Bitcoin: Legal and Regulatory Considerations

May 8, 2014, 11:00AM – 12:00PM

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Bitcoin: Legal and Regulatory Considerations

MoFo Teleconference
May 8, 2014
Presented By
Obrea Poindexter, Jeremy Mandell and Joy MacIntyre
Agenda

• What is Bitcoin?
• How does Bitcoin work?
• How should Bitcoin be regulated?
  • As currency?
  • As property?
  • As a commodity?
• What are the key legal issues?
  • Anonymity
  • Licensing requirements
  • Consumer protection
  • Banking relationships
What is Bitcoin?

- Bitcoin is a “peer-to-peer” (“P2P”) system
  - In a P2P system, there is no central administrator
  - The ledger (“block chain”) is publicly available and distributed nodes (“miners”) verify transactions
- Bitcoin is a “convertible” virtual currency
  - Bitcoin can be used to purchase real and virtual goods and services and is readily exchangeable for government-issued currency
- Bitcoin is a “cryptocurrency”
  - Transactions are signed using public and private keys
How does Bitcoin Work?

- Proposed exchange: Alice wants to transfer 50 bitcoins to Bob
  - Alice owns 100 bitcoins, and has a bitcoin wallet
  - Bob also has a bitcoin wallet
- Alice creates a message, which contains Bob’s public key, and Alice “signs” the message with her private key
  - Alice’s signature verifies that the message is authentic
  - The message also allocates a portion of Alice’s bitcoins to a transaction fee
- The proposed exchange is time-stamped and broadcast to the network of Bitcoin miners
How does Bitcoin Work?

• About every 10 minutes, recently proposed transactions are added to the block chain by Bitcoin miners
  • Miners add proposed transactions to the block chain by finding a valid “proof-of-work”
  • Finding a valid proof-of-work is, increasingly, resource intensive
• Although it is difficult to find a valid proof-of-work, the solution is easy to verify
  • The first miner to find the solution broadcasts it to other miners, who verify the solution
  • Once verified (i.e., accepted by the majority of miners), the new block is added to the block chain
• Once the new block is added to the block chain and the exchanges are confirmed, it is unlikely that the charges will be reversed
How does Bitcoin Work?

- The miner who finds the valid proof-of-work can add to the new block one additional transaction that attributes new bitcoins to the successful miner
  - Currently, the successful miner is awarded 25 bitcoins
  - The number of new bitcoins awarded to the successful miner is reduced by half approximately every four years
  - Accordingly, in terms of new bitcoins, the reward for mining will diminish over time
- Successful miners also receive transaction fees for adding a new block to the block chain, and such fees are expected to increase over time
  - This is intended to sustain the computing power necessary to preserve the block chain
Is Bitcoin Currency?

• Under the Bank Secrecy Act (“BSA”), “currency” means
  “The coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance” 31 C.F.R. § 1010.100(m)

• In contrast to real currency, “virtual currency” is a medium of exchange that operates like real currency in some environments, but does not have all the attributes of real currency
  • Specifically, virtual currency does not have legal tender status in any jurisdiction
Is Bitcoin Currency?

- The BSA regulates, among other things, money transmitters
  - Any person that provides money transmission services—i.e., “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” 31 CFR § 1010.100(ff)(5)(i)(A)
- The BSA imposes obligations on financial institutions to assist U.S. government agencies in detecting and preventing money laundering
- Under the BSA, money services businesses ("MSBs"), including money transmitters, must
  - Register with FinCEN
  - Report suspicious activity and certain currency transactions
  - Establish an anti-money laundering ("AML") program
  - Retain specified records
Is Bitcoin Currency?

- FinCEN has issued interpretive guidance and administrative rulings on administering, exchanging and using virtual currency
- Generally, an administrator or exchanger that accepts and transmits or buys or sells convertible virtual currency is a money transmitter subject to the BSA
- However, based on FinCEN guidance
  - A miner who creates virtual currency and uses it to purchase real or virtual goods and services is not a money transmitter (FIN-2013-G001)
  - A miner who creates virtual currency and uses it to pay investors in his mining operation is not a money transmitter (FIN-2014-R001)
  - A person who rents computer systems for mining virtual currency is not a money transmitter (FIN-2014-R007)
Is Bitcoin Currency?

