

**COINING BITCOIN'S "LEGAL-BITS": EXAMINING THE
REGULATORY FRAMEWORK FOR BITCOIN AND VIRTUAL
CURRENCIES**

*Matthew Kien-Meng Ly**

TABLE OF CONTENTS

I. INTRODUCTION.....	588
A. <i>What Are Currencies?</i>	589
B. <i>Virtual Currencies</i>	589
II. BITCOIN.....	590
A. <i>What Is Bitcoin?</i>	590
1. Introduction.....	590
2. The Ecosystem.....	591
a. <i>Bitcoin Mining</i>	591
b. <i>Bitcoin Exchanges</i>	592
c. <i>Merchants</i>	592
d. <i>Innovative Ventures</i>	592
B. <i>Why Are People Using Bitcoin?</i>	593
C. <i>What Is the Problem?</i>	594
1. <i>Criminal Activity</i>	595
2. <i>Tax Evasion</i>	595
3. <i>Investment Scams</i>	596
III. HOW CAN THE LEGAL SYSTEM HANDLE VIRTUAL CURRENCIES SUCH AS BITCOIN?.....	596
A. <i>Bank Secrecy Act</i>	596
B. <i>Securities Regulations</i>	597
C. <i>Stamp Payments Act of 1862</i>	598
D. <i>Electronic Fund Transfer Act of 1978</i>	599
E. <i>Uniform Commercial Code</i>	600
IV. GOVERNMENT ACTIONS RELATED TO BITCOIN.....	600
A. <i>FinCEN's Guidance on Virtual Currencies</i>	600
B. <i>California's Department of Financial Institutions'</i> <i>Cease-and-Desist Letter to Bitcoin Foundation</i>	602
C. <i>Bitcoin Asset Seizures and Arrests</i>	603

* Harvard Law School, J.D. Candidate, 2015; B.A.Sc., Electrical Engineering, University of Waterloo, 2007; I would like to thank Harvard Law School Professor Todd D. Rakoff for his insightful comments and guidance on this Note. I would also like to thank Aaron Frumkin and the rest of the editors and staff of the *Harvard Journal of Law and Technology* for their feedback and tireless effort throughout the process. Finally, thank you to Diana Lai, my family, and friends for their support and encouragement.

1. Crackdown on Silk Road.....	603
2. Mt. Gox Assets Frozen.....	603
<i>D. Regulatory Developments as of April 2, 2014</i>	604
1. New York State Department of Financial Services Inquiry into Virtual Currencies.....	604
2. Bitcoin Foundation Meeting with Federal Regulators	604
3. Senate Committee Looks into Virtual Currencies.....	605
4. Internal Revenue Service Virtual Currency Notice: Virtual Currency Is Property for U.S. Federal Tax Purposes.....	605
V. WHAT DO THE RECENT GOVERNMENT ACTIONS MEAN FOR BITCOIN'S FUTURE?.....	606
<i>A. Businesses Exchanging, Buying, and Selling Bitcoins</i>	606
<i>B. Merchants Accepting Bitcoin as an Alternative Payment Currency</i>	607
<i>C. Non-Miner Users</i>	607
<i>D. Miners</i>	607
VI. FINAL THOUGHTS.....	608

I. INTRODUCTION

The “virtual currency” and “Bitcoin” phenomena have recently garnered a great deal of media and regulatory attention.¹ However, many people do not understand what virtual currency, let alone Bitcoin, is and how it works. Fewer still know how to interpret the reports of government “crackdowns” on Bitcoin businesses. This paper explains what Bitcoin is, why people use it, and why the government should care. In addition, this paper contemplates whether any existing legal frameworks may be used to regulate Bitcoin: Which laws can be leveraged? How can they be leveraged? What has the government done to regulate Bitcoin thus far?

The laws affecting Bitcoin have changed dramatically since 2013 when regulators began to recognize Bitcoin as a currency. Businesses engaging in Bitcoin transactions now may be required to meet strict reporting and record-keeping standards. In addition, they may be required to implement anti-money laundering programs. Individual users and businesses alike will need to comply with the applicable tax

1. See, e.g., *If Bitcoin Remains Impractical, Treasury Will Let It Be*, BLOOMBERG BUSINESSWEEK, <http://www.businessweek.com/articles/2014-03-18/if-bitcoin-remains-impractical-treasury-will-let-it-be> (last visited May 7, 2014); *Putative Bitcoin Founder Categorically Denies It*, N.Y. TIMES, http://www.nytimes.com/2014/03/18/business/media/man-named-by-newsweek-issues-denial-on-bitcoin-claim.html?_r=0 (last visited May 7, 2014); *Why Warren Buffet Is Wrong on Bitcoin*, CNBC, <http://www.cnbc.com/id/101504218> (last visited May 7, 2014).

regimes as well. Because the regulatory framework of Bitcoin is a new development, the future of applicable laws remains uncertain.

A. What Are Currencies?

Currency is broadly defined as "[t]okens used as money in a country."² The Financial Crimes Enforcement Network ("FinCEN"), an Agency of the United States government, defines currency as "the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance."³ FinCEN terms these currencies "real currencies."⁴ Although currencies like the United States Dollar ("USD") used to be backed by commodities such as gold,⁵ today, most real currencies are fiat currencies, which are merely backed by their respective governments.⁶ By controlling the money supply, governments are able to influence the value of their currencies.⁷ Relatively stable currency values are achieved by public trust in the continued rational government manipulation of the money supply.⁸

B. Virtual Currencies

In contrast to a real currency, a virtual currency is a "medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency."⁹ The key difference between virtual currency and real currency is that virtual currency does not have legal tender status in any jurisdiction.¹⁰ In other words, a virtual currency is one that is not administered or issued by a sovereign.

2. *Currency*, BUSINESSDICTIONARY, <http://www.businessdictionary.com/definition/currency.html> (last visited May 7, 2014).

3. *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, DEP'T OF THE TREASURY FIN. CRIMES ENFORCEMENT NETWORK 1 (Mar. 18, 2013) (alteration in original) (quoting 31 CFR § 1010.100(m)) (internal quotation marks omitted), available at http://fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf [hereinafter *FinCEN*].

4. *Id.*

5. *Is U.S. Currency Still Backed by Gold?*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Aug. 2, 2013), http://www.federalreserve.gov/faqs/currency_12770.htm.

6. See Vincent Scheurer, *The Magic of Money*, THE MOTLEY FOOL (July 1, 2011), <http://news.fool.co.uk/news/investing/2011/07/01/the-magic-of-money.aspx>.

7. See *Back to Basics: What Is Money?*, INT'L MONETARY FUND (Sept. 2012), <http://www.imf.org/external/pubs/ft/fandd/2012/09/basics.htm>.

8. See *id.*

9. *FinCEN*, *supra* note 3, at 1.

