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VIRTUAL CURRENCIES

The authors explore virtual currencies which have grown in popularity following the creation of the Bitcoin currency in 2009. They define the concept of a virtual currency, and compare it with traditional currency, including a discussion of practical tax and accounting issues that accompany the new medium of exchange. The authors also address some of the challenges facing Bitcoin in its rise toward a global currency.

Bitcoin and Other Virtual Currencies: Are They Here To Stay?

By William C. Marquardt and Frank J. Bevvino

Introduction

In recent months the existence and use of virtual currencies have increasingly been in the news. Virtual currencies are gaining acceptance with consumers and businesses and are increasingly being scrutinized by members of Congress, the IRS, U.S. and global law enforcement, financial regulators, and banking institutions. Of the virtual currencies in the marketplace today, Bitcoin is the most well-known. Created in 2009, Bitcoin is gaining acceptance among both online and traditional retailers who are taking advantage of both the novelty of the virtual currency and the absence of traditional transaction costs associated with the regular banking system.[1]

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Because Bitcoin transactions occur in a peer-to-peer network outside of the traditional banking and regulatory systems, the ability of the U.S. Government or other interested parties to associate transactions with an individual, organization, or foreign government is limited. The anonymity of ownership and use[2] causes governments and regulatory agencies to worry that Bitcoin can be used for illicit purposes. However, the real issue for governments and regulators is their ability to identify individuals when they enter or exit the virtual currency system (or simply put, exchange virtual currency for a fiat currency like the U.S. dollar or Euro).

This article examines what defines a virtual currency, how a virtual currency compares to a traditional currency, and what practical accounting and tax issues are relevant as the public starts to accept Bitcoin as a legitimate medium of exchange. In addition, we will explore

[1] Minimum credit card usage amounts (purchase lower limits), ATM transaction fees, wire transfer fees, etc.

[2] The anonymity of ownership is obtained by creating virtual wallets where the private key is maintained. Usage is part of the public key and is thus available for review.

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some of the current challenges which Bitcoin must overcome in order to become accepted as the preeminent virtual global currency.

Part 1: Bitcoin Overview

What is Bitcoin?

Although the terms money and currency are often used interchangeably, currency is broadly defined as an acceptable form of money (or unit of account) issued by a government and circulated within an economy that is used by individuals, organizations and the government as a medium of exchange for goods and services. Money is also a store of value that is recognizable, portable, and divisible into denominations small enough to allow for everyday commerce.

Bitcoin is an anonymous, stateless peer-to-peer version of electronic cash[3] that allows payments to be sent via a smart phone or computer directly from one party to another without any interaction with an established financial institution.[4] Individually, a Bitcoin is an alphanumeric series of numbers and letters representing a history of digital signatures as the virtual coin, or a fractional portion thereof, is passed from one individual or business to the next. Accepting that the distributed peer to peer system of public and private keys which make up a Bitcoin's digital signature is protected against duplication, each Bitcoin has a unique digital fingerprint not unlike the unique serial number on a U.S. money note[5].

How do you value a Bitcoin?

Similar to the U.S. dollar, a Bitcoin is a fiat currency[6] in that it intrinsically has no value. The value of the U.S. dollar is derived from what others are willing to trade for it, and some measure of government decree and social convention. Or more succinctly, a belief that the U.S. dollar has value today based on past transactions that specifically defined its value. In practice, the value of the U.S. dollar is measured by exchange rates with other foreign currencies, the value of T-bills, and the willingness of other countries to hold U.S. dollars in foreign currency reserves (relative store of value). All of these measures of the value of the U.S. dollar reflect the stability of the U.S. economy and the U.S. government's monetary and regulatory policies. Thus, the U.S. dollar has value because people in the intertwined global financial network, including the U.S. government, are willing to accept it as payment for goods and services. Accordingly, wide acceptance of a nation's currency by individuals, organizations, and foreign governments, along with a stable, predictable monetary policy and adequate regulations, are all generally accepted precursors to a currency maintaining a relatively stable value.