• Money transmission is also regulated under state law
  • 48 states plus the District of Columbia have money transmission laws
• The core purposes of the federal and state money transmission laws are very different
  • Federal law focuses on anti-money laundering and terrorist financing
  • State laws focus on the integrity and financial health of those running the money transmission—i.e., consumer protection and safety and soundness
• The key issues are whether a third party or intermediary is “holding” money and whether that third party is exempt from state money transmission laws (e.g., bank or broker-dealer)
Is Bitcoin Currency?

- State regulators have expressed interest in virtual currency
  - California Department of Financial Institutions Cease and Desist Order
  - New York Department of Financial Services (“DFS”) subpoenas
  - New York DFS public hearings on virtual currencies
  - New York DFS order on virtual currencies
  - Texas Department of Banking supervisory memorandum
  - Georgia Department of Banking and Finance guidance for consumers
Is Bitcoin Property?

• The Internal Revenue Service (“IRS”) had been pressed by the U.S. Government Accountability Office and others to publish guidance on the tax treatment of virtual currency
• The U.S. tax code contains special rules for dealings in foreign currency, but does not define “currency,” and absent guidance it was unclear how bitcoin should be treated
• In Notice 2014-21 (March 2014) the IRS confirmed that under existing tax law:
  • Bitcoin and other “convertible” virtual currencies are not subject to the special tax rules that apply to foreign currency
  • Instead, convertible virtual currency is simply treated as “property” (not defined; a residual category) for U.S. tax purposes
  • Notice only applies to “convertible” virtual currencies
Is Bitcoin Property?

• The usual tax rules that apply to any other “property” therefore also apply to bitcoin
  • Gain or loss is recognized on the sale or exchange of bitcoin
    • No *de minimis* exception; valuation and recordkeeping issues
    • Gain/loss may be capital or ordinary, depending on holder’s tax status as investor, trader or dealer
  • Bitcoin miners realize gross income upon receipt of bitcoin
  • Usual third-party tax reporting and withholding tax obligations can apply
  • IRS invites comments on other virtual currency tax issues to be addressed in future guidance
Is Bitcoin a Commodity?

• Generally, a “commodity” is defined as an article of trade or commerce, or a tangible good
  • Bitcoins can be viewed as tangible goods, because individuals have constructive possession of bitcoins
  • Constructive possession is control of property without actual possession
• However, key characteristics of commodities are price stability and non-substitutability
  • Bitcoin is subject to severe price volatility
  • There are emerging virtual currency competitors (e.g., Peercoin and Litecoin)
Is Bitcoin a Commodity?

- If bitcoins were commodities, how would they be regulated?
  - The Commodity Exchange Act defines “commodity” to mean “wheat, cotton, rice, corn, oats, barley, [etc.]…and all services, rights, and interests…in which contracts for future delivery are presently or in the future dealt in” 7 U.S.C. § 1a(9)

- The CFTC has authority to regulate commodity futures and certain foreign-exchange instruments
  - Would bitcoin transactions be regulated as commodity futures?
  - Would bitcoin be regulated as a foreign-exchange instrument?
Key Issue: Anonymity

• Bitcoin, and virtual currency more broadly, is appealing to illicit actors because it enables use to remain relatively anonymous
  • In October 2013, the FBI shut down Silk Road and arrested an individual, who they identified as the founder and chief operator of Silk Road, on a number of charges
  • In January 2014, federal authorities arrested and charged two individuals with operating an unlicensed money transmitting business and conspiracy to commit money laundering
• Law enforcement may be able to adapt to new technology
  • The public key is a user’s pseudonym, which is tied to every transaction recorded in the public ledger
  • It may be possible to tie a public key to an individual, or at least individually identifiable information, such as an IP address; however, anonymizing software (e.g., Tor) can be used to increase pseudonymity
Key Issue: Licensing/Registration

- Exchangers (at least) must register with FinCEN and may have to apply for a license under state money transmission laws
- Extensive state application process
  - Significant fees, deposits and surety requirements
  - Extensive business plans
  - Information regarding principal officers, directors and equity owners, including background investigation reports, fingerprints and biographic documents
  - Disclosure of all legal proceedings and financials
  - Detailed descriptions of operations and compliance programs
- Ongoing compliance obligations
  - Anti-money laundering/counter-terrorist financing ("AML/CTF") obligations
  - Capital and surety bond requirements
  - Subject to regular examinations
Key Issue: Licensing/Registration