10. *Id.*

II. BITCOIN

A. What Is Bitcoin?

1. Introduction

Introduced in 2009, Bitcoin is a virtual currency that exists solely in electronic form. A program running on the Internet processes and logs every Bitcoin transaction in a public ledger.¹¹ The Bitcoin system functions in a distributed manner: No legal entity controls or administers Bitcoin.¹² Additionally, no sovereign or commodity backs the currency.¹³ Thus the value of a bitcoin is determined solely by public perception, trust, and adoption,¹⁴ causing great volatility. On April 1, 2014, the value of one bitcoin was approximately \$478 USD.¹⁵

Bitcoins are created through a process called “mining,” wherein users provide computing power to process Bitcoin transactions, and in return may earn transaction fees in the form of bitcoins.¹⁶ Tasked with processing and confirming transactions, each mining machine holds a copy of the public ledger.¹⁷ The Bitcoin algorithm is programmed to release bitcoins in decreasing quantities up to a total of twenty-one million bitcoins.¹⁸ No additional bitcoins will be created once this number is reached. As of April 2014, approximately twelve million bitcoins had been mined and are in circulation.¹⁹

In addition to mining, users may also obtain bitcoins by purchasing them on various online exchanges, through peer-to-peer transfers, or by receiving them as payment for a product or service.²⁰ Once obtained, bitcoins reside in a person’s digital wallet much like cash re-

11. *FAQ — Bitcoin, How Does Bitcoin Work?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#how-does-bitcoin-work> (last visited Dec. 3, 2013).

12. *See FAQ — Bitcoin, Who Controls the Bitcoin Network?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#who-controls-the-bitcoin-network> (last visited Dec. 3, 2013).

13. *See FAQ — Bitcoin, Why Do Bitcoins Have Value?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#why-do-bitcoins-have-value> (last visited Dec. 3, 2013).

14. *Id.*

15. Value obtained from the Bitstamp website. *Bitstamp — Buy and Sell Bitcoins*, BITSTAMP, <https://www.bitstamp.net> (last visited Apr. 1, 2014).

16. *FAQ — Bitcoin, How Does Bitcoin Mining Work?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#how-does-bitcoin-mining-work> (last visited Dec. 3, 2013).

17. *See FAQ — Bitcoin, What if I Receive a Bitcoin When My Computer Is Powered Off?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#what-if-i-receive-a-bitcoin-when-my-computer-is-powered-off> (last visited May 7, 2014).

18. *FAQ — Bitcoin, How Are Bitcoins Created?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#how-are-bitcoins-created> (last visited May 7, 2014).

19. *Total Bitcoins in Circulation*, BLOCKCHAIN, <https://blockchain.info/charts/total-bitcoins> (last visited May 7, 2014).

20. *FAQ — Bitcoin, How Does One Acquire Bitcoins?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#how-does-one-acquire-bitcoins> (last visited Dec. 3, 2013).

sides in a physical wallet. Ultimately, bitcoins resemble cash in digital form and can be used to purchase goods and services.²¹

Since its introduction in 2009, Bitcoin has witnessed increasing popularity and adoption. For instance, not only are online businesses accepting bitcoins as payment, but traditional brick-and-mortar retailers are also beginning to accept bitcoins.²² Despite this increased acceptance, the value of bitcoins remains highly volatile. In 2013, the market price of a bitcoin fluctuated between \$13 and \$1200 USD.²³

2. The Ecosystem

The ecosystem supporting Bitcoin has been growing exponentially. Notably, there are three main categories of systems: (1) the Bitcoin mining community; (2) Bitcoin exchanges; and (3) merchants who accept bitcoins as payment for goods and services. In addition, there are numerous innovative ventures based on Bitcoin, from Bitcoin automated teller machines ("ATMs") to Bitcoin-based investment instruments.

a. Bitcoin Mining

As mentioned above, Bitcoin mining is a process wherein users provide computing power to process Bitcoin transactions. Because the Bitcoin algorithm releases new bitcoins in declining numbers, it becomes more difficult to mine for bitcoins as time progresses.²⁴ As a result, there is an entire industry dedicated to mining bitcoins, where users build high-powered computers for the sole purpose of mining.²⁵ There are also numerous Bitcoin mining contractors whose primary business is to rent out computing power to mine for bitcoins.²⁶

21. *FAQ — Bitcoin, Is Bitcoin Secure?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#is-bitcoin-secure> (last visited May 7, 2013).

22. *Use Bitcoins in the Real World*, USEBITCOINS.INFO, <http://usebitcoins.info/index.php/bitcoin-in-the-real-world/#/catid=12;2;21;3;22;10;13;17;20;15;16;9;4;11;6;18;1;14;25;24;23;19> (last visited May 7, 2014); Ashley Boncimino, *Where You Can Shop with Bitcoin in Chicago*, CHICAGO BUSINESS (June 13, 2013), <http://www.chicagobusiness.com/article/20130613/NEWS08/130619907/#>; see also, e.g., Kashmir Hill, *Living on Bitcoin for a Week: The Journey Begins*, FORBES (May 1, 2013), <http://www.forbes.com/sites/kashmirhill/2013/05/01/living-on-bitcoin-for-a-week-the-journey-begins>.

23. BITCOIN CHARTS, <http://bitcoincharts.com/charts/mtgoxUSD#rg60zcszsg2013-01-01zeg2013-12-31zigSzm1g10zm2g25zv> (last visited May 7, 2014).

24. *FAQ — Bitcoin, How Are Bitcoins Created?*, *supra* note 18.

25. See *FAQ — Bitcoin, What Do I Need To Start Mining?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#what-do-i-need-to-start-mining> (last visited Dec. 3, 2013).

26. See, e.g., *MinerCloud — Bitcoin, Litecoin and Dogecoin Miner Contractor*, MINERCLOUD, <http://minercloud.com> (last visited Nov. 14, 2013).

b. Bitcoin Exchanges

Bitcoins also can be bought and sold on Bitcoin exchanges.²⁷ These exchanges match buyers and sellers, and help create a market for bitcoins.²⁸ Due to the volume of transactions, these exchanges play a vital role in establishing the value of bitcoins. Similar to stock exchanges, users can buy and sell bitcoins in exchange for popular currencies such as dollars or euros.²⁹ A few prominent Bitcoin exchanges include Mt. Gox,³⁰ Bitstamp, and BTCN.³¹

c. Merchants

Merchants are a key component of the Bitcoin ecosystem. To be sure, Bitcoin would be of little use as a currency without merchants who accepted it as payment for goods and services. Many online merchants accept bitcoins.³² Additionally, a number of brick-and-mortar retailers located throughout the United States have begun to accept bitcoins.³³ These retailers are typically located in large urban centers such as San Francisco and New York.³⁴

d. Innovative Ventures

In addition to the three main categories of systems in the Bitcoin ecosystem, there have been a plethora of innovative ventures that draw on the development of Bitcoin. For example, on October 29, 2013, Robocoin started deploying Bitcoin ATMs.³⁵ These ATMs allow users to purchase bitcoins in person.³⁶ Some large retailers such as Wal-Mart are also allowing users to purchase bitcoins.³⁷ Social game developer Zynga announced that they will accept Bitcoin for

27. *FAQ — Bitcoin, How Does One Acquire Bitcoins?*, *supra* note 20.

