankruptcy protection in Tokyo. Mt. Gox, which had experienced a series of regulatory issues leading up to the bankruptcy filing, also announced that it had lost almost 750,000 of its customers' bitcoins and 100,000 of its own bitcoins. At the time, those bitcoins combined were worth approximately half a billion dollars and represented almost 7 percent of all bitcoins in circulation.

Mt. Gox also filed for bankruptcy protection in the Northern District of Texas.[3] It subsequently announced that it had located 200,000 of the missing bitcoins, but hundreds of thousands of bitcoins remain unaccounted for and speculation by commentators as to the cause of the problem has ranged from hackers exploiting flaws in bitcoins' core technology to a full-blown Ponzi scheme.

The problems of lost or stolen bitcoins are not limited to Mt. Gox. Other virtual currency firms have recently experienced similar problems involving bitcoins. On March 3, 2014, Canadian firm Flexcoin, which aspired to be a bitcoin bank, announced it was closing after the theft by hackers of approximately $600,000 worth of bitcoins. The very next day, virtual currency exchange Poloniex announced that it was suspending trading after about 12 percent of the bitcoins on the exchange were stolen. And on March 23, 2014, Chinese virtual currency exchange Vircurex announced that it was suspending trading after a theft of bitcoins and other virtual currencies.[4]

Although bitcoin thefts raise concerns about the security of the virtual currency, the market has seemingly shrugged off these concerns. After reaching a high of over $1,000, bitcoin prices have somewhat stabilized just below $500.[5] Perhaps the greatest challenge to bitcoins, however, comes not from theft, but recent global regulatory developments.

Regulatory Developments

In our previous column on bitcoins, we described how the U.S. Department of Justice has specifically taken the position that bitcoins are not inherently illegal and the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) has issued guidance extending FinCEN's regulations to entities trading in virtual currencies. More recently, on March 25, 2014, the U.S. Internal Revenue Service issued a notice declaring that it would treat bitcoins as "property," rather than "currency," for tax purposes.[6] Many commentators immediately applauded the IRS announcement and contended it was a positive development for bitcoins because it further confirmed their legality and provided certainty regarding U.S. tax treatment. Yet, the IRS notice potentially threatens the very purpose for which bitcoins were created.

> A consensus appears to be forming that virtual currencies such as bitcoins are more in the nature of property or investments than currencies.

Recall that bitcoins were created for the purpose of making financial transactions worldwide more efficient and less expensive. Now, however, bitcoin transactions touching the United States will require record-keeping for calculating capital gains taxes. Admittedly, foreign currency gains and losses are also subject to taxation within the United States, but exemptions exist to avoid such taxation creating too much of an impediment in currency transactions. For example, the IRS permits an exemption for small "personal transactions" in foreign currencies so individu-

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als' everyday foreign currency transactions do not have to be reported and subject to taxation.[7]

No such exemption exists yet for bitcoins or other virtual currencies. Moreover, transactions in U.S. dollars between two individuals in the United States are not subject to taxes based on changes in the value of the dollar, but such transactions carried out in bitcoins are now subject to taxation based on changes in the value of bitcoins. Thus, non-personal foreign currency transactions and purely domestic bitcoin transactions currently carry greater U.S. tax burdens than transactions in dollars. The IRS notice also invites questions and comments to be addressed in future guidance.

Interestingly, the IRS notice also appears to contradict two other federal authorities—a federal district court and the guidance issued by FinCEN. First, in *SEC v. Shavers* the SEC filed an enforcement action in the Eastern District of Texas against Shavers and his Bitcoin Savings and Trust based on alleged misrepresentations by Shavers about bitcoin-related investments he offered. Shavers argued that the court lacked subject matter jurisdiction over the action because his clients invested with bitcoins, rather than money, and the investments thus do not meet the definition of a "security" under U.S. securities laws.

The district court, however, concluded that bitcoins can be used as money and thus are "a currency or form of money." The bitcoin investments thus could be considered an investment of money in an investment contract, which constitutes a security for the purposes of U.S. securities laws.[8] The opinion in *Shavers*, to the extent it likens bitcoins to money, thus appears to be contradicted by the more recent IRS guidance. No other court has addressed the issue.

Second, as set forth in our previous column, FinCEN issued guidance on March 18, 2013, extending FinCEN's regulations to entities trading in virtual currencies.[9] In its guidance, FinCEN was careful to note that virtual currencies do not fit its definition of "currency" because it is not "the coin and paper money of the United States or of any other country that is designated as legal tender."

Yet, the guidance declared that a business engaged in transmitting virtual currencies is nevertheless subject to FinCEN's regulations as a "money transmitter." This would seem to contradict the IRS's declaration that bitcoins are "property," rather than currency, but in truth the respective guidance from the two agencies is vague and both agencies appear to be attempting to regulate virtual currencies while leaving themselves room for further refinement of their policies.

Framework Still Uncertain

In short, the regulatory framework for virtual currencies is far from clear in the United States, much less globally. Indeed, soon after the IRS issued its notice that virtual currencies would be treated as property, U.S. Congressman Steve Stockman (R-TX) announced that he would introduce legislation called the "Virtual Currency Tax Reform Act" which, if passed, would result in virtual currencies such as bitcoins being treated as currency rather than property.[10] It is unclear whether such legislation will gain any traction, much less become law. Moreover, other U.S. agencies such as the Commodity Futures Trading Commission and the Federal Trade Commission, which may have authority to regulate virtual currencies, have thus far remained largely silent on virtual currencies and whether or how they might seek to regulate them.[11]

Regardless, the guidance from the IRS and FinCEN currently controls. Moreover, foreign regulators appear inclined to follow the IRS's lead. For example, Brazil's tax authority recently announced that it will also treat virtual currencies as securities, rather than currencies, implicating capital gains taxes.[12] The very next day, the governor of the Bank of Japan publicly stated that bitcoins are too unreliable to be considered a currency.[13]

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Globally, regulators worldwide have generally called for a unified regulatory approach for virtual currencies to prevent inconsistencies and loopholes. If a consensus is reached, current indications are that regulators worldwide will treat bitcoins as property or investments rather than as a currency.

Adding to Uncertainty

Although each regulatory pronouncement regarding bitcoins and virtual currencies can be perceived as further confirmation of their global acceptance by regulators, each such pronouncement also serves as a reminder that countless other regulatory authorities—domestic and foreign—still have yet to take a position on whether or how they will regulate virtual currencies. A consensus appears to be forming that virtual currencies such as bitcoins are more in the nature of property or investments than currencies.

Yet, treating bitcoins as an investment rather than a currency likely makes bitcoins less efficient than traditional fiat currencies. If so, bitcoins are unlikely to achieve the goal for which they were intended: offering a low-cost, efficient alternative to fiat currencies. Bitcoins may still draw speculative interest from investors, but at that point bitcoins may have become what their critics always claimed they are—a purely speculative bubble without any intrinsic value.

The IRS guidance and tax implications may thus dampen enthusiasm for bitcoins as currency. The true believers in bitcoins may delight in this iteration of Gresham's law: Bad or traditional money may drive the good money of bitcoin out of circulation. Regardless, the only certainty right now as to the future of bitcoins and other virtual currencies is continued uncertainty.

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