• An MSB must “develop, implement, and maintain an effective [AML] program…reasonably designed to prevent the [MSB] from being used to facilitate money laundering and the financing of terrorist activities”
  • Program must be commensurate with the risks based on location, size, and the nature and volume business
  • Program must be in writing and copies must be available for inspection upon request

• At a minimum, the AML program must
  • Describe policies, procedures, and internal controls
  • Designate a compliance officer
  • Provide training for responsible personnel
  • Provide for independent review
Key Issue: Consumer Protection

• The value of bitcoins has fluctuated wildly
  • Accordingly bitcoins are not a “store of value,” which is a key characteristic of real currency
  • State and foreign banking regulators have issued consumer warnings regarding the risks deriving from buying, holding, or trading virtual currencies, such as bitcoins
• Value “held” in bitcoin wallets is not insured, as a deposit account is insured
  • Bitcoins have been the subject of theft (e.g., Mt. Gox, Sheep Marketplace)
• Bitcoin holders do not have the same dispute resolution rights as they may with other forms of payment
• Bitcoin may not be subject to conventional counterfeiting, but risk of fraud remains
Key Issue: Banking Relationships

• Many exchangers and other Bitcoin-related start-ups have had difficulty establishing banking relationships
  • Many banks are wary of banking MSB customers, which require enhanced monitoring
    See Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States (April 26, 2005)
  • Moreover, there is substantial uncertainty around the regulatory treatment of Bitcoin and other virtual currencies, including whether exchanges need to obtain a money transmission license in every state

• Without bank accounts, exchangers cannot hold U.S. dollars or enable users to buy and sell bitcoins
Key Issue: Banking Relationships

• With respect to MSBs, like all other customers, banks must
  • Apply the banking organization’s Customer Identification Program
  • Conduct a basic BSA/AML risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary

• With respect to MSBs, unlike other customers, banks must
  • Confirm FinCEN registration, if required
  • Confirm compliance with state or local licensing requirements, if applicable
  • Confirm agent status, if applicable

• If the bank’s risk assessment indicates potential for a heightened risk of money laundering or terrorist financing, the bank is expected to conduct further due diligence in a manner commensurate with the heightened risk
Client Alert.

February 6, 2014

FinCEN Issues Additional Clarifications Regarding Bitcoin and other Convertible Virtual Currency Activities

By Obrea O. Poindexter, Ryan H. Rogers and Jeremy R. Mandell

On January 30, 2014, the Financial Crimes Enforcement Network (“FinCEN”) issued two administrative rulings that address the application of Bank Secrecy Act (“BSA”) regulations to convertible virtual currency-related activities. FinCEN is the bureau within the Department of the Treasury that administers Chapter X, the regulation which implements the BSA requirements, including regulatory requirements applicable to “money transmitters” and other types of money services businesses (“MSBs”).

The administrative rulings were issued in response to written requests from companies for guidance on the applicability of Chapter X to different activities in the virtual currency ecosystem. The first ruling states that to the extent a person creates or “mines” a convertible virtual currency solely for the person’s own use, and not the benefit of another, the person is not a money transmitter under the BSA.1 The second ruling states that a person is not a money transmitter if that person: (i) produces or distributes software that facilitates the purchase and/or sale of virtual currency; or (ii) buys and sells convertible virtual currency solely for the person’s own investment purposes.2

FinCEN’s most recent rulings follow the bureau’s March 2013 guidance on administering, exchanging and using virtual currency (“March 2013 Guidance”).3 The March 2013 Guidance, which was intended to clarify the applicability of the BSA and Chapter X to persons involved in activities related to Bitcoin or other virtual currencies, left many open questions. The recent rulings are intended to address some of these open questions.

