TAXING AND REGULATING BITCOIN: THE GOVERNMENT’S GAME OF CATCH UP

Patrick McLeod*

I. INTRODUCTION

“Bitcoin is the most important invention in the history of the world since the Internet.” These are the words of Roger Ver, CEO of MemoryDealers and “Bitcoin evangelist.” While this enthusiasm has yet to permeate main street America, Bitcoin, the most popular crypto currency, has grabbed the attention of major news outlets, investors, and United States regulators.1 Bitcoin exists digitally on the Internet, not in physical form.2 Nearly every facet of our modern lives is touched in some way by the presence of the Internet. Work, entertainment, and communication are all streamlined for the benefit of the global population that is “logged on.” It stands to reason that with the abundance of goods, services, and even jobs that are available online, the Internet can be viewed as its own unique society.

In any society where trade flourishes there is a need for some sort of exchange in values. Bitcoin has carved out an economic foothold as a dominant crypto currency on the Internet and has naturally attracted the attention of regulators in the United States who deem its use too widespread to ignore.3 Two of the central issues being scrutinized by the Federal Government are the tax implications for American users, such as how to classify these assets for tax purposes, and the fear of economic crimes, such as money laundering and

---

* I would like to thank the following people: Professor Regina Jefferson, for serving as my expert reader with her wisdom, knowledge, and valuable insight into the United States Internal Revenue Code; my parents, Scott and Elaine, for always encouraging me to reach further than I thought possible. Kelly Knox, for her unwavering love and support throughout the entire process. Finally, I would like to thank the Editorial Board of the CommLaw Conspectus for selecting my article for publication and for all their guidance and assistance.

1 Kirby Garlitos, Bitcoin London Conference Ready to Open Its Doors on July 2, CALVINAYRE.COM (June 20, 2013), http://commcns.org/1mhkl0 (quoting Roger Ver) (internal quotation marks omitted).


5 Warmbrot, supra note 3.
tax evasion. The recent collapse of the world’s former leading Bitcoin exchange may have provided one of the first large-scale financial crimes in the Bitcoin world.

Currently there is no specific statutory provision that governs the taxation of crypto currency. The IRS is tasked with distributing guidelines that clarify how to report income via Bitcoin under the current Internal Revenue Code (“IRC”). The Financial Crimes Enforcement Network (“FinCEN”) has issued guidelines on how money-laundering regulations will be applied to the use of virtual currency such as Bitcoin. However, U.S. regulators and the general public are still very much in the dark as to what Bitcoin really is, how it works, and why anyone is using it. It is important to understand the nature of the system before any steps are taken to regulate it.

This paper examines how crypto currency, specifically the Bitcoin model, fits within existing United States tax laws and discusses how the IRS should address this issue. This paper concludes that Bitcoins are financial instruments.

---


7 See generally Brett Wolf & Emily Flitter, Mt Gox: The Brief Reign of Bitcoin’s Top Exchange, REUTERS (Feb. 28, 2014), http://commcns.org/1i1BSy ("Once the world’s biggest bitcoin exchange, Mt. Gox on Friday filed for bankruptcy protection, saying it may have lost nearly half a billion dollars worth of the virtual coins due to hacking into its fault computer system.").

8 GAO REPORT, supra note 6, at 16 (“IRS has not issued guidance specific to virtual currencies used outside of virtual economies . . . because [among other things] the use of virtual currencies is a relatively recent development that requires further consideration before guidance can be issued . . . .); see also Robert W. Wood, Bitcoin in IRS Crosshairs, Says Government Report, FORBES (June 18, 2013), http://commcns.org/1ka1qyd (discussing the GAO report (GAO-13-516)).

9 GAO REPORT, supra note 6, at 9 (“IRS is responsible for ensuring taxpayer compliance for all economic areas, including virtual economies and currencies.").

10 For a description of FinCEN’s purpose, see Financial Crimes Enforcement Network: What We Do, U.S. TREASURY DEPARTMENT (Sept. 30, 2013, 5:05 PM), http://commcns.org/1psDOdm ("FinCEN is a bureau of the U.S. Department of the Treasury. . . . FinCEN’s mission is to safeguard the financial system from illicit use and combat money laundering and promote national security through the collection, analysis, and dissemination of financial intelligence and strategic use of financial authorities.").

11 See generally FINCEN, FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013) [hereinafter FINCEN INTERPRETIVE GUIDANCE] ("[FinCEN] is issuing this interpretive guidance to clarify the applicability of the regulations implementing the Bank Secrecy Act (‘BSA’) to . . . virtual currencies.").

more specifically commodities, and should be classified as such for taxation purposes. Additionally, in the absence of express Bitcoin regulation, this paper argues that Bitcoin users may come into conflict with United States Tax Evasion and Money Laundering laws. In an attempt to provide guidance to taxpayers, the paper provides theories on the applicability of these laws to the Bitcoin network and analysis on compliance by various actors in the network with these laws. Part II begins by providing a general overview of Bitcoin, with a focus on how the network operates, how transactions occur and new Bitcoins are created, and how anonymous the system truly is. Part III analyzes the regulatory interest in Bitcoin. Part IV discusses issues arising from U.S. citizens transacting in Bitcoins, focusing in particular on federal income taxation, tax evasion, and anti-money laundering laws. Part IV is divided into subsections that reflect provisions of the IRC that may be applicable to Bitcoin. Finally, Part IV concludes that commodities classification is the most appropriate model for Bitcoin currency.

II. BITCOIN BACKGROUND

Bitcoin is a decentralized crypto currency that exists digitally on the Internet through peer-to-peer networks.\textsuperscript{13} Bitcoin was created by Satoshi Nakamoto, the pseudonym for a programmer, or possibly a group of programmers, responsible for the original plans and source code.\textsuperscript{14} The goal was to create a currency that did not rely on the traditional financial institutions for backing and approval of transactions.\textsuperscript{15} Bitcoin relies on cryptography to encode each transaction, which allegedly protects users from fraudulent practices.\textsuperscript{16} Cryptography, as it relates to computers, is defined as, “the computerized encoding and decoding of information.”\textsuperscript{17} Access to the Bitcoin network requires users to

\begin{footnotesize}
\begin{tabular}{ll}
\textsuperscript{15} & Grinberg, supra note 13, at 162 (chronicling the rise of Bitcoin and how it fit into the desire of the “cypherpunks” to have an anonymous currency that would allow “untraceable pseudonymous entities to cooperate with each other more efficiently, by providing them with a medium of exchange.”).
\end{tabular}
\end{footnotesize}
download the necessary software that creates a digital wallet,\(^{18}\) which is akin to a traditional bank account. This wallet provides the user with a unique address and a system for approving transactions including two keys, one “public” and one “private.”\(^{19}\) The “public” key serves as an address for other users wishing to transfer Bitcoins to the owner of a particular public key. The “private” key is used to authorize access to the Bitcoins in that user’s wallet.\(^{20}\)

Downloading the software also turns the user’s computer into a “node” for the Bitcoin network.\(^{21}\) In effect, the user’s computer assists in validating transactions.\(^{22}\) When a transaction occurs, there is an exchange of Bitcoins for some goods or services. The recipient of the Bitcoins provides the public key (which is attached to his or her digital wallet) to the other party, so as to enable that other party to transfer Bitcoins to the recipient’s wallet.\(^{23}\) Next, each party enters its private key into a hashing algorithm, which then provides a data code for each party to “sign” the transaction.\(^{24}\) These transactions can take place on a Bitcoin Exchange, which is a popular platform for people to acquire Bitcoins for fiat currencies,\(^{25}\) or other legal tender. Or if a person is transacting with a business, their Bitcoins can serve as payment, which is processed through an e-commerce payment service or a “wallet service” that specializes in providing services for merchants to accept Bitcoin as payment.

