

The logo for K&L GATES, featuring the text "K&L GATES" in white, uppercase letters on an orange rectangular background. This logo is positioned in the upper left corner of a blue bokeh background that spans the top half of the slide.

K&L GATES

## Cash, Credit, or Bitcoin? The Law of Digital Currency

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# KEY TAKEAWAYS

## The digital currency community is divided

- Purists want government to keep its hands off digital currency—The whole point was to create an alternative to the state-sponsored financial system!
- Many entrepreneurs think regulation will beget credibility. They want regulation, as long as it is sensible and tailored to digital currency's unique structure.
- Many in the community fall between these two extremes.

## Few specific digital currency laws exist yet, but that hasn't stopped regulators from using existing tools.

- These tools often have provisions that make no sense when applied to digital currencies (the square peg/round hole problem).
- Regulators think in terms of existing categories (when you have a hammer . . . .)

## In the U.S., at least, lawmakers and regulators are (surprisingly?) eager to see digital currency thrive.

- They want to find a way to regulate it that works and makes sense.
- They'll need the digital currency community's help.

## In U.S. today, no real regulation of pure P2P transactions.

- It's the intermediaries who might be subject to regulation.
- Should purists be happy about this?

### Money Laundering and Terrorist Financing

Ensuring that a digital currency service provider does not provide a mechanism for illegal transactions.

Some regulation in this area is inevitable.

### Prudential

Ensuring that a company that holds digital currency for others is operating in a safe and sound manner.

This is a principal objective of the "Bitlicense" proposals.

### Consumer Protection

Ensuring that digital currency service providers treat consumers fairly and properly disclose all material information.

Key issue for regulators is whether disclosure is enough—or if substantive regulation is warranted.

### Securities and Commodities Futures Regulation

A Bitcoin is neither a securities nor a commodities future. But investment vehicles that provide Bitcoin exposure might be.

Application of these laws to traditional investment vehicles (think Winklevoss Trust) are clear. Innovative uses of the blockchain for securities transactions present interesting problems.

### Taxation

Bitcoin transactions will be taxed. The question is how these transactions should be classified.

Most tax regulators agree that tax statutes will need to be modified to classify digital currency in a sensible way.

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# Money Laundering, Terrorist Financing, and Other Illegal Activities

## OVERVIEW

- This is one area where I think regulation is inevitable.
  - Governments of the world will never step aside if a system can be used to send funds to groups like ISIS, etc.
  - Bitcoin's usefulness for money laundering and criminal activities is debatable. But governments will need more assurance.
- The traditional primary weapon to combat money laundering and terrorist financing is to strip back anonymity and secrecy.
  - The core of any financial institution's AML program is its "know your customer" procedures—including identity verification.
  - Financial institutions must report "suspicious activity" to law enforcement—Your bank is required to keep an eye on you for the government.
- Many sanctions laws are strict liability.
  - You can be held liable for transacting with a person identified by the Office of Foreign Assets Control even if you do not know that the person is on OFAC's list.
  - How do you deal with that in a Bitcoin transaction, when you don't (and can't) know the identity of the sender/recipient?

*How do we effectively combat money laundering and terrorist financing, and enforce sanctions laws, without undermining cryptocurrency's core principles?*

# FINCEN GUIDANCE

- FinCEN regulations define “money transmission services” as “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.” 31 C.F.R. § 1010.100(ff)(5) (*italics in original; underline added*).
- In March 2013, the United States Financial Crimes Enforcement Network (“FinCEN”) issued guidance on the application of its regulations to virtual currencies.
  - FinCEN concluded that “convertible virtual currency” qualified as “other value that substitutes for currency.”
  - FinCEN defined “convertible virtual currency” as virtual currency that “either has an equivalent value in real currency, or acts as a substitute for real currency.”
  - Therefore, the acceptance of convertible virtual currency and the transmission of said virtual currency to another location or person is a “money transmission service.”

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# Prudential Supervision

# PRUDENTIAL SUPERVISION

Do governments have an obligation to supervise Bitcoin exchanges to protect customers from another Mt. Gox?

Can this be done through a private alternative?