For Bitcoin, there are several critical differences between the characteristics of established fiat currencies that will impact its valuation. First and foremost, there is no monetary policy established for Bitcoin. No state or government regulates its existence or manages its value relative to other currencies, and thus it is not a declared legal tender of any government. Furthermore, the supply of Bitcoin is limited to a fixed amount and the increase in the available supply of Bitcoin is being purposely limited by those responsible for its creation.[7] Next, the concept of a virtual currency is relatively new. Bitcoin itself has been in existence only since 2009, and lacks a sufficient long-term track record as a currency. There have also been several instances of Bitcoin wallets and transactions being compromised by hackers, leading to the theft and attempted double usage of Bitcoin. And finally, there are relatively few merchants that accept the currency worldwide.[8]

As a result, the value of a Bitcoin has been highly volatile. This begs the question: Is Bitcoin a currency, a commodity, or some type of hybrid instrument? The value of a Bitcoin is, in theory, wholly dependent on its acceptance by individuals and businesses as a measure of the value of a good or service across multiple jurisdictions, and the ability of its supporters to maintain its integrity. Since, as previously noted, a fiat currency has no intrinsic value, how does a Bitcoin appreciate or depreciate like a commodity, or fluctuate widely in value? A fiat currency is typically a store of value, not a source of value, in that hoarding or holding the currency in hopes of an increase in value should not be the primary purpose of acquisition. In fact, hoarding Bitcoin inhibits the ability of potential consumers, organizations, and governments from collectively determining its exchange value. Accordingly, in the short-term, Bitcoin will most likely be viewed as a hybrid financial instrument in that it will continue to fluctuate in value based on supply and demand and a relatively small number of market transactions.

Regulating Bitcoin and Its Exchange.

Until recently businesses or money exchangers who dealt in Bitcoin were not regulated. However, U.S. regulators and the European Central Bank have begun to

[3] Defined as a ''crypto-currency ''meaning the money and transactions are controlled through encrypted passwords (http://www.cryptocurrency.org/about-bitcoin/)

[4] Bitcoin: A Peer-to-Peer Electronic Cash System (www.bitcoin.org)

[5] Additional network security measures include hash totals and time stamps, the difficulty in reversing the transactional history due to the computational complexity, and the lack of a vulnerable central server add to the security of a Bitcoin and should prevent electronic counterfeiting and theft.

[6] A fiat currency has value solely due to government regulation and/or laws (http://www.investopedia.com/terms/f/fiatmoney.asp). Most modern currencies are fiat currencies.

[7] Nodes within the Bitcoin network are programmed to increase the money supply according to a predetermined schedule until the maximum number of 21 million is reached in 2140 (www.bitcoin.org).

[8] One Bitcoin payment processor reports that they serve over 10,000 merchants accepting Bitcoin (http://techcrunch.com/2013/09/16/bitpay-10000-merchants/)

address the existence of virtual currencies, and in particular bi-directional[9] virtual currencies like Bitcoin. On March 18, 2013, the Financial Crimes Enforcement Network (FinCEN[10]) clarified the applicability of the Bank Secrecy Act (BSA) to include virtual currencies by issuing interpretive guidance for businesses engaged in money transmitting services that offered virtual currencies (FIN-2013-G001). The guidance states that entities that act as intermediaries in the transfer and exchange of virtual currencies are Money Services Businesses (MSBs) and must register with FinCEN and are subject to BSA regulations; including the requirements to institute effective anti-money laundering (AML) programs which encompass Know Your Customer (KYC) requirements[11] and the filing of Suspicious Activity Reports (SARs).

However, those individuals, entities, and possibly foreign governments that currently have Bitcoin are effectively exempt from existing U.S. regulations until they exchange their virtual currency for a traditional fiat currency – effectively coming into contact with an MSB. As of June 2013, there were approximately 11 million Bitcoins in circulation,[12] with an approximate value of $1 billion USD – representing a significant amount of purchasing power either held for speculative purposes or being used by consumers and companies to purchase goods and services across the globe.

Part 2: Regulatory Issues and Compliance with Laws Affecting Currency

Essential to the continued use of Bitcoin and other virtual currencies are the issues of tax-compliance and financial reporting. As virtual currencies become widely used and accepted, one must consider whether valuations of business transactions conducted in these new currencies need to comply with existing regulatory requirements in the U.S. and globally. *The Wall Street Journal* reported on August 26, 2013 that a top U.S. anti-money laundering regulator told a Bitcoin trade group that exchanges of the virtual currency must follow the same rules as established financial institutions. The same article reported that ''the trade group and some Bitcoin companies. . .support efforts to ensure that the industry is operating in compliance with certain laws.'' A significant level of professional judgment will be involved in determining the equivalent value in an established fiat currency since these values will be the basis for reporting financial results in the functional currency of respective countries in which Bitcoin is used.