Applicability of FinCEN’s Regulations to Virtual Currency Mining Operations

FinCEN’s ruling on whether Bitcoin miners are covered by Chapter X was issued to clarify statements in FinCEN’s March 2013 Guidance, which said that “user” activities related to the purchase of real or virtual goods or services with convertible virtual currency would generally not be covered by FinCEN’s regulations because such activity, in and of itself, does not fit within the definition of money transmission.4 In this first ruling, FinCEN says that the analysis regarding coverage under Chapter X for users of convertible virtual currency turns on what the person uses the currency for, and for whose benefit. Under the first ruling, Bitcoin miners (both individuals and companies) should not be covered by Chapter X if the products of their activities are used solely for the miner’s own purposes and not for the benefit of another. According to FinCEN, Chapter X does not cover “mining” or “harvesting” activity because such action does not involve “acceptance” or

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4 In the March 2013 Guidance, FinCEN defined a “user” as a person that obtains virtual currency to purchase goods or services on the user’s own behalf.
“transmission” of Bitcoin. FinCEN says in the ruling that the same conclusion applies where the miner is doing any of the following: (i) purchasing goods or services for the miner’s own use; (ii) paying debts that are incurred in the ordinary course of business; or (iii) making distributions to shareholders (in the case of a company). In a footnote, however, FinCEN cautions that payments to third parties at the direction of a seller or creditor could be considered money transmission under FinCEN’s regulations.

Applicability of the BSA to Virtual Currency Software Development and Certain Investment Activities

The second ruling was issued in response to a company that asked whether the “periodic investment” in convertible virtual currency, and the production and distribution of software to facilitate the company’s purchase of such currency, would make the company a money transmitter under the BSA. As an initial matter, FinCEN explains that the production and distribution of software that facilitates the sale of virtual currency does not, in and of itself, constitute money transmission services, because that activity does not constitute “acceptance and transmission” of value and is not covered by Chapter X.

More interestingly, the second ruling also addresses whether a company that purchases convertible virtual currency for investment purposes is a money transmitter under the BSA. In the course of reaching its determination on this issue, FinCEN restates many of the interpretive views regarding Chapter X that are addressed in the guidance for Bitcoin miners. For example, FinCEN reiterates that the guiding principle is to determine what the person uses the convertible virtual currency for, and for whose benefit. FinCEN restates that the process by which a person obtains a convertible virtual currency is “not material to” a determination of whether a person is engaging in sending currency or its equivalent value to any other person or place.

Applying these views to investment activities (or, for the sake of simplicity, purchasing activities), FinCEN states that the determining factor is whether the activities are entirely or “exclusively” for the entity’s “own account.” Thus, under the ruling, an entity is not a money transmitter for the purposes of Chapter X if the entity strictly limits its activities to investing in virtual currency for its own account.

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By Rick Fischer, Obrea O. Poindexter and Matthew Ly

On May 30, 2013, the California Department of Financial Institutions (“CADFI”) issued a cease and desist letter to Bitcoin Foundation, a not-for-profit organization established to standardize, protect, and promote the use and adoption of Bitcoin. CADFI stated in its letter that Bitcoin Foundation “may be engaged in the business of money transmission without having obtained the license or proper authorization required by” California’s Money Transmission Act. CADFI’s issuance of the letter, the Financial Crimes Enforcement Network’s (“FinCEN”) recent guidance regarding virtual currencies, and the subsequent asset seizures of prominent Bitcoin exchanges all reflect increased scrutiny of the use of virtual currencies.

CALIFORNIA DEPARTMENT OF FINANCIAL INSTITUTIONS’ CEASE AND DESIST ORDER

CADFI’s letter notes that Bitcoin Foundation may be in violation of California’s money transmitter licensing law (Cal. Fin. Code § 2030), as well as federal statutes that impose penalties for the failure to have a required state money transmission license and the failure to register as a money transmission business. (18 U.S.C. § 1960, 31 U.S.C. § 5330.)

Section 2030 of the California Financial Code prohibits persons from engaging in “the business of money transmission in California without first obtaining a license from the Commissioner of Financial Institutions.” A person in violation of this statute may be subject to civil money penalties under § 2151, and possibly criminal prosecution under § 2152. The California Attorney General may also sue under §§ 17200, 17205, and 17206 of the California Business and Professions Code.

In addition, CADFI noted that under 18 U.S.C. § 1960, it is a felony to own, control, or conduct the business of money transmission without the appropriate state license, or without registering with FinCEN. Violations of this section are punishable by “up to 5 years in prison and a $250,000 fine.” CADFI stated that this same activity without a license is also a “felony under California law, pursuant to [California] Financial Code § 2152(b).”