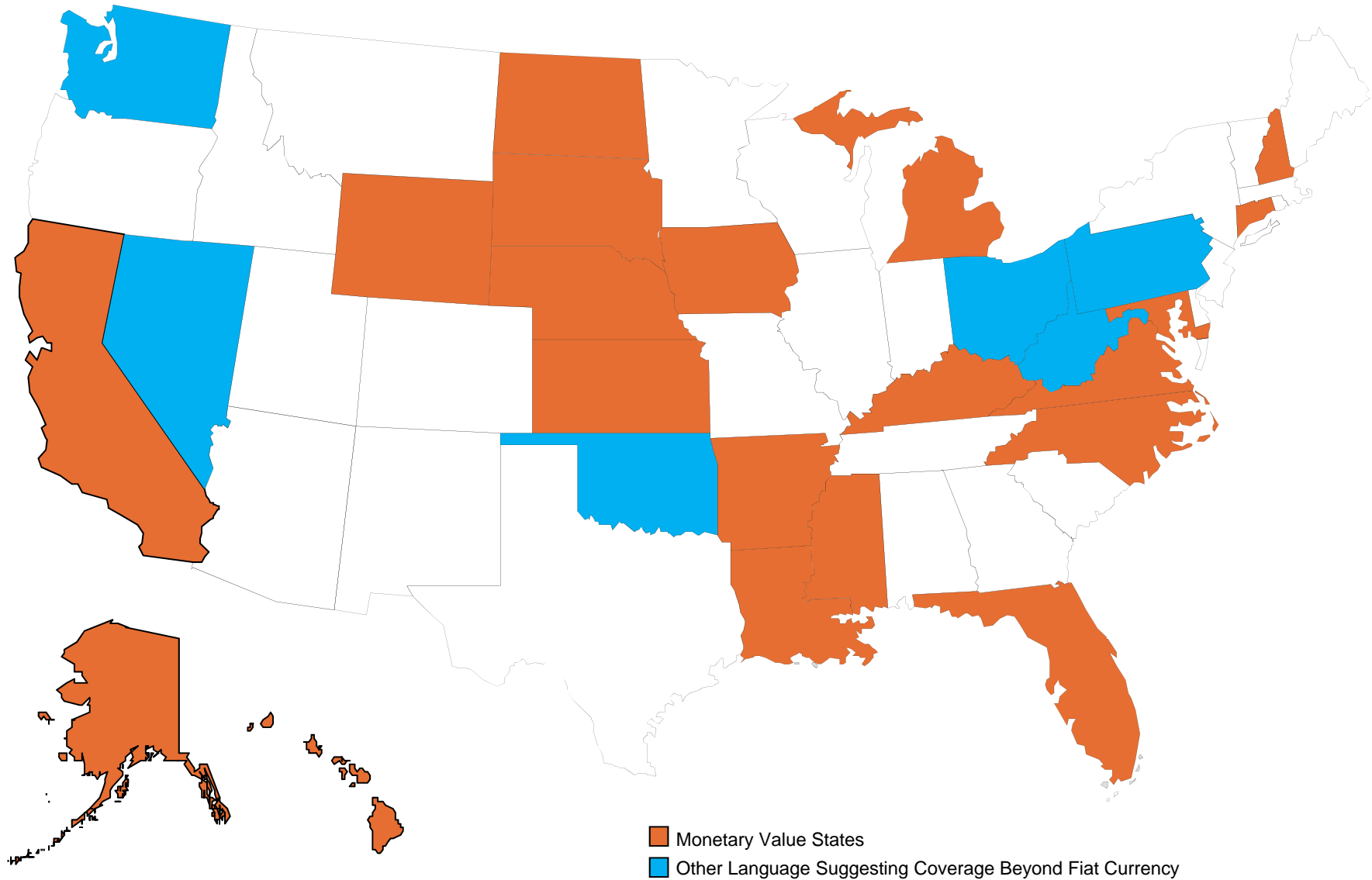
Who should supervise?  
The country/state where the service provider is chartered (similar to how banks are supervised)?  
Or each state/country where customers are located (a la money transmitters)?



# U.S. MONEY TRANSMITTER LICENSING

- In the U.S., “money transmitters” (a.k.a. “money services businesses” in some states) are regulated at the state level.
  - To engage in money transmission nationally requires 48 separate state licenses (from forty-seven states plus the District of Columbia).
  