28. *See, e.g., Bitstamp — Buy and Sell Bitcoins*, *supra* note 15.

29. *Id.*

30. Mt. Gox closed down in February of 2014 and filed for bankruptcy on February 28, 2014, after losing approximately 750,000 of its customers' bitcoins. *See MtGox Gives Bankruptcy Details* (Mar. 4, 2014), BBC NEWS, <http://www.bbc.com/news/technology-26420932>.

31. BITCOIN CHARTS, <http://bitcoincharts.com/charts/volumepie> (last visited Nov. 14, 2013).

32. USEBITCOINS, <http://usebitcoins.info> (last visited Nov. 14, 2013).

33. *Use Bitcoins in the Real World*, *supra* note 22.

34. *See id.*

35. Jon M. Chang, *First Bitcoin ATM Installed in Vancouver Coffee Shop*, ABC NEWS (Oct. 30, 2013), <http://abcnews.go.com/Technology/bitcoin-atm-conducts-10000-worth-transactions-day/story?id=20730762>.

36. *Id.*

37. *How Do You Buy Bitcoins in America?*, HOW DO YOU BUY BITCOINS, <http://howdoyoubuybitcoins.com/in/united-states> (last visited Nov. 14, 2013).

some of their online social games.³⁸ Arguably one of the more interesting examples is the Winklevoss twins' Bitcoin Exchange Traded Fund ("ETF"), allowing investors to invest in a fund holding bitcoins much like they would invest in a mutual fund holding securities.³⁹ As of April 1, 2014, the Securities and Exchange Commission had not yet approved the ETF.⁴⁰

B. Why Are People Using Bitcoin?

Why use a virtual currency like Bitcoin instead of a *real* currency such as the USD? The USD can be bought and sold on exchanges (the foreign exchange market) and is accepted by *all* merchants in the US, and electronic payment systems such as debit and credit (Visa, MasterCard, American Express) are established for it.⁴¹ Despite these arguments for using the USD rather than virtual currencies, Bitcoin is being adopted rapidly. Two main benefits of using Bitcoin are privacy and convenience.⁴²

Because bitcoins are transferred peer-to-peer without an intermediary, transacting in bitcoins provides users with high levels of privacy.⁴³ Transferors and recipients of bitcoins remain nearly anonymous.⁴⁴ Other than the equivalent of an account number, no personal information is recorded in the Bitcoin ledger.⁴⁵ Nor is personal information available by cross-referencing account numbers.⁴⁶ In other words, transferring bitcoins is much like transferring cash, except it is performed over the Internet, which allows bitcoins to be transferred to anyone anywhere in the world nearly anonymously.

38. See Olga Kharif, *Bitcoin Tops \$1,000 Again as Zynga Accepts Virtual Money*, BLOOMBERG (Jan. 6, 2014), <http://www.bloomberg.com/news/2014-01-05/bitcoin-tops-1-000-again-on-adoption-by-zynga-amid-wider-usage.html>.

39. See Nathaniel Popper & Peter Lattman, *Winklevoss Twins Plan First Fund for Bitcoins*, N.Y. TIMES (July 1, 2013), <http://dealbook.nytimes.com/2013/07/01/first-name-in-the-first-fund-for-bitcoins-winklevoss>.

40. See *Winklevoss Brothers Offer an Index To Track Price of Bitcoin*, N.Y. TIMES (Feb. 19, 2014), <http://dealbook.nytimes.com/2014/02/19/before-a-bitcoin-fund-comes-a-price-index>.

41. See *How Is Bitcoin Different from the Dollar?* (Nov. 19, 2013), FORBES, <http://www.forbes.com/sites/karlwhelan/2013/11/19/how-is-bitcoin-different-from-the-dollar/>; see also *Bitcoin Seen as Little Threat to Payment Firms* (Feb. 24, 2014), BLOOMBERG, <http://www.bloomberg.com/news/2014-02-24/bitcoin-seen-by-payment-networks-as-little-threat-to-dominance.html>.

42. See *FAQ — Bitcoin, What Are the Advantages of Bitcoin?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#what-are-the-advantages-of-bitcoin> (last visited May 7, 2014).

43. *Id.*

44. See *FAQ — Bitcoin, Is Bitcoin Anonymous?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#is-bitcoin-anonymous> (last visited May 7, 2014).

45. *See id.*

46. *See id.*; see also *Protect Your Privacy*, THE BITCOIN FOUNDATION, <https://bitcoin.org/en/protect-your-privacy> (last visited May 7, 2014).

Bitcoin also offers high levels of convenience. As mentioned above, bitcoins can easily be transferred to anyone, anywhere in the world. In addition, there are few, if any, transaction fees associated with transfers.⁴⁷ In contrast, using established payment systems incurs relatively sizeable transaction fees.⁴⁸ This difference allows Bitcoin users to make payments that may otherwise be impractical due to transaction costs.

Another benefit of Bitcoin, albeit possibly unintended, is that it provides financial stability where a national currency is unstable.⁴⁹ For instance, in 2012, the Iranian Rial was experiencing hyperinflation.⁵⁰ At the same time, there was a shortfall of USD in Iran due to sanctions by the United States and its allies.⁵¹ Unable to buy the more stable USD and faced with holding onto the hyper-inflating Rial, some Iranians turned to bitcoins as a haven for financial stability.⁵² The value of bitcoins was deemed more stable than the Rial and funds could easily be transferred into and out of Iran over the Internet.⁵³

C. What Is the Problem?

As mentioned earlier, one of the primary benefits of Bitcoin is anonymity in transactions. However, it is precisely this characteristic that drives many of the concerns related to Bitcoin.⁵⁴ Numerous articles have been written about Bitcoin and other virtual currencies being used as tools to support criminal activity such as money laundering and buying illegal goods.⁵⁵ There is also the potential for

47. See *Advantages*, *supra* note 42.

48. See *Bitcoin Seen as Little Threat to Payment Firms*, *supra* note 41; see also *Bitcoin Targets Payments Business Giants Visa to JPMorgan* (Jan. 22, 2014), BLOOMBERG, <http://www.bloomberg.com/news/2014-01-22/bitcoin-targets-giants-visa-to-jpmorgan-with-lower-cost-payments.html>.