The process does not stop there. The signature code must be approved by confirming the hash value of the block.\(^{26}\) This approval is given only if a majority of the nodes on the Bitcoin Network accept it as valid.\(^{27}\) The transaction is then broadcast to the network by being recorded on a public ledger known as the “block chain.”\(^{28}\) This process is called “mining.”\(^{29}\) “Mining” results in a

---

18 Winklevoss Bitcoin Trust, Registration Statement (Form S-1), at 8 (July 1, 2013) [hereinafter Winklevoss Bitcoin Trust Form S-1], available at http://commcnst.org/IjTkTrt.
19 Id. at 8.
20 Id.
21 Id. at 27.
22 Id.
23 Id.
24 Id.
25 Fiat currency, or money, is defined as “[c]urrency that a government has declared to be legal tender, but is not backed by a physical commodity.” Fiat Money, INVESTOPEDIA, http://commcnst.org/IjTkYve (last visited Apr. 3, 2014).
26 A block is defined as a “record of some or all of the most recent Bitcoin transactions . . . .” Blocks, BITCOIN WIKI, http://commcnst.org/1nr8lc4 (last visited Jan. 26, 2014).
27 Winklevoss Bitcoin Trust Form S-1, supra note 18, at 27–28.
28 Id. at 28.
29 Id. at 28–29 (“The process by which Bitcoins are ‘mined’ results in new blocks being added to the Blockchain and new Bitcoins being issued to the miners. Miners engage in a set of prescribed complex mathematical calculations in order to add a block to the Blockchain and thereby confirm Bitcoin transactions in that block’s data.”).
time stamp of the transaction’s addition to the block chain and is legitimized by “proof of work” demonstrating the miner’s confirmation of the hash value. These measures function as checks against the double-spending of Bitcoins, which would usually be the province of some central authority.

The mining process creates new Bitcoins. Each time a miner solves the previous block they are awarded a number of Bitcoins. As more miners compete in the network, the solutions become more difficult, to ensure that Bitcoins are created at the set speed. Currently the rate is 25 Bitcoins every 10 minutes. This rate will automatically reduce to half that amount in 2017, and will continue that pattern every four years; however, the total number of Bitcoins will never exceed 21 million. This is all controlled by an algorithm. The purpose of using this algorithm is that, “it approximates the rate at which commodities like gold are mined.” Projections indicate that by 2020, at least 90% of the 21 million Bitcoins will have been mined. Because the Bitcoin population will never exceed 21 million, the network has attracted many users who believe that the currency is less inflation prone and, therefore, less risky than other currencies. While Bitcoins are not directly exchangeable for “fiat currency” such as the U.S. Dollar, their value can be measured by such and sold at a price that reflects that value—as of February 15, 2014 that value was $646.30 per Bitcoin. This is done through a variety of mediums including face-to-face cash transactions and virtual exchanges, where Bitcoin is bought and sold online through bank accounts for fiat currency. The value is volatile, and has ranged anywhere from $0.05 cents to as much as $646.30.

31 Id. at 1, 8.
33 Grinberg, supra note 13, at 163.
37 Id.
38 Winklevoss Bitcoin Trust Form S-1, supra note 18, at 30.
42 See, e.g., Dominic Rushe, Bitcoin Hits New High Before Losing $160 in One Day,
tility is attributable to the value of Bitcoin being determined by the extent of users’ desire for Bitcoins. 45 The weighted average value of Bitcoin is determined by the last trade price, the highest bid price, current lowest ask price, and the 24-hour trading volume recorded on the exchanges roughly every minute. 46

Bitcoin transactions are “pseudo-anonymous.” 47 While the identity of the user remains private, the Bitcoin transaction is public. 48 There is no personal information attached to the transaction, which is stored in the public ledger (known as the “block chain”); therefore, by seeing the transactions into and out of an address, the public can discern the balance of that address, but not the user’s identity. 49 This is a concern for regulators. 50 Bitcoin can be used to buy and sell illicit goods or services, and some have labeled it a funding mechanism for terrorists. 51 However, Bitcoin anonymity is partially compromised when a user converts the Bitcoins to cash, 52 or a user spends the Bitcoins with a service. 53 Third party payment systems, such as Dwolla, and exchanges such as BitStamp, request more information than is required to claim Bitcoins generated from a mining pool or a single-person mining endeavor, which only requires the users’ public-key wallet address. 54 In addition to the availability of

GUARDIAN (Apr. 13, 2013, 4:44 PM), http://commcns.org/1jVwqYy; Maureen Farrell, Bitcoin Prices Surge Post-Cyprus Bailout, CNN MONEY (Mar. 28, 2013), http://commcns.org/SGZ6sN (stating that, in its early days around mid-July 2010, the value of Bitcoin was $0.05).

50 Neal, supra note 12.
51 Bitcoin Hit by Denial of Service Attacks As Regulators Prepare Clampingdown, CNBC (Feb. 12, 2014), http://commcns.org/59BP2h (commenting that Canada will “toughen rules targeting money laundering and terrorist financing to keep a closer eye on the use of virtual currencies”); Neal, supra note 12 (noting the use of Bitcoin as a funding mechanism for illicit activity).
53 Id.
illicit goods, regulators are concerned with the possible use of Bitcoin for the purposes of tax evasion and money laundering.\textsuperscript{53}

As evidenced by the recent closure of Mt. Gox,\textsuperscript{54} regulators may also want to consider the opportunity for large-scale fraud against American citizens. Mt. Gox’s owners and operators disclosed that it was hacked and that roughly 750,000 Bitcoins were stolen from users.\textsuperscript{55} Mt. Gox executives kept the exchange open for over two weeks after they uncovered the alleged hack, and the only affirmative action they took was to disable the withdrawal feature.\textsuperscript{56} Allegations of fraud were brought against the former Bitcoin exchange in a class action filed in district court.\textsuperscript{57} However, Mt. Gox filed for bankruptcy in the United States to shield itself from lawsuits in U.S. courts.\textsuperscript{58} The class action against Mt. Gox was amended to name Mizuho Bank Ltd. as a defendant for allegedly aiding in Mt. Gox’s fraud by “providing banking services to the exchange.”\textsuperscript{59}

III. REGULATORY INTEREST IN BITCOIN

The IRS has very recently provided some guidance on reporting Bitcoin in response to taxpayer questions. Additionally, the Government Accountability Office (“GAO”) released a report that highlighted the lack of a legal definition for virtual currency and outlined the differences in virtual currency models (e.g., open flow, hybrid, and closed flow).\textsuperscript{60} The GAO’s report considered the Bitcoin network an open-flow system, because of the user’s ability to purchase real and virtual goods and services and because people may buy Bitcoins for U.S. dollars through exchanges.\textsuperscript{61} The report highlighted certain problems that the IRS has begun to address, including: taxpayers’ unawareness that Bitcoin constitutes taxable income; confusion over how to report Bitcoin transactions;

\textsuperscript{53} GAO REPORT, supra note 6, at 12.


\textsuperscript{56} Id.

\textsuperscript{57} Tom Hals, \textit{U.S. Class Action over Bitcoin Losses Names Mizuho As Defendant}, REUTERS (Mar. 15, 2014), http://cnet.com/1onGdMM.

\textsuperscript{58} Id.

\textsuperscript{59} Id.

\textsuperscript{60} GAO REPORT, supra note 6, at 3–4.

