Is Bitcoin in Your Wallet?

By: Daniel Richardson

[i]Although virtual currencies are not new they have rapidly evolved in recent years and their use is entering the financial mainstream. Bitcoin is the most widely used of the virtual currencies and is accepted by over 10,000 online retailers including Overstock.com and Expedia.com. So, what is Bitcoin? Is it currency, property, a security, or a wholly new financial instrument altogether? More importantly, what are the upsides and pitfalls of using Bitcoin?

What are Bitcoins and How do You Get Them?

Bitcoin is used as a substitute for real currency. Bitcoin has no physical presence and is not backed by gold, U.S. Dollars, or any other thing of value. Instead, a database of Bitcoins is maintained over a peer-to-peer network where every transaction is documented in what is known as a "blockchain." Bitcoin and other virtual currencies like it are known as cryptocurrency because the validity of each Bitcoin is verified through cryptography.

Bitcoins are "mined" by sophisticated computers using free software that solves a series of complex algorithms that verify a Bitcoin transaction. When an equation is solved, the "miners" that solved the equation first extract new Bitcoins in blocks of 25. The number of Bitcoins that can be mined is limited by the Bitcoin protocol which requires each equation to be successively harder, thus limiting the total number of Bitcoins in circulation. The Bitcoin program is designed to only allow 21 million Bitcoins into circulation. Currently, there are just over 12.66 million Bitcoins in circulation with the final Bitcoin expected to be mined in 2140. Although the software to mine Bitcoins is free, the computing power required to mine the coins is substantial and off-the-shelf computers do not have the power to mine for Bitcoins. However, all is not lost for prospective miners on a budget. Small miners can contribute their computing power to pools of other miners on sites such as Slush's Pool and receive a percentage of Bitcoins awarded based on the computing power they contribute.

Mining is the not the only method of obtaining Bitcoins. Bitcoins can be purchased from other Bitcoin holders through a person-to-person exchange or through an established Bitcoin currency exchange such as Bitstamp and BTC-e. As of the date of this article, one Bitcoin is worth $465.69.

Using Bitcoins

Bitcoin transactions are made from the holder's Bitcoin address and must be authorized by the holder's private key. The private key is kept in the holder's "wallet" which can be stored on a personal computer, mobile device, or in the cloud using an online service such as Strongcoin.[ii] The wallet's designated address is used to make or receive Bitcoin payments. Bitcoins can be sent anywhere in world almost instantly and since transactions using Bitcoin require no middleman, the processing of transactions is very low.

Bitcoin transactions are recorded in the blockchain that can be viewed by anyone. Transactions in the blockchain, however, only record the Bitcoin address which is not linked with any individual, hence Bitcoin's reputation for being an anonymous means to transfer funds and its heavy use on the black market.

Classifying Bitcoin

There has been a great deal of debate over exactly what Bitcoin is. Bitcoin has been compared to currency, property, securities, and commodities. According to Bitcoin's founder, Satoshi Nakamoto, Bitcoin is a new type of financial instrument that is a "purely peer-to-peer version of electronic cash [that] would allow online payments to be sent directly from one party to another without going through a financial institution." Legally speaking, however, a definitive conclusion as to what Bitcoin is and how it should be treated has not yet been reached.

As a starting point, although Bitcoin operates like "real" currency in that it is used as a medium of exchange, it is not legal tender in any jurisdiction. According to the IRS, Bitcoin and other virtual currencies are considered property for federal tax purposes. Generally speaking this means that Bitcoins are subject to capital gains taxes. Therefore, any transaction using Bitcoins could potentially be a taxable event.

Bitcoins are also compared to securities since Bitcoins are often purchased as investments with the expectation that they will increase in value. While investing in Bitcoins may seem similar to investing in stocks or bonds, Bitcoins do not fall under any of the listed statutory definitions of securities (note, stock, treasury stock, security future, security-based swap, bond). Bitcoin is also not a security under an investment contract analysis. Under an investment contract analysis, an investment contract is investment of money in a common enterprise with the expectation of profit through the efforts of others. Bitcoin does not fit under this construct because it is not a common enterprise for profit, but rather a virtual currency. It should be noted that investments in enterprises for profit through the efforts of others that are *related* to Bitcoin could be treated as securities. This was the case in *SEC v. Shavers*, 2013 WL 4028182, where the court for the Eastern District of Texas found contributions of Bitcoins to the operator of Bitcoin Savings and Trust in exchange for the promise of a guaranteed interest payment constituted an investment contract.