49. See Max Raskin, *Dollar-Less Iranians Discover Virtual Currency*, BLOOMBERG BUSINESSWEEK (Nov. 29, 2012), <http://www.businessweek.com/articles/2012-11-29/dollar-less-iranians-discover-virtual-currency>.

50. See Jon Matonis, *As Inflation Rages in Iran, Bitcoin Software Not Available*, FORBES (Oct. 9, 2012), <http://www.forbes.com/sites/jonmatonis/2012/10/09/as-inflation-rages-in-iran-bitcoin-software-not-available>.

51. See Raskin, *supra* note 49.

52. *Id.*

53. *Id.*

54. See Kashmir Hill, *Congress Is Nervous About This Whole Bitcoin Thing*, FORBES (Aug. 15, 2013), <http://www.forbes.com/sites/kashmirhill/2013/08/15/congress-is-nervous-about-bitcoin/>.

55. See, e.g., *id.*; Kashmir Hill, *The FBI's Plan for the Millions Worth of Bitcoins Seized from Silk Road*, FORBES (Oct. 4, 2013), <http://www.forbes.com/sites/kashmirhill/2013/10/04/fbi-silk-road-bitcoin-seizure>; Marc Santora, William K. Rashbaum, and Nicole Perroth, *Online Currency Exchange Accused of Laundering \$6 Billion*, N.Y. TIMES (May 28, 2013), <http://www.nytimes.com/2013/05/29/nyregion/liberty-reserve-operators-accused-of-money-laundering.html>.

tax evasion.⁵⁶ In addition, due to the unclassified nature of Bitcoin, there is the potential for investment scams.⁵⁷

1. Criminal Activity

A prime example of Bitcoin being used in criminal activity is the Silk Road online marketplace, launched in February 2011.⁵⁸ Based on Bitcoin, this marketplace facilitated the exchange of illegal drugs and weapons for bitcoins — with all parties cloaked in anonymity.⁵⁹ Criminal activity is not limited to just Bitcoin; anonymity exists for other virtual currencies as well. In 2006, an online currency named Liberty Reserve was founded in Costa Rica.⁶⁰ Liberty Reserve allowed users to transfer money with minimal personal information recorded and did not verify the identity of its users.⁶¹ In 2013, the co-founder of Liberty Reserve pleaded guilty to money laundering for laundering proceeds from credit card fraud, identity theft, investment fraud, child pornography, and narcotics trafficking through the operations of Liberty Reserve.⁶²

2. Tax Evasion

Another problem area of Bitcoin is its potential facilitation of tax evasion. Like many other governments, the U.S. government taxes income. There are two main ways for bitcoins to generate income. First, because the value of a bitcoin fluctuates, bitcoins can be sold at higher values than the original purchase price and thus generate a net income gain for the seller.⁶³ Second, bitcoins can be received by merchants as payment for goods and services and therefore be taxable as

56. Robert W. Wood, *Bitcoin: Tax Evasion Currency*, FORBES (Aug. 7, 2013), <http://www.forbes.com/sites/robertwood/2013/08/07/bitcoin-tax-evasion-currency>.

57. See George Frey, *Banshee Bitcoins: \$5 Million Worth of Bitcoin Vanish in China*, RT (Nov. 12, 2013), <http://rt.com/business/banshee-bitcoin-vanish-china-601>; see also SEC Charges Texas Man with Running Bitcoin-Denominated Ponzi Scheme, U.S. SEC. EXCH. COMM'N (July 23, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583#.UoVzwmsh8E>.

58. See Doug Gross, *Web's Black Market Peddles Drugs, Guns and More*, CNN (Oct. 4, 2013), <http://www.cnn.com/2013/10/04/tech/web/internet-black-market>.

59. See James O'Toole, *Feds Seize \$28 Million in Bitcoins from Alleged Silk Road Operator*, CNNMONEY (Oct. 25, 2013), <http://money.cnn.com/2013/10/25/news/economy/bitcoins-silk-road>.

60. *Co-founder of Liberty Reserve Pleads Guilty to Money Laundering in Manhattan Federal Court*, U.S. DEP'T OF JUSTICE (Oct. 31, 2013), <http://www.justice.gov/opa/pr/2013/October/13-crm-1163.html>.

61. Santora, *supra* note 55.

62. *Co-founder of Liberty Reserve Pleads Guilty to Money Laundering in Manhattan Federal Court*, *supra* note 60.

63. See FAQ — *What About Bitcoin and Taxes?*, BITCOIN PROJECT, <https://bitcoin.org/en/faq#what-are-the-advantages-of-bitcoin> (last visited May 7, 2014).

though the merchant received USD.⁶⁴ Ultimately, due to the anonymity provided by Bitcoin, there is the potential for individuals to withhold reporting Bitcoin-related income and thus evade taxes.⁶⁵

3. Investment Scams

An additional concern stemming from Bitcoin is the potential for investment scams. Due to the difficulty in classifying Bitcoin, opportunistic individuals may engage in activities that swindle unsuspecting people of their bitcoins while skirting the law. For example, although the case is still ongoing, it is alleged that the owner of Bitcoin Savings and Trust, Trendon T. Shavers, operated the equivalent of a Ponzi scheme.⁶⁶ Shavers solicited investments in bitcoins, promised interest to investors, improperly paid investor withdrawals with new investments of bitcoins, and misappropriated bitcoins for personal use.⁶⁷ In the summer of 2013, the Securities and Exchange Commission ("SEC") charged Shavers with defrauding investors in a Ponzi scheme.⁶⁸ In his defense, Shavers argued that Bitcoin investments were not securities because Bitcoin is not money and is not regulated by the United States.⁶⁹ Thus he argued that he did not violate any U.S. securities laws.

III. HOW CAN THE LEGAL SYSTEM HANDLE VIRTUAL CURRENCIES SUCH AS BITCOIN?

The government could leverage a few legal frameworks should it choose to regulate Bitcoin and virtual currencies. The most relevant frameworks include: (1) the Bank Secrecy Act; (2) Securities Regulations; (3) the Stamp Payments Act; (4) the Electronic Funds Transfer Act; and (5) the Uniform Commercial Code.