- The definition of “money transmission” in many of these states is broad.
  - Many adopted definition from the Uniform Money Services Act.
    - Proposed by the National Conference of Commissioners on Uniform State Laws in 2000.
    - Revised in 2004.
    - Defined “money transmission” as “selling or issuing payment instruments, stored value, or receiving money or monetary value for transmission.” UMSA § 102(14) (emphasis added).
    - “‘Monetary value’ means a medium of exchange, whether or not redeemable in money.” Id. § 102(11).

## Explicit Coverage Beyond Pure Money Transactions



## “MONEY” STATES AND DIGITAL CURRENCY

- Even when MT law is limited to transactions involving “money,” it can apply to some digital currency services.
  
- Texas Dep’t of Banking Supervisory Memo. 1037 (April 3, 2014)
  - Only receipt of fiat currency for transmission constitutes “money transmission” as defined under Texas Money Services Act.
  - “Because cryptocurrency is not money under the Money Services Act, receiving it in exchange for a promise to make it available at a later time or different location is not money transmission. . . . However, when a cryptocurrency transaction does include sovereign currency, it may be money transmission depending on how the sovereign currency is handled.”
  - Examples:
    - Exchanging cryptocurrency for fiat currency between two parties is not money transmission.
    - Exchanging cryptocurrency for another cryptocurrency is not money transmission, no matter how many parties involved.
    - Transfer of cryptocurrency by itself is not money transmission.
    - A third party exchanger that facilitates exchange of cryptocurrency for fiat currency generally is engaged in money transmission.
    - Operating a Bitcoin ATM “is usually but not always money transmission.”

## PERMISSIBLE INVESTMENTS AND DIGITAL CURRENCY

- Most money transmitter laws require the licensee to hold permissible investments equal to outstandings nationally (not just outstandings attributable to transactions in the state).
  - An “outstanding” is an amount owed by the licensee in connection with a money transmission transaction.
- There are a large range of assets (including cash) that qualify as permissible investments—but digital currencies do not.
- If a licensee receives digital currency for “transmission,” it must hold permissible investments to back up outstandings. This is in addition to any digital currencies it holds to back up these obligations.
- This is a result of the fact that money transmitter laws were not drafted with digital currency in mind. Regulators recognize this, but their authority to waive the permissible investment requirement varies.

## A BETTER APPROACH?

- New York Department of Financial Services Proposed Rules on Virtual Currency
  - Licensee must hold minimum capital in cash, virtual currency, and high-quality, highly liquid, investment-grade assets.
    - DFS has broad discretion to determine the required capital amount for each licensee.
    - DFS can decide whether proportions of different assets are appropriate.
  - If a licensee “stores, holds, or maintains custody or control of Virtual Currency” for another person, the licensee must “hold Virtual Currency of the same type and amount.”
- Conference of State Bank Supervisors (“CSBS”) Draft Model Regulatory Framework for Virtual Currencies (Dec. 16, 2014)
  - Seeks comment on whether virtual currencies should be used to satisfy capital and permissible investment requirements.
  - “Capital, permissible investments, and surety bond requirements exist to create financial security in the event of failed transactions or a failed business. For financial services companies dealing in virtual currencies, should these safety funds be denominated in the applicable virtual currency or in dollars?”

## VOLUNTARY LICENSING A SOLUTION?

- Digital currency service providers could, but would not be required to, obtain licenses.
- If they obtain licenses, they will be required to submit to extensive safety-and-soundness regulation and supervision.
  - Service providers who think that licensing engenders trust and credibility will have that option.
  - Purists who want no government regulation do not need to submit.
  - The market will decide how important supervision is.
- Precedent might be the original conception of the FDIC insurance program.
  - Originally, FDIC insurance was voluntary for state-chartered banks.
    - Now required by state law in most states.
  - If a bank obtained FDIC insurance, it had to submit to federal supervision.

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# Consumer Protection

# GAO REPORT

- *Virtual Currencies: Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges*, GAO-14-496 (May 2014)
- Addresses:
  - 1) Federal agency responsibilities related to the use of virtual currencies; and
  - 2) Initiatives to date by the agencies.
- Agency actions:
  - 1) Law enforcement agencies and bank regulators have been active.
  - 2) CFPB has largely not been involved with interagency working groups and has undertaken limited initiatives on its own.
- Speculated that CFPB involvement must be limited in part because:
  - “[T]he extent to which individuals using virtual currencies are speculative investors or ordinary consumers is unclear[.]”
  - The CFPB has received few consumer complaints about digital currencies.
- Only one recommendation: CFPB should be more involved with interagency initiatives.
  - Did not discuss whether and to what extent CFPB has authority over digital currency service providers.