\textsuperscript{61} Id. at 5. As the GAO explained, “An open-flow currency can also be developed and designed primarily to be used to purchase real goods and services outside an online game virtual economy. An example is bitcoin, a decentralized digital currency that uses a peer-to-peer computer network to move bitcoins around the world.” Id.
and the difficulty of reporting, for tax purposes, the additional value that Bitcoin assets add to an individual’s income due to the difficulties associated with calculating a basis for Bitcoin assets. Additionally, the lack of identifying information makes Bitcoin and similar digital services particularly difficult for third-party information reporting. However, the successful recent seizures and shutdown of criminal operations using Bitcoin should steer regulators away from changing the nature of the network to focus on incorporating it into the existing legal framework.

The aforementioned seizures demonstrated that the methods used by law enforcement to find individuals committing the same crimes, but by traditional means, are just as effective when pursuing those utilizing Bitcoin to attempt to evade justice. Simply put, regulators should not fear that by recognizing Bitcoin as legitimate that they are handing criminals the means to abscend the law any more than they do by allowing people to purchase goods and services with cash. Focusing on the financial regulatory implications is a necessary step. In the recently issued guidance, the IRS has explained how they will treat Bitcoins for tax purposes and how they expect U.S. taxpayers to account for their Bitcoin assets. The guidance is an informal response to frequently asked questions by taxpayers and presents some complicated issues in its application. It would be beneficial for the IRS to issue further guidance on Bitcoin and to adopt a taxation model that mirrors the taxation of commodities. To assess the validity of treating Bitcoin as a commodity there must be an understanding of the possibilities of applicability of the IRC to Bitcoin.

IV. FEDERAL INCOME TAX LAWS AND APPLICATIONS

When determining what assets they must pay taxes on, taxpayer’s need to be aware that what constitutes income has a broad definition under Federal tax law. Section 61 provides the statutory definition of gross income. Gross in-

---

62 Id. at 12–13.
63 Id. at 14.
64 Andy Greenberg, FBI Says It’s Seized $28.5 Million in Bitcoins from Ross Ulbricht, Alleged Owner of Silk Road, FORBES (Oct. 25, 2013, 12:50 PM), http://commcnns.org/1fTnldq (stating that the hacker known as “Dread Pirate Roberts” was arrested for criminal charges associated with the online black market known as Silk Road); Jeff John Roberts, Feds Seized $2.9 Million in Bitcoin Funds From Mt. Gox, Court Docs Show, GIGAOM (Aug. 19, 2013, 7:07 PM), http://commcnns.org/1fTnpl (discussing the seizure of funds belonging to Mutum Sigillum LLC).
66 Id. at 1.
income is defined as “all income from whatever source derived, including” an extensive list of items.68 This statutory language has continually been construed by the Supreme Court to constitute Congress’s intent that the taxing power has a “sweeping scope.”69 Additionally, when sources of income are explicitly excluded from gross income, these provisions are to be narrowly construed.70

To determine whether Bitcoin transactions meet the definition of “gross income” under section 61, the facts and circumstances of the transaction must be considered. Such a fact-based inquiry is necessary, because, as the GAO observed, there are no tax rules that are specific to virtual currencies.71 Users who convert Bitcoin to cash might have received income from this conversion under § 61.72 However, the IRS has yet to decide whether Bitcoin is a stock or commodity (subject to the capital gains taxes), or whether it is a currency equivalent to dollars or Euros (subject to the income tax).73 Because the value of digital currencies constantly fluctuates and is often difficult to ascertain, it is unclear when Bitcoin owners should value their Bitcoin holdings for the purposes of taxation. The GAO has recommended that the IRS clarify this issue for taxpaying purposes.74 According to the GAO, Bitcoin should be considered “property, barter, foreign currency, or a financial instrument.”75 Therefore, it is prudent to analyze the probability of each of these classifications.

A. The Flawed Bitcoin Barter Theory

The barter theory of Bitcoin taxation is thought by some to be the most appropriate framework under which to place virtual currencies like Bitcoin.76 In

---

68 Id. § 61(a)(1)–(7) (listing, among other things, the following items: “(1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends”).
70 Id. at 328.
71 GAO REPORT, supra note 6, at 10.
72 Id.; see also 26 U.S.C. § 61(a).
73 Joe Harpaz, Who Will Tax Bitcoin and How?, FORBES (Jan. 16, 2014), http://commcns.org/1gvVIU (“One of the central questions surrounding taxes on bitcoin transactions is whether bitcoin will be treated as a capital asset, like a stock or commodity that is subject to capital gains taxes . . . or as a fiat currency, such as dollars, euros and yen, for which gains are taxed like income . . . .”).
74 GAO REPORT, supra note 6, at 17.
75 Id. at 13. The GAO indicated its belief by requesting that the IRS clarify under which of the four categories (property, barter, currency, financial instrument) the virtual currencies belonged. Id.
76 See, e.g., Patrick Westaway, Taxing Virtual Money: The Bitcoin and the CRA, MON-DAQ (Feb. 16, 2014), http://commcns.org/1gvV1SZ (“You might object that the Bitcoin has nothing to do with bartering since it is fundamentally liquid . . . But for practical purposes,
an IRS ruling, the agency outlined how participants in a barter club are required to report income derived from that club.\textsuperscript{77} In the ruling, the IRS defined barter club transactions as using “credit units to credit or debit members’ accounts for goods or services provided or received.”\textsuperscript{78} The dollar value of these credits is then reported in the taxpayer’s gross income.\textsuperscript{79} Consider the following hypothetical (labeled “Situation 1”) given in the IRS’s ruling:

\textit{Situation 1 . . . } Through the club, \( A \) bartered to \( B \) for 200 credit units services that \( A \) would normally perform for $200. During the same taxable year, \( B \) bartered to \( A \) for 200 credit units services that \( B \) would normally perform for $200.\textsuperscript{80}

There is an argument that Situation 1 is identical to the concept of a transaction of Bitcoins. The “credit units” in the hypothetical could be analogized to Bitcoins. The IRS concluded that under Situation 1, “\( A \) and \( B \) must include $200 in their gross incomes for the taxable year in which the credit units are credited to their accounts.”\textsuperscript{81}

To be the workable model for classifying Bitcoin assets, it must be assumed that Bitcoins themselves would be the credit units in the IRS’s Scenario 1. When individuals exchange Bitcoins for goods and services, the transaction mirrors the barter club situation in the IRS’s ruling. In such a case, therefore, it would be reasonable to construe the Bitcoin transactions as gross income for tax purposes. Nevertheless, the analogy between barter clubs and virtual currencies is not so cut-and-dry. Bitcoin’s utility and distribution is not limited to the confines of the redeemable credit units used to barter in the place of traditional currency. For example, Bitcoin miners create Bitcoins for themselves through the verification of previous transactions; the miners do not receive the Bitcoins as credit in an exchange system. Even those users who do receive Bitcoins as part of an exchange are doing so by purchase via fiat currencies on Bitcoin exchanges.

Bitcoin exchanges are distinguishable from barter clubs, because the price of Bitcoins is highly volatile (barter club credits are fixed), individuals can exchange their fiat currency for Bitcoins (barter club credits arise from the ex-

\textsuperscript{78} Id. at 100.
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id. at 101.
change of “property and services”), and the Bitcoins can be used like regular currency to buy goods and services. A barter club uses credit units to credit or debit members for providing or receiving goods or services. The credit units arise from the member providing goods and services.

The downside of the barter system is that each individual only wants so much of a particular type of good or service. Stated differently, the barter club can be oversaturated by a particular type of good or service. In contrast, a Bitcoin is versatile and can be utilized in much the same way as fiat currency. An individual can pay their rent with Bitcoins or that individual could buy groceries with Bitcoins—assuming that the landlord and grocery store accept Bitcoins. Unlike goods and services, Bitcoins have no practical function other than buying and selling goods and services. Therefore, a Bitcoin has characteristics that distinguish it from the credit unit in the barter club.

