



## Cryps, Bits & Bots...Oh My!

Flying monkeys are tame by comparison and Dorothy would probably be terrified as virtual currency schemes (also known as cryptocurrencies) have proliferated in recent years, gaining ground as a means of exchange. Proponents of these cryptocurrencies argue that they provide benefits of anonymity, speed, convenience, and remove the need for a payment intermediary, such as a credit card, that impose hefty transaction fees. Opponents, on the other hand, claim that anonymity facilitates crime, including money laundering and virtual currencies depend, almost entirely, on information technology networks that may themselves be subject to risk.

There are multiple classes of virtual currencies that differ in their underlying mechanics. Some rely on cryptography, hence the name "cryptocurrency," and some do not. Bitcoin, the best known and most prevalent virtual currency, is a cryptocurrency created by a technological process referred to as "mining." Alternative cryptocurrencies to Bitcoin, commonly known as altcoins, vary in the ways they are developed, mined and marketed. One altcoin platform that has gained notoriety is Ethereum, where transactions are executed in an altcoin referred to as Ether. Unlike the Bitcoin platform, Ethereum offers programmable, automated transaction functionality also known as "smart contracts."

Despite some of their differences, all forms of cryptocurrencies are essentially money with no physical presence. Vendors that accept cryptocurrencies as payment are exposed to a number of legal issues that are not fully understood or defined at this time. Nonetheless, cryptocurrencies are here and being accepted by many US banks, which means they are likely here to stay.

### Potential Pitfalls

Many such issues arise because of the inherent volatility of cryptocurrencies. Purchasing an item with Bitcoin is akin to buying goods or services using a volatile stock as payment. While that stock could be valuable today, it also could be worth half as much tomorrow or perhaps double that amount in the near future.

### Cryptocurrency and IRS

A notice issued by the Internal Revenue Service in 2014 provided that virtual currency is to be treated as property for U.S. Federal tax purposes. Therefore, cryptocurrency wages paid to an



employee are taxable and must be reported by the employer on a Form W-2. Likewise, payment in cryptocurrency is subject to federal income tax withholding and payroll taxes. Payments to independent contractors with cryptocurrencies are also taxable and self-employment tax rules would apply. Gain or loss from the sale or exchange of cryptocurrency depends on whether the virtual currency is a capital asset in the hands of a particular taxpayer. Finally, any payments made

with virtual currency are subject to information reporting requirements to the same extent as any other payments made in property.

It is a fundamental concept pursuant to IRS regulation that an individual can receive income in the form of money, property or services. If you receive more in income in the virtual world than you spend, you may be required to report the gain as taxable income. However, if you spend more in the virtual world than you receive you may not be able to claim a loss on your income tax return.

### ***Electronic Transfer Fund Act***

The Electronic Transfer Fund Act ("ETFA") is a federal law enacted to protect consumers when they use electronic means to manage their finances. Electronic fund transfers are defined as transactions that use computers, phones or magnetic strips to authorize a financial institution to credit or debit a customer's account. The EFTA allows a mechanism for consumers to challenge transactions and recover funds transferred improperly. However the EFTA applies to transfers of money electronically and does not appear to be applicable to digital currency unless a financial institution is involved. The ETFA applies to transfers of funds "initiated by electronic means from a consumer's account held at a financial institution." Since cryptocurrency use a peer to peer network, they eliminate the need for a financial institution so EFTA Rules likely would not apply, therefore potentially limiting a wronged consumer's avenues of recovery.

### ***The Stamps Payment Act***

The Stamps Payment Act ("SPA") criminalizes the issuance, circulation or payout of "any note, check, memorandum, token or other obligation, for less than the sum of \$1.00 intended to circulate as money or to be received or used in the United States." The SPA seems to be limited to tangible forms of currency, rather than cryptocurrency, but if a cryptocurrency were to become a legitimate competitor of the U.S. dollar, the U.S. government might attempt to apply this section.

### ***The United States Bank Secrecy Act***

Currency dealers or exchanges, check cashers, and issuers of travelers checks or money orders for stored value fall under the umbrella term of

a Money Service Business ("MSB"). The United States Bank Secrecy Act imposes a requirement on all MSBs to implement anti-money laundering programs to identify and stop such crimes, and to file reports for transactions exceeding \$1,000. Businesses and individuals that change Bitcoin or other cryptocurrencies into U.S. dollars or other forms of currency must register as an MSB and comply with the Bank Secrecy Act.

The net result of this is that there are multiple types of electronic currency with multiple platforms and multiple regulatory schemes that may apply. At this time, the issues involving these electronic currencies and their regulations (or lack of regulation) are fluid and any individuals or businesses attempting to use or deal in such currency must keep that in mind. What works today, may not work tomorrow. Likewise, what is not illegal today may be illegal tomorrow and vice versa.

Like Dorothy, there are many perils in this journey and so far no one fully understands "the little man behind the curtain." Anyone proposing to use or deal in these electronic currencies should use extreme caution and consult with advisors. Our team of business lawyers will continue to monitor the situation and provide updates as available. Please contact one of our business law attorneys with any questions you may have.