A. Bank Secrecy Act

Codified in Title 31 of the Code of Federal Regulations Chapter X, the Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the Bank Secrecy Act ("BSA"), was enacted in response to concerns that financial institutions were facilitating

64. *Id.*

65. Wood, *supra* note 56.

66. See SEC Charges Texas Man with Running Bitcoin-Denominated Ponzi Scheme, *supra* note 57.

67. *Id.*

68. *Id.*

69. Kirsten Salyer, *Ponzi-Scheme Charge Is Good News for Bitcoin*, BLOOMBERG (Aug. 7, 2013), <http://www.bloomberg.com/news/2013-08-07/ponzi-scheme-charge-is-good-news-for-bitcoin.html>.

money laundering.⁷⁰ As such, the BSA is also sometimes referred to as an "anti-money laundering" law.⁷¹ The Act requires U.S. financial institutions to assist U.S. government agencies in detecting and preventing money laundering.⁷² Among other provisions, the specific requirements for financial institutions (i.e., money services businesses) include the need to "register with the government, implement anti-money laundering procedures," and keep records.⁷³ Additionally, financial institutions are required to report cash transactions exceeding \$10,000 and suspicious activity, including money laundering, tax evasion, or other criminal activities.⁷⁴

The BSA would be more relevant to governing businesses as opposed to individuals transacting in bitcoins. Specifically, Bitcoin exchanges and other related businesses allowing the exchange of bitcoins for other currencies would fall under the purview of the BSA. If the BSA is applicable, any business that facilitates transactions of currency for bitcoins would be required to register with the government, implement anti-money laundering procedures, and meet strict reporting requirements, possibly undermining the beneficial anonymity of Bitcoin transactions. The implication would be that the benefit of anonymity in Bitcoin transactions could be undermined for its users.

The key question is whether Bitcoin has the legal status of a currency for the purposes of the BSA. To be sure, almost any object can exhibit the main characteristic of a currency — its acceptance as payment for goods and services — yet many objects do not have the legal status of a currency.

B. Securities Regulations

Codified in 15 U.S.C. § 78, the Securities and Exchange Act of 1934 ("SEA") governs the exchange of securities and contains, among other things, registration, disclosure, and antifraud provisions.⁷⁵ Notably, if the SEA is applicable, it may be used to govern Bitcoin exchanges and other businesses that exchange bitcoins for currency and vice-versa. Securities are broadly defined under the SEA to include notes, stocks, and investment contracts. The question here is whether

70. See *FinCEN's Mandate from Congress*, DEP'T OF THE TREASURY FIN. CRIMES ENFORCEMENT NETWORK, http://www.fincen.gov/statutes_regs/bsa (last visited May 7, 2014).

71. *Id.*

72. *Id.*

73. Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 204 (2012); See *Am I an MSB?*, FINANCIAL CRIMES ENFORCEMENT NETWORK, http://www.fincen.gov/financial_institutions/msb/amimbs.html (last visited May 7, 2014).

74. *FinCEN's Mandate from Congress*, *supra* note 70.

75. See 15 U.S.C. § 78 (2012).

Bitcoin falls within one of these categories. Currencies are not within the scope of the SEA.⁷⁶

The answer appears to be that Bitcoin would not be considered a security for SEA purposes. It lacks the characteristics that are common to any of the three general categories enumerated as securities. First, Bitcoin does not have note-like characteristics, as it is not an instrument for which the maker promises to pay a sum of money to another party.⁷⁷ Second, Bitcoin cannot be classified as stock, because holding a bitcoin does not confer rights to the holder such as the “right to receive dividends” or “voting rights.”⁷⁸

Finally, it is unlikely that Bitcoin will be considered an investment contract.⁷⁹ The Supreme Court has stated that an investment contract for SEA purposes requires the following four elements: (1) a person invests money; (2) the money is invested into a common enterprise; (3) profits are expected from the investment; and (4) the expected profits are generated solely from the efforts of the promoter or a third party.⁸⁰ Here, while a person pays money to buy bitcoins, that person is not investing in Bitcoin. Paying money to purchase a good or even another currency is not, in and of itself, an investment. In addition, the money used to buy bitcoins does not go to a common enterprise that is expected to generate profits from the efforts of the promoter or a third party.⁸¹

C. Stamp Payments Act of 1862

The Stamp Payments Act (“SPA”), enacted in 1862, prohibits the issuance and circulation of any token “for a less sum than \$1, intended to circulate as money or to be received or used in lieu of lawful money of the United States.”⁸² The purpose of the Act was to protect the value and use of U.S. coins against unofficial competing currencies.⁸³ Prior judicial decisions indicate that the “Act is unlikely to apply to anything that (1) circulates in a limited area, (2) is redeemable only in goods, [or] (3) does not resemble official U.S. currency and is otherwise unlikely to compete with small-denominations of U.S. currency.”⁸⁴ The relevant question here is whether bitcoins detract from the

76. See *id.* at § 78(c).

77. See Derek Dion, Note, *I’ll Gladly Trade You Two Bits on Tuesday for a Byte Today: Bitcoin. Regulating Fraud in the E-Economy of Hacker-Cash*, 2013 U. ILL. J.L. TECH. & POL’Y 165, 176–77 (2013).

78. See Grinberg, *supra* note 73, at 195 (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985)) (internal quotation marks omitted).

79. See *id.* at 196–98.

80. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

81. See Grinberg, *supra* note 73, at 196–98.

82. 18 U.S.C. § 336 (2012).

83. See Grinberg, *supra* note 73, at 183.

84. See *id.* at 185.

use of U.S. coins. At the current state of adoption, Bitcoin does not seem to be reducing the demand for U.S. coins. There are simply not enough uses (merchants and retailers accepting Bitcoin) for Bitcoin to be a competing currency. Even if the government decides that Bitcoin falls under the scope of the SPA, there may be significant challenges to enforcing the law.

The key issue with enforcement is the absence of a central authority that creates and manages bitcoins. As mentioned above, bitcoins are created and awarded by the Bitcoin software program running on a network of computers on the Internet. Without attributing the creation of bitcoins to specific persons or entities, who would the government prosecute? Thus, at least in the current ecosystem, not only is Bitcoin unlikely to fall within the scope of the SPA, but enforcement of the law also seems impractical.

D. Electronic Fund Transfer Act of 1978

The Electronic Fund Transfer Act ("EFTA") was enacted in 1978 and provides a "framework establishing the rights, liabilities, and responsibilities of participants in electronic fund and remittance transfer systems."⁸⁵ Because bitcoins exist electronically, and thus transfers between users are performed electronically, the EFTA seems applicable to Bitcoin, at least at first glance.

A closer examination suggests, however, that it is unlikely that Bitcoin falls under the scope of the EFTA. The EFTA is designed to apply to financial institutions engaging in or facilitating electronic fund transfers.⁸⁶ Whether the EFTA is applicable to Bitcoin depends on whether Bitcoin is a financial institution and whether Bitcoin performs electronic fund transfers. As mentioned above, Bitcoin is a software program that runs on the Internet. It is not a financial institution (it is not even a recognizable legal entity), nor does it hold accounts belonging to customers.⁸⁷ Thus the Bitcoin software program is not a financial institution for the purposes of the EFTA. In addition, Bitcoin does not "order, instruct, or authorize a financial institution"⁸⁸ to transfer funds electronically. Transfers are initiated by users, and are performed peer-to-peer without an intermediary.