CADFI requested that Bitcoin Foundation “advise [it] in writing within [20] days” of the date of the letter regarding the “steps [] taken to comply with [CADFI’s] order.” In addition, CADFI noted that “[n]othing in [its] letter is intended to affect any legal remedies, criminal or civil, which the State of California or the Commissioner might pursue for past or future violation of [the] laws [cited].”

WHAT IS BITCOIN?

Introduced in 2009, Bitcoin is a virtual currency that is controlled by a software algorithm (“Bitcoin Algorithm”) running on the Internet. Both the creation and transfer of Bitcoins is performed by this algorithm. Bitcoins are created by a procedure called “mining,” where users provide their computer resources to help the Bitcoin Algorithm process Bitcoin transactions. In exchange, users are compensated with Bitcoins. The Bitcoin Algorithm restricts the total number of Bitcoins to be “mined” to 21 million Bitcoins. Currently, there are approximately 11 million mined Bitcoins that are in circulation.
Like other forms of currency, Bitcoins can be exchanged for goods and services. However, the value of a Bitcoin (how many goods or services can be exchanged for a Bitcoin) is volatile. This volatility is attributable to the fact that, unlike currencies like the U.S. dollar or the Euro, which are issued by their respective governing bodies, Bitcoins are not supported by any sovereign entity. As a result, the value of a Bitcoin is driven and determined by public perception.

Since Bitcoin's inception, the virtual currency has been gaining popularity and acceptance. Currently, several Bitcoin exchanges and payment Web sites allow users to exchange (buy and sell) Bitcoins with popular currencies, such as the U.S. dollar. In addition, some merchants, both online and in person, are beginning to accept Bitcoins as an alternative to traditional currencies for payment. The value of a Bitcoin has fluctuated from about $0.0025 since its inception to a high of about $266 on April 10, 2013. The current value is approximately $78 per Bitcoin.

**Why Do Individuals Use Bitcoin?**

A major reason why individuals may prefer to use Bitcoin transfers instead of traditional electronic transfers is for anonymity and privacy. Bitcoins are transferred from peer to peer without the need for an intermediary financial institution to process payments. The Bitcoin-transmitting party merely needs to know the receiving party’s Bitcoin address to execute a transfer. In contrast, when a traditional payment card is used to make a transaction, there typically are records identifying the transferor, transferee, and the amount transferred. Because Bitcoin transfers do not rely on established payment systems to process transactions, Bitcoin transfers allow the transferor and transferee to remain anonymous.

**Concerns Driving Regulatory Interest**

In issuing the cease and desist letter to Bitcoin Foundation, CADFI was likely concerned about the same aspects of Bitcoin that attracts its users—anonymity and privacy. Specifically, the concern regarding the anonymous aspects of Bitcoin is its potential for facilitating criminal activity, money laundering, and illegal transactions. On the other hand, by classifying Bitcoin Foundation as a money transmitter and, by extension, classifying the transfer of Bitcoins as transmission of money, CADFI can subject Bitcoin Foundation to the same requirements as traditional money transmitters. The resulting mandatory record keeping could significantly diminish the anonymous aspects of Bitcoin, and in turn diminish the attractiveness of using Bitcoin for the transfer of funds related to criminal activity.

**CADFI'S ACTION COMES ON HEELS OF RECENT FINCEN GUIDANCE**

On March 18, 2013, FinCEN issued interpretive guidance, entitled “Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies.” The guidance is intended by FinCEN to clarify the applicability of the Bank Secrecy Act (“BSA”) and its implementing regulations to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies. The guidance addresses “convertible” virtual currency, which is described as a type of virtual currency that either has an equivalent value in real currency, or acts as a substitute for real currency.