## CFPB CONSUMER ADVISORY

- Released August 2014
- Warns consumers to:
  - Keep their private keys safe;
  - Investigate any company offering digital currency products or services before doing business with them, such as by checking whether they are registered with FinCEN or hold state money transmitter licenses;
  - Be prepared for significant fluctuations in digital currency value;
  - Be aware that digital currency transactions are not always private; and
  - Watch out for scammers, who are trying to take advantage of people entering the digital currency marketplace without fully understanding the market.
- Invites consumers to submit complaints about digital currency service providers.

# WHAT DOGS AREN'T BARKING?

- Consumer Advisory—Not Guidance
  - CFPB's guidance documents are directed at industry, and explain CFPB's interpretation of the law or warn that certain practices might raise issues.
  
- No specific discussion of how various kinds of malfeasance in connection with digital currencies might violate laws under CFPB's jurisdiction.
  
- No specific promise to bring enforcement actions against digital currency companies that harm consumers.
  - Announcement says that the CFPB will refer complaints to the appropriate federal or state regulator.
  - Announcement quotes Director Cordray as saying that “consumers are stepping into the Wild West when they engage in the market” for digital currencies.
  - No promise to be the sheriff who brings order.
  - Announcement of the advisory says vaguely that the “CFPB will also use the complaints to help enforce federal consumer financial laws and, if appropriate, take consumer protection policy steps.”

# RULEMAKING & ENFORCEMENT AUTHORITY

- **CFPB derives rulemaking and enforcement authority from two sources:** (1) Title X of Dodd-Frank; and (2) the rulemaking and enforcement provisions of various federal consumer financial laws (including the Electronic Fund Transfer Act).
  - Supervisory authority—the authority to conduct routine compliance examinations of an institution—is beyond the scope of this presentation.
  
- **Federal Consumer Financial Laws**
  - Scope of authority to issue rules to implement a federal consumer financial law (e.g., EFTA) or to bring an enforcement action is defined by the federal consumer financial law.
  
- **Title X of Dodd-Frank**
  - Gives the CFPB authority to issue rules declaring certain practices to be *unfair, deceptive, or abusive*.
    - These rules may apply only to *covered persons* and *service providers*.
  
  - Section 1031(a) of Dodd-Frank also authorizes the CFPB to take “any action under subtitle E [Enforcement Powers] **to prevent** a covered person or service provider from committing or engaging in an **unfair, deceptive or abusive** act or practice **under Federal law** in connection with any transaction by a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.”

## ***COVERED PERSON DEFINED***

- Any person that engages in offering or providing a consumer financial product or service; and
- Any affiliate of such person, if the affiliate acts as a service provider to such person.

## ***SERVICE PROVIDER DEFINED***

- “[A]ny person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service[.]”
- Expressly includes any person that:
  - Participates in the design, operation, or maintenance of the consumer financial product or service; or
  - Processes transactions relating to the consumer financial product or service.

# CONSUMER FINANCIAL PRODUCT OR SERVICE

- Any financial product/service that fits into certain categories, and is offered or provided for use by consumer primarily for personal, family, or household purposes.
- Categories Potentially Relevant to Digital Currencies:
  - Extending credit.
  - “[D]eposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer.”
  - “[S]elling, providing, or issuing stored value or payment instruments.”
    - However, a seller of stored value is not covered if it does not exercises substantial control over the terms and conditions and is not a party to the contract with the consumer.
  - “[P]roviding payments or other financial data processing products or services to a consumer[.]”
    - However, merchants that sell nonfinancial goods or services that store payments data or engage in financial processing for payments to the merchant are excluded.
- There’s also a catch-all category: “[S]uch other financial product or service as may be defined by the Bureau, by regulation, for purposes of this title, if the Bureau finds that such financial product or service is . . . permissible for a bank or for a financial holding company to offer or to provide under any provision of a Federal law or regulation applicable to a bank or a financial holding company, and has, or likely will have, a material impact on consumers.”

## FOR USE BY A CONSUMER

- “[U]se by consumer primarily for personal, family, or household purposes.”
- B2B services excluded.
- For many digital currencies, the line between a consumer and an investor is not clear cut.