General business practices, no matter what country a transaction occurs in, require compliance with tax laws, regulatory rules, and standards of financial reporting. The following is a brief summary of some of the available guidance as it applies to Bitcoin or other virtual currencies.

General Overview of Taxes and Income.

I. Federal Taxes

For federal tax reporting purposes, transactions in Bitcoin and other virtual currencies, will generate inquiries as to the timing, valuation and taxability of the transaction. In addition, classification of the income (for example, is the income ordinary or capital gain income) may also need to be examined. As with most tax questions, these issues will be dependent on the individual nature of the transaction, and will involve a level of judgment either by or on behalf of the taxpayer. As with many regulatory issues, oftentimes the U.S. government takes a ''wait and see'' attitude before issuing formal guidelines. In many cases, the IRS relies on a post-filing review of a taxpayer position, usually involving a challenge to the position the taxpayer selected, to begin to formulate pronouncements detailing reporting requirements.

In May of 2013, the United States Government Accountability Office (GAO) issued a report to the U.S. Senate Committee on Finance about virtual economies and currencies. The report recommended that the Internal Revenue Service begin to post on their website instructions and guidance on how to deal with Bitcoin and other virtual currencies.[13] The GAO's recommendations to the IRS include publishing guidelines that support the IRS's ''. . . strategy for preventing and minimizing noncompliance''[14] by reaching out to and assisting taxpayers in understanding and meeting their tax compliance and reporting responsibilities.

However, in the absence of specific IRS or other guidelines, taxpayers are not relieved of their responsibility of complying with existing tax laws under the Internal Revenue Code (IRC). The IRC states that ''. . . gross income means all income from whatever source derived . . . .''[15] The immediately following code sections 62 and 63 continue to define adjusted gross income and taxable income respectively. What appears to be true is that any value increase on the exchange of Bitcoin or any other virtual currency is subject to the same rules and treatment as any other exchange of traditional currencies or commodities.

The GAO's report indicates that transactions using virtual currencies could indeed produce taxable income and describes two types of transactions to support its assertion. A ''closed-flow'' transaction is one in which no taxable income is generated because a virtual currency is being used to purchase virtual goods and services; citing an example of the purchase of items to use within an online game (virtual services/property). However, an ''open-flow'' system is where a taxpayer who receives virtual currency as payment for real goods or services may have taxable income since the virtual currency can be exchanged for real goods or services or exchanged for a traditional fiat currency.[16]

While the GAO, other governmental agencies, business groups, and tax and accounting professionals

[9] The exchange of one currency for another

[10] FinCEN is a bureau of the U.S. Treasury Department and reports to the Office of Terrorism and Financial Intelligence.

[11] Requires that MSB collect information about their customers the same way as traditional financial institutions.

[12] http://blockchain.info/charts/total-Bitcoin, http://www.reuters.com/article/2013/06/26/investing-bitcoin-idUSL2N0EV0XJ20130626

[13] United States Government Accountability Office (GAO), GAO-13-516, Report to the Committee on Finance, U.S. Senate, May 2013, *Virtual Economies and Currencies, Additional IRS Guidance Could Reduce Tax Compliance Risks*. p. 21.

[14] Ibid., p. 10.

[15] Internal Revenue Code, United State Treasury, Code Section 61.

[16] op.cit GAO Report. Highlights.

would like to see specific areas addressed in IRS guidelines, for now the only course of action is to apply current rules and laws as best they can be applied.

II. State and International Taxes

Another area of taxation that may be troublesome in transactions dealing with Bitcoin is the determination of income for state and international tax purposes. In addition to the determination of the amount of taxable income, another area of concern is the location of where the income is earned by the taxpayer. Was the income earned in the United States? And if so, for which state would the income be reported for state tax purposes?

Generally, any income earned by an entity is subject to the application of rules and regulations regarding tax nexus, apportionment and allocation which govern which taxing authority has the right to tax the income. While federal taxable income is determined primarily under the Internal Revenue Code, state and local laws regarding nexus, apportionment and taxability are the determining factors for state and local taxation.

Global trade at both the business and individual levels is an integral part of the world economy in the 21st century. Like international transactions involving traditional currencies, Bitcoin and other virtual currencies will be subjected to similar tax rules. Cross-border transactions using virtual currencies create special problems for the U.S. and their trade partners. Tax treaties and the requirements involved for transactions involving virtual currencies will need to be researched, investigated and developed to address the related tax issues. Thus, foreign taxing authorities will have to develop guidelines as to their specific treatment of transactions involving any virtual currency transactions.