The guidance defines “users,” “administrators,” and “exchangers” of convertible virtual currency and explains which of these participants in a virtual currency environment is a Money Services Business (“MSB”) for purposes of the BSA and FinCEN's implementing regulations. Under the guidance, an administrator or exchanger that accepts and transmits a convertible virtual currency, or that buys or sells convertible virtual currency for any reason, is a money transmitter under FinCEN's regulations (unless a limitation or exemption from the money transmitter definition applies). The guidance also explains that accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the BSA's implementing regulations.
SEIZURES OF ASSETS OF BITCOIN EXCHANGES

Since FinCEN’s virtual currency guidance was issued, U.S. regulators have seized assets of several virtual currency exchanges. Notably, on May 14, 2013, one of the world’s largest Bitcoin exchanges, Mt. Gox, had its U.S.-based assets seized by U.S. authorities.

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Notice 2014-21

SECTION 1. PURPOSE

This notice describes how existing general tax principles apply to transactions using virtual currency. The notice provides this guidance in the form of answers to frequently asked questions.

SECTION 2. BACKGROUND

The Internal Revenue Service (IRS) is aware that “virtual currency” may be used to pay for goods or services, or held for investment. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like “real” currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but it does not have legal tender status in any jurisdiction.

Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as “convertible” virtual currency. Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies. For a more comprehensive description of convertible virtual currencies to date, see Financial Crimes Enforcement Network (FinCEN) Guidance on the Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (FIN-2013-G001, March 18, 2013).

SECTION 3. SCOPE

In general, the sale or exchange of convertible virtual currency, or the use of convertible virtual currency to pay for goods or services in a real-world economy transaction, has tax consequences that may result in a tax liability. This notice addresses only the U.S. federal tax consequences of transactions in, or transactions that use, convertible virtual currency, and the term “virtual currency” as used in Section 4 refers only to convertible virtual currency. No inference should be drawn with respect to virtual currencies not described in this notice.

The Treasury Department and the IRS recognize that there may be other questions regarding the tax consequences of virtual currency not addressed in this notice that warrant consideration. Therefore, the Treasury Department and the IRS request comments from the public regarding other types or aspects of virtual currency transactions that should be addressed in future guidance.

Comments should be addressed to:
SECTION 4. FREQUENTLY ASKED QUESTIONS

Q-1: How is virtual currency treated for federal tax purposes?

A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

Q-2: Is virtual currency treated as currency for purposes of determining whether a transaction results in foreign currency gain or loss under U.S. federal tax laws?

A-2: No. Under currently applicable law, virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes.

Q-3: Must a taxpayer who receives virtual currency as payment for goods or services include in computing gross income the fair market value of the virtual currency?

A-3: Yes. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency,
measured in U.S. dollars, as of the date that the virtual currency was received. See Publication 525, *Taxable and Nontaxable Income*, for more information on miscellaneous income from exchanges involving property or services.

**Q-4: What is the basis of virtual currency received as payment for goods or services in Q&A-3?**

**A-4:** The basis of virtual currency that a taxpayer receives as payment for goods or services in Q&A-3 is the fair market value of the virtual currency in U.S. dollars as of the date of receipt. See Publication 551, *Basis of Assets*, for more information on the computation of basis when property is received for goods or services.

**Q-5: How is the fair market value of virtual currency determined?**

**A-5:** For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.

**Q-6: Does a taxpayer have gain or loss upon an exchange of virtual currency for other property?**

**A-6:** Yes. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. See Publication 544, *Sales and Other Dispositions of Assets*, for information about the tax treatment of sales and exchanges, such as whether a loss is deductible.

**Q-7: What type of gain or loss does a taxpayer realize on the sale or exchange of virtual currency?**

**A-7:** The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. A taxpayer generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer. Inventory and other property held mainly for sale to customers in a trade or
business are examples of property that is not a capital asset. See Publication 544 for more information about capital assets and the character of gain or loss.

Q-8: Does a taxpayer who “mines” virtual currency (for example, uses computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger) realize gross income upon receipt of the virtual currency resulting from those activities?

A-8: Yes, when a taxpayer successfully “mines” virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. See Publication 525, *Taxable and Nontaxable Income*, for more information on taxable income.

Q-9: Is an individual who “mines” virtual currency as a trade or business subject to self-employment tax on the income derived from those activities?

A-9: If a taxpayer’s “mining” of virtual currency constitutes a trade or business, and the “mining” activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. See Chapter 10 of Publication 334, *Tax Guide for Small Business*, for more information on self-employment tax and Publication 535, *Business Expenses*, for more information on determining whether expenses are from a business activity carried on to make a profit.