If Bitcoins transactions were treated as barter for the purposes of taxation, then serious tax-reporting concerns would be raised. The IRS expects individuals to report their barter income on Form 1099 and has little way of knowing about the barter-realized income apart from the individual’s self-reporting. A typical barter transaction contains personal identifying information about both parties. Unlike barter transactions, however, Bitcoin transactions omit personal identifying information. Therefore, there is an increased incentive for individuals to hide their Bitcoin-related income from the taxing authorities, because the identity of individuals transacting in Bitcoins is difficult to discern and because taxes on barter income depend upon self-reporting.

B. Bitcoin is not a “Foreign Currency”

In order to report Bitcoin transactions to the IRS as currency, then one would need to treat Bitcoins as a foreign currency. This would require that Bitcoins be converted into U.S. dollars. This already presents problems for the

---

83 Rev. Rul. 80-52, 1980-1 C.B. at 100; see also Kerry Lynn Macintosh, How to Encourage Electronic Global Electronic Commerce: The Case for Private Currencies on the Internet, 11 HARV. J.L. & TECH. 733, 788–89 (1998) (discussing the local exchange trade schemes (“LETS”), which are a type of “small-scale barter system”)
84 A more in-depth discussion can be found at the website Mrunal.org. See Barter-Money-Bitcoin: Fungibility, Double Coincidence of Wants, Division of Labour (Part 1), MRUNAL, http://commcnrs.org/1HfRBk (last visited Feb. 16, 2014, 6:50 PM).
86 GAO REPORT, supra note 6, at 14.
taxpayer, because the Bitcoin exchange rate with the U.S. Dollar has been volatile.\textsuperscript{87} As discussed earlier, there are many privately owned exchanges with different valuations; however, for equity amongst taxpayers, the government must adopt an official conversion rate for Bitcoin to U.S. Dollars. If this is done, the foreign currency argument could be more feasible.

All income tax determinations must be made in the taxpayer’s functional currency (e.g., the U.S. Dollar or other foreign currency).\textsuperscript{88} It could be argued that the Bitcoin network requires taxpayers to use foreign currency—here, Bitcoins—when transacting. An exception exists to the U.S. Dollar functional currency rule for taxpayers, which are Qualified Business Units (“QBU”).\textsuperscript{89} QBUs are defined as “any separate and clearly identified unit of a trade or business of a taxpayer, which maintains separate books and records.”\textsuperscript{90} Individual taxpayers using Bitcoins cannot qualify as QBUs and therefore would be subject to the standard foreign currency reporting regulations. Whether Bitcoins can be a QBU depends on whether the Bitcoin exchange is a “trade or business” and whether it maintains “separate books and records.”

A “trade or business” is a “specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit . . . [and] must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.”\textsuperscript{91} Bitcoin mining could very well qualify as a “trade or business” under this definition. That is, Bitcoin exchange’s “group of activities” include those activities which constitute “mining,” such as “spending computing power to process transactions, secure[ing] the network, and keep[ing] everyone in the system synchronized together.”\textsuperscript{92} “Separate books and records” include “books of original entry and ledger accounts, both general and subsidiary, or similar records.”\textsuperscript{93} As discussed earlier, all transactions occurring on the Bitcoin network are recorded in the block chain. This block chain accounts for all transactions that are entered into by users. The block chain could, therefore, serve as a separate set of books and records for the Bitcoin transactions occurring on a Bitcoin exchange.\textsuperscript{94} Thus, Bitcoins could very well qualify as a QBU.

\begin{itemize}
\item \textsuperscript{87} Id. at 8.
\item \textsuperscript{88} Foreign Currency and Currency Exchange Rates, IRS (Sept. 13, 2013), http://commcns.org/INNmD53.
\item \textsuperscript{89} Id.
\item \textsuperscript{90} 26 U.S.C. § 989(a) (2012).
\item \textsuperscript{91} 26 C.F.R. § 1.989(a)-1(c) (2012).
\item \textsuperscript{93} 26 C.F.R. § 1.989(a)-1(d)(1).
\item \textsuperscript{94} See id.
\end{itemize}
Even if Bitcoin exchanges are determined to be a QBU, taxpayers owning these exchanges with a principle place of business in the United States must use the U.S. Dollar for their functional currency.95 Therefore, U.S. taxpayers would be required to “immediately translate into dollars all items of income, expense, etc. (including taxes), that [they] receive, pay, or accrue in [Bitcoins] and that will affect computation of [their] income tax.”96 In the presence of more than one exchange rate, the IRS requires that the individual use the rate that “most properly reflects” the individual’s income.97 With respect to Bitcoins, valuation is typically determined by the average trading prices of all transactions on certain Bitcoin exchanges.98 However, because there is no specific valuation method,99 each individual’s taxable income on their Bitcoin transactions will vary.

C. The IRS Claims Bitcoin Is “Property”

The IRS considers Bitcoin and other virtual currencies to be property.100 The guidance comes in the form of a Notice published by the IRS stating how existing tax law should be applied to Bitcoin, the guidance was based on IRS responses to frequently asked questions.101 Key points from the IRS’s Notice include the following: (1) Bitcoins are considered property; (2) a taxpayer’s basis in any Bitcoins received by the taxpayer in a transaction will be the fair market value of the Bitcoins at the time of the transaction; (3) fair market value will be determined in U.S. Dollars by the taxpayer on the date of receipt based on current listings on Bitcoin exchanges; (4) taxpayers must calculate any gain or loss on each transaction and determined if that gain is capital or ordinary; (5) wages paid in Bitcoins are reported on Form W-2; and (6) the guidance is expected to be applied retroactively and failure to comply may result in penalties.102 This means that IRS and taxpayer’s have a duty to account for transactions prior to the March 25, 2014 Notice issuance date.103

---

96 Id.
97 Id.
98 Winklevoss Bitcoin Trust Form S-1, supra note 18, at 12; see also Grinberg, supra note 13, at 166–68.
99 Patrick Murck, The True Value of Bitcoin, CATO UNBOUND (July 31, 2013), http://commcns.org/1ilDoAE.
101 Id. at 1.
102 Id. at 2–6.
103 Id. at 6.
There is a convincing argument that the IRS guidance has made Bitcoin use incredibly complex for taxpayers. Daily fluctuations in prices across the Bitcoin exchanges could make it very difficult to calculate gains or losses when taxpayers transact in Bitcoins. Further, tax experts and former-commissioner of the IRS, Mark Everson, are skeptical of the IRS’s ability to enforce its guidance. However, trades in Bitcoins could fit within the provisions of § 61, because income gains realized from property transactions (here, those from Bitcoin trades) are explicitly identified in the statutory language. Property for taxation purposes must be either tangible items or intangible items such as goodwill. Despite Congress’s intent that the term “tangible personal property” be construed broadly, information is considered intangible property. Bitcoins are “digital units of exchange” that are not backed by a government. Therefore it may seem rational that Bitcoin should be considered intangible property.

It is possible that the IRS has decided that Bitcoins are intangible property. Another basis for the IRS’ decision to classify Bitcoin as property may be a recognition of Bitcoin as a capital asset. The IRS has said it will treat gains and losses derived from Bitcoin as capital gains and losses when the Bitcoins are capital assets in the hands of the taxpayer. Since capital assets are property, and the IRS has made no determination as to the specific capital assets Bitcoins are, further classification as a commodity should be considered by the IRS. Arguably, treating Bitcoins as commodities will be less burdensome on the taxpayer by allowing their gains and losses to be calculated based on the value of Bitcoins held at the end of the taxable year. This will be explained in detail in the next section of this article.