85. 15 U.S.C. § 1693(b) (2012).

86. See Nikolei M. Kaplanov, *Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against Its Regulation*, 25 LOY. CONSUMER L. REV. 111, 137–38 (2012).

87. *Id.* at 157–58.

88. 15 U.S.C. § 1693a (2012).

E. Uniform Commercial Code

Although not binding law, the Uniform Commercial Code (“UCC”) has been adopted in one form or another by a majority of states.⁸⁹ The UCC sets out a framework to govern sales and other commercial contracts.⁹⁰ A quick analysis suggests that the UCC can be used to validate Bitcoin transactions rather than limit Bitcoin use; whether Bitcoin is considered a currency or property does not affect the use of bitcoins in transactions under the UCC.⁹¹ If it were considered a currency, Bitcoin would be treated like a foreign currency under the UCC.⁹² Transactions involving foreign currencies are recognized.⁹³ On the other hand, if Bitcoin were considered property, then transactions involving bitcoins in exchange for goods would be treated as barter transactions.⁹⁴ In both cases, the UCC would recognize and validate transactions involving bitcoins.

IV. GOVERNMENT ACTIONS RELATED TO BITCOIN

The U.S. government has taken several steps toward regulating Bitcoin. The most important law leveraged by the government has been the Bank Secrecy Act. In early 2013, FinCEN, the Agency authorized to enforce the Bank Secrecy Act, issued guidance on the applicability of regulations to virtual currencies.⁹⁵ Since then, both federal and state authorities have been actively scrutinizing Bitcoin activities. Notices have been issued and investigations have commenced, and in some instances authorities have arrested individuals and seized assets.

A. FinCEN’s Guidance on Virtual Currencies

On March 18, 2013, FinCEN issued an interpretive guidance document titled “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies.”⁹⁶ The document was meant “to clarify the applicability of the regulations implementing the Bank Secrecy Act . . . to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual cur-

89. *States Adopting the UCC*, US LEGAL, INC., <http://uniformcommercialcode.uslegal.com/states-adopting-the-ucc> (last visited May 7, 2014).

90. *Uniform Commercial Code*, US LEGAL, INC., <http://uniformcommercialcode.uslegal.com> (last visited May 7, 2014).

91. See Kaplanov, *supra* note 86, at 163–64.

92. *Id.*

93. See *id.*

94. *Id.* at 164.

95. *FinCEN*, *supra* note 3.

96. *Id.* at 1.

rency."97 The goal was to clearly delineate which of an entity's activities would make the entity a money services business ("MSB") and thus subject to FinCEN's registration, reporting, and recordkeeping regulations for MSBs.98 Although there is no specific mention of Bitcoin in the guidance document, the timing of the release seems to suggest that it was issued in part due to Bitcoin's increased adoption.

The document distinguishes between "'users,' 'administrators,' and 'exchangers.'"99 As defined, a user is one who "obtains virtual currency to purchase [real or virtual] goods or services."100 Users are not considered MSBs for the purposes of FinCEN's regulations.101 Administrator is defined as "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency."102 An exchanger is defined as "a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency."103 An administrator or exchanger who "(1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is [considered] a money transmitter under FinCEN's regulations, unless a limitation to or exemption from the definition applies to the person."104 Money transmitters fall under the umbrella of MSBs, and thus administrators and exchangers who engage in money transmission are considered MSBs for the purposes of FinCEN's regulations.105

The guidance document also categorizes three different types of virtual currencies: "e-currencies and e-precious metals; centralized convertible virtual currencies; and de-centralized convertible virtual currencies."106 The de-centralized virtual currencies ("DVCs") category is the most applicable to Bitcoin. The guidance document notes that a DVC "has no central repository and no single administrator," and "persons may obtain [units of the currency] by their own computing or manufacturing effort."107 Following the guidance for the DVC category, a person who creates units of a currency and uses them to purchase goods or services falls under the "user" category.108 In contrast, a person who creates units and sells those units to another for real cur-

97. *Id.*

98. *See id.*

99. *Id.*

100. *Id.* at 2.

101. *Id.* at 1.

102. *Id.* at 2.

103. *Id.*

104. *Id.* at 3.

105. *Id.* at 1.

106. *Id.* at 3.

107. *Id.* at 5.

108. *Id.*

rency is considered a money transmitter rather than a user.¹⁰⁹ In addition, a person is considered an exchanger if the person accepts units of a DVC from one person and transmits them to another person as a substitute for a currency.¹¹⁰

The guidance document suggests two major implications for Bitcoin. First, a user purchasing goods or services with bitcoins, without more, is not a money services business. However, the act of selling bitcoins, whether as an individual (provided that the coins were mined by the individual), or as a business, makes the actor a money transmitter and thus subject to FinCEN's regulations for MSBs. Second, it appears as though any business that facilitates the conversion between Bitcoin and USD will be considered an exchanger under the guidance document and will also be subject to FinCEN's regulations for MSBs. Ultimately, with the exception of merchants, all other businesses transacting in Bitcoin will have to meet registration, reporting, and record-keeping requirements in accordance with the implementing regulations of the BSA — neutralizing some, if not all, of Bitcoin's anonymity benefits.

B. California's Department of Financial Institutions' Cease-and-Desist Letter to Bitcoin Foundation

On May 30, 2013, California's Department of Financial Institutions ("CADFI") issued a cease-and-desist letter to Bitcoin Foundation ("BF"), a "not-for-profit organization established to standardize, protect and promote the use and adoption of Bitcoin."¹¹¹ The letter stated that BF may be "engaged in the business of money transmission without having obtained the license or proper authorization required by the California Financial Code."¹¹² In addition, the letter notes that it is also a federal violation to engage in money transmission without the appropriate state license, or without registering with the U.S. Treasury Department in accordance with the regulations implementing the BSA.¹¹³

109. *See id.*

110. *Id.*

111. Rick Fischer, Obrea O. Poindexter & Matthew Ly, *Bitcoin Receives Cease and Desist Order Evidencing Increased Regulatory Scrutiny of Virtual Currency*, SOCIALLY AWARE BLOG (July 25, 2013), <http://www.sociallyawareblog.com/2013/07/25/bitcoin-receives-cess-and-desist-order-evidencing-increased-regulatory-scrutiny-of-virtual-currency>; *see also* Jon Matonis, *Bitcoin Foundation Receives Cease and Desist Order from California*, FORBES (June 23, 2013), <http://www.forbes.com/sites/jonmatonis/2013/06/23/bitcoin-foundation-receives-cess-and-desist-order-from-california>; *About*, BITCOIN FOUNDATION, <https://bitcoinfoundation.org/about> (last visited Feb. 16, 2014).

112. Letter from Paul T. Crayton, Senior Counsel, Cal. Dep't of Fin. Institutions, to Bitcoin Found. (May 30, 2013), *available at* <http://www.scribd.com/doc/149335233/ca-state-cess-and-desist-may-30#page=1>.