III. Accounting Treatment

As the presence of Bitcoin continues to grow, the Financial Accounting Standards Board (FASB) and regulatory agencies, such as the SEC, FDIC, etc. will need to weigh in on the application of existing rules to virtual currency transactions. Additional guidance in the form of specific regulations regarding virtual currency transactions will need to begin to address both the current status of these transactions and the future use of Bitcoin and any of their competitors or successors.

Part 3: The Future of Bitcoin (Fad or Global Currency)

Bitcoin is just one of many virtual currencies introduced in the last two decades. Beginning during the dotcom boom of the late 1990s, virtual currencies have been introduced by half a dozen or so entities. Many failed attempts at developing virtual currencies preceded the launch of Bitcoin. Whether Bitcoin survives remains to be seen, or whether it is replaced by a new virtual currency is hard to predict at this point in time.

As increasing globalization continues to create a world of more complex economic relationships, it is safe to say that virtual currencies will most likely continue to appear in an attempt to ease the transfer of funds globally.

Responsibilities of Virtual Currency Users

At this time it is uncertain as to whether Bitcoin is sustainable as a global virtual currency. However, what is important to remember is that in order for Bitcoin, or any of its successors, to survive the laws, rules, and regulations currently in place for traditional forms of currency and trade transactions will most likely need to expand to encompass virtual currencies. Until new or revised guidelines are issued by regulatory organizations and governmental agencies, prudence suggests that current laws and regulations should be the basis upon which any transactions involving virtual currencies are evaluated.

Paramount in this quest for compliance with regulatory requirements is the maintenance of adequate books and records for all transactions involving virtual currencies. Documentation and reasonable consideration of the treatment of virtual currencies within current regulations is the only viable approach until the regulatory environment addresses these types of transactions.

Part 4: Parting Thoughts: What's Next & Questions to Consider

1. Do global financial regulators and governments need to catch up with Bitcoin and other virtual currencies? *It appears that specific rules on Bitcoin or any virtual currency will not be forthcoming anytime soon until either Bitcoin or one of its successors establishes itself as a long-term viable medium of exchange.*

2. Does the regulation of Bitcoin MSB's legitimize the currency or reflect the U.S. government's fear that virtual currencies and the associated anonymity make them an ideal vehicle for illegal activities? *Bitcoin and any of its successors (just like any currency) will always have the potential for illegal use. Legitimacy of any virtual currency will be a market issue and not dependent on specific regulations. However, controls will need to be established and communicated in order to give virtual currencies credibility in the global marketplace.*

3. Is additional regulation the key to legitimizing Bitcoin? *Fees and other transactional costs have been one of the issues leading up to the emergence of virtual currencies. Regulations legitimizing these currencies could also potentially open these currencies to existing fee structures and/or other new fees.*

4. Does the acceptance of Bitcoin by a growing number of online businesses as well as brick and mortar retailers make it a legitimate currency (means of exchange) and stabilize its relative value? *Clearly this appears to be the way that legitimacy will be established. As mentioned earlier, market acceptance, sustained use and confidence by retailers and customers will create a long term marketplace for Bitcoin or any successor virtual currency.*

5. Does Bitcoin offer a way for those who operate outside of the traditional marketplace to transact online in the global marketplace? *It appears that the availability of smart phones will far exceed the availability of established banking services in emerging markets and economies across the globe. Thus the demand for methods of exchange involving non-traditional banking systems and processes will increase. Bitcoin offers safe and reliable peer-to-peer micro-financing opportunities to the developing world where cell phones are more accessible and safer than local bank branches.*

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6. Is additional regulation by global financial institutions and law enforcement agencies necessary and helpful to expand the acceptance of Bitcoin? *Additional regulation should lead to greater public confidence that the currency is a legitimate medium of exchange. However, the reactions of global financial institutions acting in their own self-interest may impact how governments' approach new regulations and how they in turn may adversely impact the viability of virtual currencies.*

As the global economy emerges from the current recession, the free flow of capital and new technologies will no doubt play a major role in the next round of globalization. Further expansion, refinement and regulation of virtual currencies could create a global ''coin of the realm'' which is universally accepted in an ever more integrated global economy.