# EXTENDING CREDIT

- Digital currency loans might be covered.
- A lot will depend on whether digital currency is considered money or property.
- *Credit* Definition: “the right granted by a person to a consumer to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment for such purchase.”
- Thus:
  - If Bitcoins are money, a loan of Bitcoins repayable in Bitcoins constitutes the extension of credit.
  - Even if Bitcoins are not money, a loan of Bitcoins repayable in “real” currency is an extension of credit (it is “the right . . . to . . . purchase property . . . and defer payment for such purchase.”)
  - If Bitcoins are not money, a loan of Bitcoins repayable in Bitcoins will constitute an extension of credit *only* if an obligation to deliver possession of specified property is a “debt.”
    - If Bitcoin is property, then Bitcoin loan repayable in Bitcoins is analogous to a transaction in which I give you a certain amount of a fungible property today in exchange for a promise to provide me with a larger amount at some point in the future, am I in “debt” to you?



# TRANSMITTING OR EXCHANGING FUNDS

- *Transmitting or exchanging funds* is defined as “receiving currency, monetary value, or payment instruments from a consumer for the purpose of exchanging or transmitting the same by any means.”
- *Monetary value* is not separately defined. Some definitions of monetary value would encompass a digital currency, but others might not.
  - UMMSA Definition: “A medium of exchange, whether or not redeemable in money.” The comments say that the term *medium of exchange* “connotes that the value that is being exchanged be accepted by a community, larger than the two parties to the exchange.”
  - Texas Definition: Monetary value is defined as “currency or a claim that can be converted into currency through a financial institution, electronic payments network, or other formal or informal payment system.” Tex. Fin. Code § 151.301(b)(3).
- When does a digital currency become a “medium of exchange”?
  - Bitcoin arguably has reached the level of “medium of exchange” because a community of users actually are accepting it as payment. But is a new digital currency that is only being purchased by speculators for investment purposes a “medium of exchange” yet?

## CUSTODIAN OF FUNDS

- A wallet service provider arguably is a “custodian” of Bitcoins. Are Bitcoins “funds”?
- *Transmitting or exchanging funds* is specifically defined to encompass transmitting or exchanging “monetary value”. But there’s no similar definition for “custodian of funds.”
- FinCEN concluded that digital currencies are not “funds” for purposes of FinCEN rules.

## CATCH-ALL CATEGORY

- “[S]uch other financial product or service as may be defined by the Bureau, by regulation, for purposes of this title, if the Bureau finds that such financial product or service is . . . permissible for a bank or for a financial holding company to offer or to provide under any provision of a Federal law or regulation applicable to a bank or a financial holding company, and has, or likely will have, a material impact on consumers.”
- Could be the primary source of authority over digital currency service providers in the future.
- However, banking agencies have not yet opined comprehensively on the kinds of digital currency-related activities in which banks and financial holding companies may engage.
  - CFPB might be reluctant to opine on this issue before the bank regulators do.

## WHAT CAN THE CFPB DO IF IT HAS JURISDICTION?

- Require online wallets/exchanges to recredit unauthorized transactions?
  - Because BTC transactions themselves are irreversible, this means that the wallet/exchange would take the hit.
- Require disclosures?
- Impose capital and other prudential requirements?
- Impose information security standards?

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# Taxation of Digital Currency Transactions

## BITCOIN AND INCOME TAXES

- Most tax experts agree that bitcoin is most appropriately characterized as analogous to currency for income tax purposes.
- However, income tax laws in many countries limit the concept of currency to government-backed currencies.
- Most tax authorities that have addressed the issue have concluded that bitcoin is an asset (or an equivalent concept) for tax purposes.
  - This generally is more favorable to the taxpayer.