Bitcoin may be most like a commodity. Finland and Japan have official recognized Bitcoin as a commodity. One of the reasons for this label is that a currency, in theory, is supposed to be relatively stable. Bitcoin's annualized volatility was 105% in 2013 whereas the U.S. Dollar's volatility for the same year was only 5.5%. Under U.S. law, to be a commodity there must be a contract for present or future delivery. Since there are now several Bitcoin futures exchanges, this may be the definition that best fits Bitcoin. Virtual currency, however, is not usually what comes to mind when one thinks of traditional commodities such as gold, wheat, oil, etc.

Finally, states are beginning to weigh in on Bitcoin and other virtual currencies. For instance, California repealed Cal. Corp. Code § 107 which had prohibited the issuance or circulation, as money, anything but currency of the United States. According to the bill sponsor, Assembly member Roger Dickinson (D), § 107 was repealed since it had made it technically illegal for Californians to use alternative currencies already used everyday by many consumers such as Starbucks Stars and Amazon Coins. But, while California has taken measures to accept the use of digital currencies, other states have not been as receptive. For example, in reaction to virtual currencies, the Illinois legislature has proposed a bill that would provide that virtual currencies do not have legal tender status.[iii]

Considerations when using Bitcoin

There are many advantages to using Bitcoins such as the ability to transfer value to anyone in the world with little to no transaction cost. However, there are some financial and legal implications to using Bitcoin that need to be considered to avoid negative repercussions. Here are a few considerations to keep in mind when using Bitcoins:

- Value fluctuation. Bitcoin values have been extremely volatile. The value of a Bitcoin fluctuated between $100 and $1,200 between March 2013 and March 2014. Before investing in or excepting Bitcoins as payment, the potential for a decrease in value should be taken into consideration.
- Lack of Government Regulation. The government does not regulate Bitcoin and other virtual currencies and there are very few consumer protections for Bitcoin users.
- Tax Implications. Since Bitcoins are treated as a property, each Bitcoin transaction is potentially subject to capital gains taxes. The character of gain or loss from the sale or exchange of Bitcoins depends on whether it is considered a capital asset in the hands of the taxpayer.
- Payroll. Some employers, especially in technology fields, have begun to pay employees in Bitcoin. Some payroll services, such as Canada based Wagepoint, even offer services for employers who wish to pay their employees in Bitcoin. Under the IRS guidelines, payments made to employees using virtual currency must be reported on a Form W-2 or on Form 1099 for independent contractors. Furthermore, under the Fair Labor Standards Act, it is uncertain whether Bitcoin meets the criteria to be considered "wages" or whether it satisfies minimum wage requirements.
- Lost, Stolen, or Hacked Bitcoins. If Bitcoins are stolen by hackers or if the hardware storing the Bitcoins is lost or destroyed, there is no way to recover or identify the Bitcoins. Furthermore, Bitcoin Exchanges do not provide the same level of security as other financial institutions like banks. For instance, in March Mt. Gox, the largest Bitcoin exchange, declared bankruptcy after it "lost" over $409 million in Bitcoins. As a result, over one million people lost their Bitcoins with little recourse.

Only time will tell whether Bitcoin and other virtual currency will become commonplace in the financial mainstream. As with other emerging technologies, the law has not yet caught up with Bitcoin and there is still uncertainty as to how it should be treated. Bitcoin has exciting implications if it becomes part of the financial mainstream, but caution should be exercised if you choose to use Bitcoin or any other virtual currency to avoid negative legal and financial consequences.

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[ii] This online wallet is provided as an example only and is not an endorsement by Bay Oak Law.

[iii] The bill is still pending.