---

105 Id.
106 Id.
110 Comshare, Inc., v. United States, 27 F.3d 1142, 1142, 1145 (6th Cir. 1994) (noting that although physical tapes and discs were tangible property, the information on those disks was intangible property).
111 GAO REPORT, supra note 6, at 3.
112 I.R.S. Notice 2014-21, supra note 65, at 3.
113 For a discussion of the terms relating to capital gains and losses, see 26 U.S.C. § 1222(1)–(4) (2012).
D. The Workable Federal Taxation Model: Bitcoin As a Financial Instrument

Bitcoin as a financial instrument is the best course of action that regulators in the United States can pursue. A district court has recognized that investments in Bitcoins offered by the Bitcoin Savings and Trust ("BTCST") are securities.116 Under 15 U.S.C. § 77b, a security is "any note, stock, treasury stock, security future, security-based swap, bond . . . or investment contract." 117 The district court believed that BTCST investments were investment contracts.118 An investment contract is any "contract, transaction, or scheme involving (1) an investment of money, (2) in a common enterprise, (3) with the expectation that profits will be derived from the efforts of the promoter or a third party."119 Each of these requirements, the district court believed, was satisfied.120 The "investment of money" requirement was satisfied, because Bitcoins can be used like money to purchase goods and services.121 The "common enterprise" requirement was satisfied, because the investors had collectively relied on the defendant’s knowledge of Bitcoin Markets.122 The Court found that the final prong, "expectation of profits," was satisfied by the defendant’s promise to the investors of interest earnings.123 In the wake of this decision, there has been much emphasis placed on the district court’s recognition of Bitcoin as money.124 If Bitcoin is money, then it falls under § 61.125 The court’s analysis may provide a basis for the Government to consider Bitcoin assets as financial instruments.

The financial instrument model that is most analogous to Bitcoin is that of a commodity. Commodities, for tax purposes, are excepted from the definition of capital assets when held by a commodities derivatives dealer.126 which could

118 Shaver, 2013 WL 4028182, at *2.
119 Id.
120 Id.
121 Id.
122 Id.
123 Id.
126 26 U.S.C. § 1221(a) (2012) ("[T]he term ‘capital assets’ means property held by the taxpayer . . . but does not include . . . (6) any commodities derivative financial instrument held by a commodities derivatives dealer . . .").
affect the rates at which they would be taxed. Bitcoin is the subject of two current financial endeavors to bring investment opportunities to people outside of the standard Bitcoin Exchange model, the Winklevoss Bitcoin Trust and SecondMarket’s Bitcoin Investment Trust.\textsuperscript{127} Both seek to allow investors to invest in Bitcoins in a manner that circumvents the difficulties associated with direct trading on a standard Bitcoin exchange.\textsuperscript{128} The Bitcoin Investment Trust run by SecondMarket is a private, open-ended fund, while the Winklevoss Bitcoin Trust is planned to be a publicly traded fund.\textsuperscript{129} The Winklevoss Bitcoin Trust files regular disclosures with the SEC.\textsuperscript{130} SecondMarket functions as an alternative investment vehicle for accredited investors seeking exposure to bitcoin currency.\textsuperscript{131} Both of these trusts could be considered investment vehicles for the commodities markets (\textit{i.e.}, Bitcoin currency).

The legal definition of a commodity is, “\textit{[a]ny movable and tangible thing that is ordinarily produced or used as the subject of barter or sale.}”\textsuperscript{132} Thus, Bitcoin must be a tangible thing if it is to be a commodity. “Tangible” means that either actual or constructive possession can be exercised over an item.\textsuperscript{133} Constructive possession means having “ownership, dominion or control” over a particular item and, “dominion over the premises in which the [item] is concealed.”\textsuperscript{134} Historically, the courts have not limited constructive possession to items occupying the physical world.\textsuperscript{135} Rather, the courts have embraced those items occupying the digital realm of existence as being subject to their owner’s constructive possession.\textsuperscript{136} Therefore, it follows that Bitcoin should be considered a tangible good, because Bitcoins can only be distributed from an owner’s wallet which is in the exclusive possession and control of that owner through their possession of the private key.\textsuperscript{137}

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Bitcoin Investment Trust, supra} note 127 (allowing minimum investments of $25,000 as of 11/9/13).
\item State ex. Rel Moose v. Frank, 169 S.W. 333, 336 (Ark. 1914).
\item \textit{BLACK’S LAW DICTIONARY} 712 (9th ed. 2009).
\item United States v. Cardenas, 748 F.2d 1015, 1019 (5th Cir. 1984) (internal quotation marks omitted).
\item \textit{What U.S. Regulations Apply to Bitcoins As Commodities, BITCOIN TITAN & TRADING TITAN BLOG,} http://commcns.org/1kFE3Bf (last visited Feb. 7, 2014).
\item \textit{Id.} (citing several cases as support for the proposition that constructive possession is not limited to things occupying the physical world).
\item Winklevoss Bitcoin Trust Form S-1, \textit{supra} note 18, at 8.
\end{enumerate}
\end{footnotesize}
Providing more viability to the Bitcoin commodities argument is the analogy to gold, which is a recognized commodity.\textsuperscript{138} The analogy provides that the value of a Bitcoin is tied directly to people’s desire for it, much like the value of gold.\textsuperscript{139} Additionally, the supply of both Bitcoins and gold is limited and both must be mined, although Bitcoin mining is a mathematical computer process.\textsuperscript{140} The determination still remains to be made for what a commodity classification could mean for Bitcoin’s tax implications. For tax purposes, commodities are “section 1256 contracts” under the IRC.\textsuperscript{141} Commodities are nonequity options, which are listed under § 1256(b)(1)(C) as one of the definitions of “section 1256” contracts.\textsuperscript{142} Non-equity options are usually classified as “any option that is based on a stock index traded on a contract market designated by the CFTC.”\textsuperscript{143} However, the Treasury has the power to decide that some option can be considered a non-equity option and in those cases CFTC designation is not required.\textsuperscript{144} This is the necessary determination that is required for Bitcoin to qualify as a commodity. Bitcoin is not “based on a stock index traded on a contract market designated by the CFTC.”\textsuperscript{145} Additionally, most Bitcoin transactions are excepted from CFTC regulations, which furthers the need for the Treasury to make a determination on whether Bitcoins constitute non-equity options.\textsuperscript{146} If the Treasury were to make this decision, which is the argument put forth in this discussion, then gains or losses in income realized from Bitcoin assets would be subject to capital gains tax rates.

Capital gain means the excess from the sale or exchange of a capital asset over the loss from that sale or exchange.\textsuperscript{147} Capital assets are “property held by the taxpayer.”\textsuperscript{148} As discussed above, Bitcoins could be deemed commodities, and commodities are § 1256 contracts.\textsuperscript{149} Section 1256 contracts qualify as


\textsuperscript{139} \textit{Id.}

\textsuperscript{140} \textit{Id.}

\textsuperscript{141} See 26 U.S.C. § 1256 (2012); see also \textit{Staff of Joint Comm. on Taxation, 112th Cong., Description of Revenue Provisions Contained in the President’s Fiscal Year 2012 Budget Proposal 152} (Comm. Print 2011) (stating that commodities dealers are dealers in Section 1256 contracts).

\textsuperscript{142} 26 U.S.C. § 1256(b)(1)(C).

\textsuperscript{143} \textit{Kevin M. Keyes, Federal Taxation of Financial Instruments & Transactions} § 13.03(3)(d) (1997).