113. *See id.*

Interestingly, BF does not seem to engage in commerce related to Bitcoin.¹¹⁴ According to the BF website, their main mandate is to improve the Bitcoin software and to promote Bitcoin.¹¹⁵ It is unclear in what capacity BF engages in the business of money transmission as noted in the letter. Nevertheless, CADFI's action demonstrates that Bitcoin is attracting both state and federal regulatory attention.

C. Bitcoin Asset Seizures and Arrests

There have been numerous arrests and asset seizures related to Bitcoin use. Two of the more notable incidents occurring in 2013 include the crackdown on the Silk Road website and the asset seizure of Mt. Gox.

1. Crackdown on Silk Road

In early October of 2013, the FBI seized the Silk Road website, widely known as a marketplace for drugs and other illegal goods.¹¹⁶ The FBI also arrested the owner of the website, William Ulbricht, on charges of narcotics conspiracy, computer hacking conspiracy, and money laundering conspiracy in connection with the operations of the Silk Road website.¹¹⁷ By October 25, 2013, government authorities had seized more than 33.6 million USD worth of bitcoins belonging to Ulbricht.¹¹⁸ After the seizure of the Silk Road website and the arrest of Ulbricht, authorities arrested frequent users of the Silk Road marketplace.¹¹⁹

2. Mt. Gox Assets Frozen

In May of 2013, U.S. authorities seized the assets of Mt. Gox, one of the world's largest Bitcoin exchanges at the time.¹²⁰ The seizure was based on suspicions that Mt. Gox was engaging in the business of

114. See BITCOIN FOUNDATION, *supra* note 111.

115. *Id.*

116. *Manhattan U.S. Attorney Announces Seizure of Additional \$28 Million Worth of Bitcoins Belonging to Ross William Ulbricht, Alleged Owner and Operator of "Silk Road" Website*, FBI (Oct. 25, 2013), <http://www.fbi.gov/newyork/press-releases/2013/manhattan-u.s.-attorney-announces-seizure-of-additional-28-million-worth-of-bitcoins-belonging-to-ross-william-ulbricht-alleged-owner-and-operator-of-silk-road-website>.

117. *Id.*

118. *Id.*

119. Raphael Satter, *Silk Road Drug Busts: 8 More Arrested*, USA TODAY (Oct. 8, 2013), <http://www.usatoday.com/story/news/world/2013/10/08/silk-road-busts/2946925>.

120. Kashmir Hill, *The Feds Are Cracking Down on Mt. Gox (Not on Bitcoin)*, FORBES (May. 15, 2013), <http://www.forbes.com/sites/kashmirhill/2013/05/15/the-feds-are-cracking-down-on-mt-gox-not-on-bitcoin>.

money transmission without an appropriate license.¹²¹ Notably, the grounds for seizure seem to follow the language of the March FinCEN guidance document on virtual currencies.¹²² In late February of 2014, Mt. Gox shut down its website and subsequently filed for bankruptcy on February 28, 2014, after losing approximately 750,000 of its customers' bitcoins following a security breach.¹²³

D. Regulatory Developments as of April 2, 2014

Much like the price of Bitcoin, which has exploded from \$13 to \$1200 in 2013,¹²⁴ the number of regulatory developments concerning Bitcoin has increased dramatically as well. This section highlights some of the significant regulatory events since June of 2013.

1. New York State Department of Financial Services Inquiry into Virtual Currencies

On August 12, 2013, the New York State Department of Financial Services ("NYDFS") issued a memorandum regarding its inquiry into virtual currencies.¹²⁵ The goal of the inquiry was to develop the "appropriate regulatory guidelines that . . . should [be] put in place for virtual currencies."¹²⁶ The memorandum states that the "emergence of Bitcoin and other virtual currencies has presented a number of unique opportunities and challenges."¹²⁷ In addition, NYDFS notes that it has made "requests for information from virtual currency firms," and that it is concerned that "virtual currency exchangers may be engaging in money transmission," an activity regulated by the NYDFS.¹²⁸

2. Bitcoin Foundation Meeting with Federal Regulators

On August 26, 2013, representatives from the Bitcoin Foundation met with Federal Regulators to discuss Bitcoin.¹²⁹ The meeting was geared towards educating regulators on Bitcoin technology.¹³⁰ Ac-

121. Stacy Cowley, *Bitcoin Exchange Mt. Gox Lands in Feds' Crosshairs*, CNNMONEY (May 16, 2013), <http://money.cnn.com/2013/05/16/technology/bitcoin-mt-gox>.

122. See Hill, *supra* note 120; see also FinCEN, *supra* note 3.

123. See *MtGox Gives Bankruptcy Details*, *supra* note 30.

124. BITCOIN CHARTS, *supra* note 23.

125. *Notice of Inquiry on Virtual Currencies*, N.Y. STATE DEP'T OF FIN. SERVS. (Aug. 12, 2013), available at <http://dfs.ny.gov/about/press2013/memo1308121.pdf>.

126. *Id.*

127. *Id.*

128. *Id.*

129. Jesse Hamilton & Olga Kharif, *Bitcoin Foundation Meets with U.S. Regulators, Law Enforcement*, BLOOMBERG (Aug. 27, 2013), <http://www.bloomberg.com/news/2013-08-26/bitcoin-group-to-meet-with-federal-regulators-law-enforcement.html>.

130. See *id.*

According to the Treasury Department spokesman, the meeting was part of the Treasury's "ongoing dialogue with virtual currency providers."¹³¹ In attendance were representatives from the FBI, Internal Revenue Service ("IRS"), Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Secret Service.¹³²

3. Senate Committee Looks into Virtual Currencies

In October of 2013, it was reported that the Senate Committee on Homeland Security and Governmental Affairs had recently launched an inquiry into Bitcoin and other virtual currencies.¹³³ The goal of the inquiry was to gather information and guidance from financial regulators and law enforcement agencies.¹³⁴ A letter soliciting information in accordance with this inquiry noted that the "expansive nature of this emerging technology demands a holistic and whole-government approach in order to understand and provide a sensible regulatory framework for their existence."¹³⁵ In addition, "the federal government must make sure that potential threats and risks are dealt with swiftly; however, we must also ensure that rash or uninformed actions don't stifle a potentially valuable technology."¹³⁶

4. Internal Revenue Service Virtual Currency Notice: Virtual Currency Is Property for U.S. Federal Tax Purposes

On March 25, 2014, the IRS issued a notice declaring that it will treat virtual currencies such as Bitcoin as property rather than currency for federal tax purposes.¹³⁷ The notice indicated that the IRS will apply the same "general tax principles [that apply] to property transactions [] to transactions using virtual currency."¹³⁸ The result is that any value gains or losses from the sale or exchange of bitcoins fall

131. *Id.* (internal quotation marks omitted).