## TAX TREATMENT OF BITCOIN IN SELECTED COUNTRIES

<b>Australia</b>	According to the Australian Tax Office, bitcoin is not a currency for tax purposes. Sellers of goods and services must include bitcoin transactions in the Goods and Services Tax returns. (The GST is a VAT.)
<b>Brazil</b>	In April of 2014, the Receita Federal (RF), Brazil's tax authority, said it will treat bitcoins as financial assets or securities rather than as currency.
<b>Bulgaria</b>	In April of 2014, Bulgaria's National Revenue Agency (NRA) issued a post on bitcoin taxation. According to commentators, this post treats income from the sale of bitcoins as income from the sale of financial assets, thereby subjecting the personal income gained from trading bitcoins to an annual income tax. These commentators say the NRA does not consider bitcoin to be property and will not subject bitcoin to capital gains taxes. Rather, "Bulgaria appears to be treating bitcoin as a hybrid form of currency and property, taxable at a flat 10% rate when either used as currency or sold for fiat."
<b>Canada</b>	In November of 2013, the Canada Revenue Agency (CRA) issued a news release stating that bitcoin is subject to barter transaction regulation. This means the CRA does not treat bitcoin as a currency, since a barter transaction is defined as an exchange of goods or services without using legal currency as a medium. The value of goods sold for bitcoin must be included in the seller's income, valued in Canadian dollars. When bitcoin is bought or sold as a commodity, the resulting gains or losses can be taxable income or capital.
<b>Denmark</b>	In March of 2014, the Tax Board in Denmark ruled that gains and losses from bitcoin trading are not subject to taxation. "[T]he Tax Board concluded that any gains made from bitcoin trading are exempt from being taxed by the Danish government, and similarly any losses from trading are not deductible." The Tax Board views bitcoin as a private asset because bitcoin does not exist in physical form and thus cannot be considered real money. Businesses that directly trade with bitcoin as their primary function, however, must still declare their winnings and losses to the government
<b>Estonia</b>	In March of 2014, the Estonian Tax and Customs Board (TCB) published a guideline saying that bitcoin is neither treated as an e-currency nor as a security. "For individual income tax purposes, bitcoin is treated as property the alienation and exchange of which gives rise to capital gains." Bitcoin transactions are therefore subject to the standard VAT rate as non-exempt provisions of services related to alternative payment instruments.
<b>Finland</b>	In August of 2013, Vero Skatt, the Finnish Tax Authority, said bitcoin is a commodity rather than a currency or payment instrument.
<b>Japan</b>	In March of 2014, the Japanese government released a statement announcing that Japanese law does not recognize bitcoin as a currency, and therefore transactions using bitcoins should be taxed based on income, corporate, and consumption tax laws.
<b>Netherlands</b>	In June of 2013, the Dutch Finance Minister said bitcoins are neither electronic money nor financial products under Dutch law, and therefore subject to VAT and income taxes.
<b>Norway</b>	The Director of General Taxation and the Minister of Finance said that bitcoin is an asset, not a currency. Bitcoin transactions are subject to capital gains tax.
<b>Poland</b>	In May of 2014, the Polish Tax Administration (PTA) issued a statement saying that the VAT on goods and services will be imposed on profits received from sales of bitcoins.
<b>Singapore</b>	The Inland Revenue Authority of Singapore (IRAS) has established clear guidelines on how it will tax bitcoin. IRAS does not consider bitcoin to be money or currency. The buyer or seller of a bitcoin must declare taxes based on gains from the sale. However, long-term bitcoin investments will be considered "capital in nature and therefore not taxable" as Singapore has no capital gains tax. Meanwhile, the sale and exchange of bitcoins in return for money or consideration in kind is a taxable supply of services or barter exchange under Singapore's VAT
<b>Spain</b>	In May of 2014, the Agencia Estatal de Administración Tributaria (AEAT), Spain's tax authority, announced that bitcoin is to be treated as cash for tax purposes. This places bitcoin transactions in the realm of foreign currency transactions.
<b>United Kingdom</b>	Her Majesty's Revenue and Customs (HMRC) classifies bitcoins as assets or private money (a reversal from its earlier classification of bitcoins as vouchers). This classification exempts bitcoin mining and selling from the VAT, though exchanging goods for bitcoins still requires the seller to pay the VAT. Income, corporate, and capital gains taxes still apply to individuals and businesses that buy, sell, or exchange bitcoins. Gains and losses incurred on bitcoin transactions are still chargeable or allowable for capital gains taxes if they accrue to an individual.

## OTHER TAX ISSUES.....

- Sales tax
  - Do you collect sales tax in Bitcoins or USD?
  - If you collect it in BTC, you need to convert to USD before turning over to state. What conversion rate do you use?
  
- Employee tax withholding
  - If you pay an employee in BTC, how do you calculate the withholding amount?



**Important Disclaimer**

*If you're going to do business in a highly-regulated area like payments, you need a lawyer; a PowerPoint you got at a conference isn't enough. Don't rely on anything herein as legal advice.*

*I'm sure you knew that already. But my firm requires me to remind you.*

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