\textsuperscript{144} \textit{Id.}

\textsuperscript{145} This is the definition of a non-equity option that was given by Kevin Keyes. \textit{See id.}

\textsuperscript{146} \textit{What U.S. Regulations Apply to Bitcoins As Commodities, supra} note 135.

\textsuperscript{147} 26 U.S.C. § 1222(9) (2012).


\textsuperscript{149} See discussion supra.
capital assets. Therefore, the Government should recognize Bitcoin as a capital asset, and then the income from the buying or selling of Bitcoins on exchanges or the income realized through transacting for goods and services will be subjected to the Capital Gains Tax. However, some Bitcoin users may not be able to take advantage of the preferential treatment of their income as capital gains. While Bitcoin traders and miners who sell their Bitcoins do not explicitly fall into the capital asset exceptions of § 1222, the Treasury Department arguably could determine that these entities and people are engaged in the business of selling Bitcoins and as such their gains are ordinary income gains rather than capital gains.

The method for determining taxes due on capital gains income is found in section 1 of the IRC. Section 1256 contracts are treated uniquely for the purpose of the capital gains tax. The IRC provides that “each section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year . . . .” Further, the IRC stipulates the rate that this fair market value is subjected to with respect to losses or gains that the taxpayer received. Any gains or losses in income from Bitcoin would be capital gains and taxed at a unique 60/40 split of long and short-term capital gains rates. These rates are calculated by multiplying 60% by the maximum long-term capital gains rate; then multiplying 40% by the maximum short-term capital gains rate; and then adding these two figures together to determine the appropriate blended tax rate for commodities.

Currently, Germany is the only nation that has subjected Bitcoin to any sort of explicit tax classification. The German model classifies Bitcoin trading as capital gains and subjects the income gained in Bitcoin to its capital gains tax rates. However, there is an exception that allows those who hold their Bitcoins for a year without trading them to become exempt from this taxation.

---

150. 26 U.S.C. § 1221(b)(1)(B)(i) (excluding § 1256 contracts from the definition of Commodity Derivative Financial Instrument which are excepted from the definition of capital asset).
153. Id. § 1256(a)(1).
154. Id. § 1256(a)(3).
155. Id. § 1256(a)(3)(A), (B).
158. Id.
159. Id.
This particular system arguably would not work in the United States.\textsuperscript{160} Additionally, if regulators deemed Bitcoins to be commodities (as they should) there is clear statutory guidance as to how taxation is assessed on those assets.\textsuperscript{161} In the United States, capital gains are subject to a different tax rate depending on how long—a year or less than a year—they are held before a sale.\textsuperscript{162} They are also subject to differing rates within the distinction of short- or long-term, based on the taxpayer’s marginal income tax rate.\textsuperscript{163} Currently, in the United States, the only taxpayers who pay 0% capital gains on capital assets held longer than a year are those taxpayers within the 10% and 15% marginal income tax rate the year of their sale.\textsuperscript{164} Changing the capital gains tax rate to zero for all marginal income tax rates in the United States for people with Bitcoin assets would arguably change the progressive nature of the IRC to a flat tax for all Bitcoin users holding onto their assets. Additionally, this incentive in the German model may be detrimental to the Bitcoin networks operation.

As discussed earlier,\textsuperscript{165} transactions are approved by mining procedures, which in turn create new Bitcoins as a reward to the miners for ensuring transaction authenticity.\textsuperscript{166} If there are fewer users transacting and more users holding their Bitcoin assets for at least one year, then the rate of the transactions being added to the block chain will slow down. Fewer blocks in the chain mean less work for miners, who, in turn, may provide disincentives to solve for hash values. A more pressing problem with this possible outcome is related network security. Gaining over 50% of the Network’s processing power may allow a malicious actor to control fraudulently the network for his gain.\textsuperscript{167} The most basic type fraudulent manipulation an actor with this processing power could engage in would be double spending their Bitcoins.\textsuperscript{168} The collective

\textsuperscript{160} The United States has a capital gains tax system that subjects taxpayers to different rates depending on the length that they hold capital assets before selling them. Germany, however, has “no separate capital gains tax . . . capital gains are included in taxable income unless exempt under the participation exemption.” \textit{Taxation and Investment in Germany 2013 Reach, Relevance, and Reliability}, DELOITTE 1, 11–12, available at http://commens.org/1INBrO1 (last visited May 20, 2014). The United States does not offer an exemption of capital assets no matter how long they are held. \textit{See generally} 26 U.S.C. § 1222 (2012).

\textsuperscript{161} See the guidance with respect to section 1256 contracts at 26 U.S.C. § 1256 (2012).

\textsuperscript{162} 26 U.S.C. § 1222(1), (3).


\textsuperscript{164} \textit{Id.}

\textsuperscript{165} \textit{See supra} Part II.

\textsuperscript{166} \textit{Blocks, supra} note 26.

\textsuperscript{167} Winklevoss Bitcoin Trust Form S-1, \textit{supra} note 18, at 9.

processing power at present makes this a nearly impossible for any actor to achieve.\textsuperscript{169}

Another possible scenario is that disincentives to miners would result in a higher risk of fraudulent “double spending.” Double spending occurs if a malicious actor is able to re-solve each block in a chain from whatever block they are targeting and proceeding backwards at a rate that exceeds all other miners who are currently adding blocks to the chain.\textsuperscript{170} The number of miners currently operating the hash rate already exceeds 1,700 petaFLOPs\textsuperscript{171} and the world’s fastest known supercomputer can only operate at 54.9 petaFLOPs, which is less than one percent of the Bitcoin network rate.\textsuperscript{172} Therefore, taking away incentives to miners by requiring them to hold Bitcoins for a year to receive favorable tax treatment may result in a decline in the number of miners. This in turn could lead to the possibility of double spending, considering the rapid nature of growth in computer processing power.

V. TAX EVASION AND MONEY LAUNDERING

A. Tax Evasion and Foreign Account Tax Compliance Act (“FATCA”) Another concern of the Government’s is tax evasion through the use of the Bitcoin Network.\textsuperscript{173} To be convicted of the crime of tax evasion, one must meet the required elements, which are “willfulness; existence of a tax deficiency . . . and an affirmative act constituting an evasion or attempted evasion of the tax.”\textsuperscript{174} Attempt under this statute requires the “intent to evade tax” and “[s]ome act done in furtherance of such intent.”\textsuperscript{175} The attempt need not be successful.\textsuperscript{176} The affirmative act requires that a taxpayer purposefully claim that his income is lower than it truly is.\textsuperscript{177}

The question as applied to Bitcoin is, as things stand now, whether the government has the authority to bring legal action against taxpayers under this law

\textsuperscript{169} Winklevoss Bitcoin Trust Form S-1, supra note 18, at 28.
\textsuperscript{170} Id.
\textsuperscript{171} PetaFLOP Definition, WEBOPEDIA, http://comcmns.org/1iE74L (last visited Feb. 9, 2014) (“the ability of a computer to do one quadrillion floating point operations per second.”).
\textsuperscript{172} Winklevoss Bitcoin Trust Form S-1, supra note 18, at 28.
\textsuperscript{173} Szu Ping Chan, Bitcoin Among Virtual Currencies Targeted in US Crackdown on Tax Evasion, TELEGRAPH (June 11, 2013, 9:46 AM), http://comcmns.org/1NBBQRb.
\textsuperscript{174} Sansone v. United States, 380 U.S. 343, 351 (1965).
\textsuperscript{176} United States v. Norris, 205 F.2d 828, 829 (2d Cir. 1953) (noting that more than the mere failure to report is required; there must a willful failure to report).
\textsuperscript{177} United States v. Burrell, 505 F.2d 904, 911 (5th Cir. 1974).
based on their dealings in Bitcoin. The answer to this question seems to hinge on whether in the current unregulated state of Bitcoin exchanges there can be an affirmative act on the part of the taxpayer to satisfy the willful element of the statute. There are many different actions that a taxpayer can take to satisfy the willful element, but when taxpayers have no reference as to whether they are receiving taxable income, then they arguably cannot be taking any affirmative action to evade that tax liability. Failure to report by itself does not constitute tax evasion.\textsuperscript{178} The IRS has failed to provide much guidance concerning Bitcoin.\textsuperscript{179} Therefore, Bitcoin exchange users should not currently be susceptible to punishment for not reporting their Bitcoin holdings under tax evasion laws.