132. *Id.*

133. *Senate Committee Looks into Virtual Currencies*, BSA/AML UPDATE, Oct. 15, 2013, at 1.

134. *Id.*

135. *Id.*

136. *Id.*

137. See *IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply* (Mar. 25, 2014), INTERNAL REVENUE SERVICE, <http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>; see also *IRS Says Bitcoin Is Property, Not Currency* (Mar. 25, 2014), FORBES, <http://www.forbes.com/sites/joeharpaz/2014/03/25/update-irs-says-bitcoin-is-property-not-currency>.

138. See *Notice 2014-21*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

under the capital asset tax regime, and accepting bitcoins for payment will trigger the income tax regime.¹³⁹

V. WHAT DO THE RECENT GOVERNMENT ACTIONS MEAN FOR BITCOIN'S FUTURE?

In the past year, Bitcoin has witnessed increasing adoption and popularity. The Bitcoin ecosystem is expanding exponentially in the United States and in many parts of the world. In response, the U.S. government has taken steps to define and govern uses of Bitcoin. These actions have implications for Bitcoin-related activity going forward. The actions generating the most impact include FinCEN's guidance letter noting that virtual currencies are considered money for purposes of the regulations implementing the BSA, and the IRS's guidance noting that virtual currencies such as Bitcoin will be treated as property for federal tax purposes.

The most obvious implication is that there will be increased regulation and scrutiny of entities transacting in Bitcoin and other virtual currencies. With virtual currencies being treated as money for BSA purposes, businesses transacting in bitcoins need to ensure that they meet the applicable regulatory provisions. Although the majority of the impact will be on businesses, individual users of bitcoins need to be aware of potential tax implications as well. There are four types of actors in the Bitcoin system that may feel the impact of regulation: (1) businesses exchanging, buying, and selling bitcoins; (2) merchants accepting Bitcoin as an alternative payment currency; (3) non-miner users; and (4) miners.

A. Businesses Exchanging, Buying, and Selling Bitcoins

Businesses buying, selling, or facilitating the transfer of bitcoins (e.g., Bitcoin exchanges) will likely be more extensively governed. Notably, the implementing regulations of the BSA promulgated by FinCEN will need to be followed by all money services businesses transacting in bitcoins. Among other things, these businesses will be required to register as a form of MSB with FinCEN,¹⁴⁰ implement anti-money laundering procedures, and meet strict reporting and record-keeping requirements, such as recording detailed customer and transaction information.

139. See *Bitcoin Is Property, Not Currency, In Tax System: IRS* (Mar. 25, 2014), BLOOMBERG, <http://www.bloomberg.com/news/2014-03-25/bitcoin-is-property-not-currency-in-tax-system-irs-says.html>.

140. *FinCEN*, *supra* note 3. Businesses may also have to register with an equivalent state agency.

B. Merchants Accepting Bitcoin as an Alternative Payment Currency

Based on the March FinCEN guidance document, there do not seem to be additional requirements for businesses accepting Bitcoin as an alternative payment currency for goods or services. However, based on the IRS Virtual Currency notice, these businesses will need to report Bitcoin income for tax purposes much as they are required to do for USD income.¹⁴¹

C. Non-Miner Users

These users are individuals who obtain bitcoins through means other than mining. There are two consequences for these users: (1) the increased record-keeping requirement on Bitcoin businesses diminishes the anonymity and privacy aspects of Bitcoin use; and (2) gains incurred from Bitcoin transactions are subject to capital gains taxation.¹⁴² The requirement that businesses keep detailed customer information means that the privacy benefit of transacting in bitcoins is diminished. This will likely deter illegal uses; however, assuming the majority of Bitcoin users engage in only legal uses, this will not substantially chill Bitcoin use overall. To be sure, using bitcoins will still provide convenience and financial security benefits.

Those using their bitcoins to pay for goods and services are not considered money transmitters for the purposes of the BSA's implementing regulations.¹⁴³ However, it is unclear under the FinCEN guidance whether users who sell their bitcoins for profit would be considered money transmitters. In addition, based on the IRS Virtual Currency notice, gains from buying and selling bitcoins are subject to capital gains taxation.¹⁴⁴

D. Miners

For FinCEN purposes, miners who subsequently use their bitcoins to pay for goods and services are not considered money transmitters.¹⁴⁵ However, miners who sell bitcoins that they obtained through mining efforts are considered money transmitters.¹⁴⁶ These miners

141. See *IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, *supra* note 137 and accompanying text.

142. See *id.*

143. *FinCEN*, *supra* note 3, at 2.

144. See *IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, *supra* note 137 and accompanying text.

145. *Id.* at 5.

146. *Id.*

will need to register with FinCEN and are subject to the implementing regulations of the BSA. In addition, based on the IRS Virtual Currency notice, bitcoins obtained through mining activities are subject to standard income taxation.

VI. FINAL THOUGHTS

The use of virtual currencies and Bitcoin in particular is growing. As the economy and commerce is becoming more globalized, currencies that are not tied to a sovereign are increasingly appealing. The growing adoption of Bitcoin on a global scale might indicate that the currency is here to stay. As a result, governments — including the U.S. Government — can no longer ignore virtual currencies like Bitcoin. The recent increase in regulatory developments for virtual currencies suggests that the government understands this. Intriguingly, such government regulatory efforts may have the effect of legitimizing the virtual currency, and possibly further driving market adoption.

Both established and new businesses considering Bitcoin adoption need to be aware of the latest regulatory requirements to stay on the right side of the law. Depending on the business, this could mean adhering to the BSA requirements of record keeping and reporting, and staying in line with anti-money laundering provisions. In addition, all businesses transacting in Bitcoin should be aware of the applicable tax requirements for virtual currencies. Ultimately, because virtual currency regulation is a relatively new development and the government is still trying to fully understand the technology, businesses should keep a pulse on regulatory agencies for any new laws that may apply to them.

Although there is a need for regulators to get ahead of the virtual currency phenomenon, they should be cautious about over-regulation. Excessive regulation can stifle the development and innovation of this technology within U.S. borders. At the moment, there seems to be low risk associated with allowing the virtual currency technology to develop, while there is significant risk in stifling its development. Allowing free-market development of the technology can ensure that the United States is a leader in the technology if it gains widespread adoption. Of course, there would be consequences to free-market participants if Bitcoin and other virtual currencies generally prove to be a dying fad, but this is true for participants in any new technology. Because Bitcoin is being adopted on a global scale, over-regulation in the United States could entail economic consequences for the country in relation to the rest of the world. In the event that the technology gains widespread adoption, other countries with fewer regulations could take the lead with virtual currency technology and innovation, leaving the United States behind.