Q-10: Does virtual currency received by an independent contractor for performing services constitute self-employment income?

A-10: Yes. Generally, self-employment income includes all gross income derived by an individual from any trade or business carried on by the individual as other than an employee. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax. See FS-2007-18, April 2007, *Business or Hobby? Answer Has Implications for Deductions*, for information on determining whether an activity is a business or a hobby.

Q-11: Does virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes?

A-11: Yes. Generally, the medium in which remuneration for services is paid is immaterial to the determination of whether the remuneration constitutes wages for employment tax purposes. Consequently, the fair market value of virtual currency paid as wages is subject to federal income tax withholding, Federal Insurance Contributions
Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2, Wage and Tax Statement. See Publication 15 (Circular E), Employer’s Tax Guide, for information on the withholding, depositing, reporting, and paying of employment taxes.

Q-12: Is a payment made using virtual currency subject to information reporting?

A-12: A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

Q-13: Is a person who in the course of a trade or business makes a payment using virtual currency worth $600 or more to an independent contractor for performing services required to file an information return with the IRS?

A-13: Generally, a person who in the course of a trade or business makes a payment of $600 or more in a taxable year to an independent contractor for the performance of services is required to report that payment to the IRS and to the payee on Form 1099-MISC, Miscellaneous Income. Payments of virtual currency required to be reported on Form 1099-MISC should be reported using the fair market value of the virtual currency in U.S. dollars as of the date of payment. The payment recipient may have income even if the recipient does not receive a Form 1099-MISC. See the Instructions to Form 1099-MISC and the General Instructions for Certain Information Returns for more information. For payments to non-U.S. persons, see Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities.

Q-14: Are payments made using virtual currency subject to backup withholding?

A-14: Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property. Therefore, payors making reportable payments using virtual currency must solicit a taxpayer identification number (TIN) from the payee. The payor must backup withhold from the payment if a TIN is not obtained prior to payment or if the payor receives notification from the IRS that backup withholding is required. See Publication 1281, Backup Withholding for Missing and Incorrect Name/TINs, for more information.

Q-15: Are there IRS information reporting requirements for a person who settles payments made in virtual currency on behalf of merchants that accept virtual currency from their customers?
A-15: Yes, if certain requirements are met. In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third party settlement organization (TPSO). A TPSO is required to report payments made to a merchant on a Form 1099-K, Payment Card and Third Party Network Transactions, if, for the calendar year, both (1) the number of transactions settled for the merchant exceeds 200, and (2) the gross amount of payments made to the merchant exceeds $20,000. When completing Boxes 1, 3, and 5a-1 on the Form 1099-K, transactions where the TPSO settles payments made with virtual currency are aggregated with transactions where the TPSO settles payments made with real currency to determine the total amounts to be reported in those boxes. When determining whether the transactions are reportable, the value of the virtual currency is the fair market value of the virtual currency in U.S. dollars on the date of payment.

See The Third Party Information Reporting Center, http://www.irs.gov/Tax-Professionals/Third-Party-Reporting-Information-Center, for more information on reporting transactions on Form 1099-K.

Q-16: Will taxpayers be subject to penalties for having treated a virtual currency transaction in a manner that is inconsistent with this notice prior to March 25, 2014?

A-16: Taxpayers may be subject to penalties for failure to comply with tax laws. For example, underpayments attributable to virtual currency transactions may be subject to penalties, such as accuracy-related penalties under section 6662. In addition, failure to timely or correctly report virtual currency transactions when required to do so may be subject to information reporting penalties under section 6721 and 6722. However, penalty relief may be available to taxpayers and persons required to file an information return who are able to establish that the underpayment or failure to properly file information returns is due to reasonable cause.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Keith A. Aqui of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information about income tax issues addressed in this notice, please contact Mr. Aqui at (202) 317-4718; for further information about employment tax issues addressed in this notice, please contact Mr. Neil D. Shepherd at (202) 317-4774; for further information about information reporting issues addressed in this notice, please contact Ms. Adrienne E. Griffin at (202) 317-6845; and for further information regarding foreign currency issues addressed in this notice, please contact Mr. Raymond J. Stahl at (202) 317-6938. These are not toll-free calls.