Issues with tax evasion are a natural result as Bitcoin becomes more widely used and the government begins to consider what tax laws Bitcoins will be subjected to. The nature of Bitcoin wallets keeps them hidden to anyone except the holder of the private key.\textsuperscript{180} According to case law, “any conduct, the likely effect of which would be to mislead or conceal, is sufficient to satisfy the ‘affirmative act’ element of tax evasion.”\textsuperscript{181} The anonymity of Bitcoin wallets could be construed as a concealment and therefore affirmative act in committing tax evasion. The government needs to consider the detrimental effect that this would have on the nature of the Bitcoin network when structuring any future tax legislation concerning virtual currency tax compliance.

Bitcoin exchanges arguably will face tax implications under the FATCA. FATCA requires Foreign Financial Institutions (“FFIs”) to register with the IRS and to provide the IRS with information pertaining to U.S. accounts to avoid a 30% withholding tax on U.S. payments made to them.\textsuperscript{182} Once registered and entered into an agreement, the FFI may be required to provide information on U.S. account holders to the Secretary of the Treasury Department.\textsuperscript{183} Bitcoin exchanges operate all around the world in various countries; many of these countries with exchanges have entered into Bilateral Joint Statements with the United States Treasury.\textsuperscript{184} The agreements are in place, thus, the ques-

\textsuperscript{178} United States v. McGill, 964 F.2d 222, 231 (3d Cir. 1992).
\textsuperscript{179} See GAO REPORT, supra note 6, at 17.
\textsuperscript{180} Winklevoss Bitcoin Trust Form S-1, supra note 18, at 27.
\textsuperscript{181} United States v. Voigt, 89 F.3d 1050, 1090 (3d Cir. 1996).
\textsuperscript{182} 26 U.S.C. § 1471(a) (2012).
\textsuperscript{183} Id. § 1471(b)(1)(A), (c).
tion is whether the operating Bitcoin exchanges are FFI’s for the purposes of FATCA. Under 26 U.S.C. § 1471, FFIs are defined as “any financial institution which is a foreign entity.” More specifically, the test is whether the foreign entity:

(A) accepts deposits in the ordinary course of a banking or similar business, as a substantial portion of its business,

(B) as a substantial portion of its business, holds financial assets for the account of others, or

(C) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in section 475(c)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in section 475(c)(2)), or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.

The Bitcoin exchanges arguably should be deemed FFIs because they are engaged in the business of trading commodities, which qualifies under § 1471(d)(5)(C).

The former exchange Mt. Gox, and some of the biggest and most popular Bitcoin exchanges should fall under FACTA’s jurisdiction, because the countries that they operate in have entered into bilateral agreements with the United States. There should be no compliance issues for exchanges located in FATCA agreement countries. Therefore, foreign exchanges would have the option of entering into an agreement with the Secretary of the Treasury to comply with FATCA or pay the 30 percent withholding on their U.S. accounts. Of course, this leads to the possibility that exchanges in FACTA complaint countries may begin refusing American account holders based on wanting to limit the exchanges exposure to United States regulation. Bitcoin exchanges have readily accessible information on their United States account holders. The information that exchanges are required to turn over with respect to United States account holders includes the name, address, account number, account balance, and the gross withdrawals or payments from the ac-

---

186 Id. § 1471(d)(5).
187 Id. § 1471(d)(5)(A)–(C).
188 See id. § 1471(d)(5)(C).
189 Note that Mt. Gox is currently going through bankruptcy proceedings. Yoshifumi Takimoto & Sophie Knight, Mt. Gox Files for Bankruptcy, Hit with Lawsuit, REUTERS (Feb. 28, 2014), http://commcnns.org/1mhnMkh.
190 26 U.S.C. § 1471(b)(1) (setting forth certain reporting requirements for foreign financial institutions); see also FATCA Resource Center, supra note 184 (listing the multiple bilateral agreements countries have signed with the United States to implement FACTA).
191 Id. § 1471(c)(1)(D).
192 See discussion supra Part II.
count. This is all information available through Bitcoin exchanges that require personal information to conduct deposits and withdrawals of funds from buying, selling and trading of Bitcoin. FACTA also gives each FFI the option to be treated as a U.S. financial institution when reporting on U.S. accounts. If a foreign Bitcoin exchange elected this method of reporting, then they would be exempted from reporting the account balance or value of their U.S. accounts and the requirement that gross receipts and withdrawals from the accounts are reportable. However, in turn, these exchanges would have to comply with certain reporting requirements of a U.S. financial institution.

There also may be a loophole within the FACTA reporting requirements that applies exclusively to Bitcoin assets, not the fiat currency income gained from their sale. Exchanges offer private key withdrawal options to a user’s wallet for withdrawals of Bitcoin assets. The argument can be made that the unique private key does not qualify as any of the statutorily identified records that FFI’s are required to turn over through FACTA. The account information required to be reported under FACTA refers to the depository and custodial accounts maintained by the FFI. Using Mt. Gox as an example, the depository account would arguably refer to the account set up on Mt. Gox that U.S. users deposit U.S. dollars into for use on the exchange. The custodial account would arguably be the account that Bitcoins are deposited and withdrawn from. Exchanges offer the option to use your private key to deposit and withdraw Bitcoins. Bitcoins are arguably not “money,” which would indicate a depository account; therefore, a user’s private key is not included in the information that is reported concerning depository accounts. It could also be argued that this does not mean that one’s private key is somehow equivalent to one’s custodial account number for FACTA purposes. The private key is just a method of withdrawal of Bitcoins from the custodial account maintained by the Bitcoin FFI. This is important for the privacy of Bitcoin. If an American user elected to remove himself from an exchange he could do so knowing that the United States Treasury did not possess the access code to his Bitcoin wallet, despite the records they possess as a result of his transactions on the exchange.

194 See discussion supra Part II.
196 Id. § 1471(c)(2)(A).
197 Id. § 1471(c)(2)(B).
198 See discussion supra Part II.
200 See discussion supra Part II.
202 See discussion supra Part II.
B. Bank Secrecy Act and Money Laundering

Whereas foreign Bitcoin exchanges, such as the former Mt. Gox, are subject to the provisions of FATCA, any domestic exchanges arguably fall subject to the Currency and Foreign Transactions Reporting Act, commonly known as the Bank Secrecy Act (“BSA”) as U.S. financial institutions. 203 The BSA was drafted to address the issues of American financial assets being placed into foreign or “offshore” accounts. 204 These accounts operated under heightened secrecy laws, shielding the assets from a substantial amount of their normal tax liability and providing criminal enterprises a private banking resource that they exploited for the purposes of “cleaning” illegally obtained funds. 205 The BSA is intended to impose, among other things, mandatory record-keeping requirements on U.S. financial institutions. 206 U.S. financial institutions must keep and report detailed records of any information that the Secretary of the Treasury is authorized to require financial institutions to maintain with respect to the institution’s operation as an uninsured bank or uninsured institution. 207 The record-keeping provisions of this act are incredibly broad, and they give the Treasury Secretary the authority to require the records of any financial institution 208 based on the determination that the information:

[Has] a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, recognizing that, given the threat to the security of the Nation on and after the terrorist attacks against the United States on September 11, 2001, such records may also have a high degree of usefulness in the conduct of intelligence or counterintelligence activities, including analysis, to protect against international terrorism. 209

Domestic Bitcoin exchanges could be construed to fall under the definition of financial institutions based on its broad nature and based on the argument that Bitcoin is a commodity. 210 Currency exchanges fall under this definition, as do dealers in securities and commodities, and “any other business designated by the Secretary whose cash transactions have a high degree of usefulness in

204 James E. Eldridge, Comment, The Bank Secrecy Act: Privacy, Comity, and the Poli-
205 Id. at 669–70.
criminal, tax, or regulatory matters.”211 The Treasury Department imposes reporting requirements—which it believes are a major component of the BSA—on domestic financial institutions concerning, payment, receipt, or transfer of currency in excess of $10,000.212 Therefore, domestic Bitcoin exchanges could avoid these reporting requirements by limiting daily money transfers and account sizes. One Bitcoin trading platform, CampBX, appears to be doing just that. CampBX limits daily money transfers, withdrawals and deposits, to $1,000 per day.213 Further, CampBX sets the default maximum account size to $9,000.214 The BSA’s statutory domestic reporting threshold is measured in U.S. dollars.215 CampBX is not an outlier, as other members of the Bitcoin community are taking steps to limit their reporting obligations, because complying with the regulations is difficult if not impossible for many in the Bitcoin community.216

However, simply limiting their daily transactions to avoid statutory reporting requirements may not be enough to avoid scrutiny and further reporting requirements under the BSA. The anonymity of Bitcoin has attracted criminals to the network to finance their endeavors.217 For example, the FBI has recently shut down the website Silk Road and arrested its founder.218 Silk Road was a massive drug market that operated through multiple levels of encryption and anonymity, using Bitcoins as the primary means of exchange.219 The FBI demonstrated that Bitcoin can not offer a safe haven for transfers of funds for illicit activity, even if the Bitcoin trader uses Tor220 or some other network providing anonymity to its users.221

211 Id. § 5312(a)(2)(H), (J), (Z).
214 Id.
217 Andy Greenberg, An Interview with a Digital Drug Lord: The Silk Road’s Dread Pirate Roberts (Q&A), FORBES (Aug. 14, 2013, 1:45 PM), http://commcns.org/1jnREbD.
220 Tor is a network of virtual tunnels that allows people and groups to improve their privacy and security on the Internet. . . . Tor provides the foundation for a range of applications that allow organizations and individuals to share information over public networks
Bitcoin’s utility for those who engage in criminal activity provides an incentive for lawmakers to clampdown on the currency. Additionally, WikiLeaks’ call for donations via Bitcoins provides more “anti-Bitcoin ammunition” to those calling for its regulation.\textsuperscript{222} As noted earlier, domestic financial institutions must disclose transactions that exceed $10,000.\textsuperscript{223} Exchanges, such as the former Mt. Gox, might collect information about their users’ name, address, phone number, email address, dates of birth, and trades.\textsuperscript{224} Further, exchanges might record the users’ IP addresses and operating system details. The government has shown that it is interested in cracking down on Bitcoin.\textsuperscript{225} Because Exchanges collect so much information about their users, they might well serve as the focal point of regulation and enforcement activities.

FinCEN, part of the Department of the Treasury, has issued guidance on how institutions can comply with the BSA.\textsuperscript{226} The report divides Bitcoin participants into two categories.\textsuperscript{227} The first, “users,” are people who use Bitcoins to buy goods and services.\textsuperscript{228} “Users” are not subject to the FinCEN’s registration, recordkeeping, and recording regulations.\textsuperscript{229} A person or institution that accepts and transfers Bitcoins or buys and sells Bitcoins is designated a “Money Transmitter.”\textsuperscript{230} A “Money Transmission Service” is “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.”\textsuperscript{231} One who mines for Bitcoins and thereby creates the units to be used for buying or trading for real or virtual goods and services are considered “Users.”\textsuperscript{232} If one creates (mines) Bitcoin units and then sells them for Government backed currency, then that person falls under the money transmission regulations.\textsuperscript{233} If a person accepts

\begin{small}
\begin{itemize}
\item See \textit{Accessing Bitcoin Fog}, BITCOIN FOG CLEARNET PORTAL (last visited Jan. 25, 2014), http://commens.org/1nNmCC.
\item Andy Greenberg, \textit{WikiLeaks Asks for Anonymous Bitcoin Donations}, FORBES (June 14, 2011, 8:01 PM), http://commens.org/1mhoaPK.
\item 31 C.F.R. § 103.22(b)(1) (2010).
\item See discussion \textit{supra} Part II.
\item Roberts, \textit{supra} note 64.
\item FinCEN INTERPRETIVE GUIDANCE, \textit{supra} note 11.
\item Id.
\item Id.
\item Id.; \textit{see also} 31 C.F.R. § 1010.100(ff)(5)(i)(A) (2013) (defining “Money Transmitter”).
\item Id.
\item FinCEN INTERPRETIVE GUIDANCE, \textit{supra} note 11.
\item Id.
\end{itemize}
\end{small}
Bitcoin as part of a transfer for goods and services, then that person is also subject to the money transmission regulations. FinCEN’s guidance on the BSA provides that domestic Bitcoin exchanges and payment systems qualify as “Money Transmitters” under FinCEN’s regulations and be subject to the registration, reporting, and recordkeeping requirements.

Bitcoin businesses must comply not only with FinCEN’s regulations, but also with state licensing regimes. Bitcoin transactions are not confined within a single state’s borders. Thus, because states and the federal government have yet to issue clear guidance on the legal nature of Bitcoins, the Bitcoin businesses face murky and uncertain regulatory landscape. Such uncertainty interferes with the operation of legitimate Bitcoin businesses. States must recognize that FinCEN guidelines for crypto currencies, such as Bitcoin, will facilitate the growth of exciting and new Bitcoin businesses. States and the federal government should ensure that their laws reflect the evolving landscape of digital currency.

VI. CONCLUSION

Bitcoin is an innovative system, even though it currently operates in a legal gray area. The Government should consider its nature, an intentional detachment from centralized or institutional financial systems, when the inevitable regulation of it proceeds. If the Government seeks to tax Bitcoin, it will have to approach this regulation in a unique way due to the administrative issues of collecting these taxes. Financial instruments, specifically commodities, are the closest semblance to Bitcoin; as such, this classification for taxation should serve as a basis for any legislation moving forward. In the absence of explicit tax legislation, it is the government’s duty to exempt Bitcoin users from prosecution for tax evasion because it is unclear as to what taxes they are actually evading. Thus it is unlikely that Bitcoin users could be taking some affirmative action to avoid paying taxes simply by not reporting their assets held in Bitcoin. Finally, Bitcoin exchanges currently may be subject to FATCA, depending on their country of operation, FinCEN, and also the Bank Secrecy Act if they are operating in the United States. Therefore, these exchanges have a duty imposed by statute to forge the required agreements with the Department of Treasury because of their classification as money transmission service or bilat-

---

234 Id.
235 Id.
237 Id.
eral agreements between their country of operation and the United States. There is, however, the unavoidable nature of the network that will present problems for reporting extensive information on account holders who have suspect transactions. One thing is certain, if the Government wishes to regulate Bitcoin for American users, then it is going to have to adapt and possibly amend many of the statutory provisions currently in place to create a workable regulatory model for this unique system.