Understanding Government Regulation In Cryptocurrency

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From taxation to securities, the ownership and sale of bitcoin and other cryptocurrency is subject to a complex patchwork of federal laws. Tax, securities, commodities and anti-money laundering regulations may apply to those who engage in cryptocurrency transactions as a consumer, business enterprise or investor. This article provides an understanding of the regulatory structure and obligations arising from transactions involving virtual currency.

Tax Regulation

The IRS considers "virtual currency," such as bitcoin, ethereum tokens and other cryptocurrency, as "property" for tax purposes, with taxes owed if there is any realized gain on sale. *See* IRS Notice 2014-21, *Guidance on Virtual Currency* (March 25, 2014). For an individual filing a federal income tax return, the gains or losses from a sale of virtual currency that was held as a "capital asset" (*i.e.*, for investment purposes) are reported on (1) Schedule D of IRS Form 1040 and (2) IRS Form 8949 (Sales and Other Dispositions of Capital Assets).

The IRS requires, on Form 8949, for each virtual currency transaction, that the following information be disclosed: (1) a description of the amount and type of virtual currency sold; (2) the date acquired; (3) the date the virtual currency was sold; (4) the amount of proceeds from the sale; (5) the cost (or other basis); and (6) the amount of the gain or loss. It should be noted that the recordkeeping requirements of IRS Form 8949 can be particularly onerous for those who have used cryptocurrency to make numerous small purchases of goods or services throughout the year.

Any realized gains on cryptocurrency held for more than one year as a capital asset by an individual are subject to capital gains tax rates. Any realized gains on cryptocurrency held for one year or less as a capital asset by an individual are subject to ordinary income tax rates.

For 2018, federal income taxes are owed on any realized gains in the value of cryptocurrency upon the following events: the sale of cryptocurrency for cash; the purchase of goods and services with cryptocurrency; and the exchange of one cryptocurrency for another cryptocurrency.

Ordinary income tax is also owed for the "fair market value" of any cryptocurrency that has been mined by the taxpayer. If the mining is done as a hobby activity, then the value of the cryptocurrency on the date of mining would be reported in the "other income" line of the taxpayer's Form 1040.

The IRS has not yet provided specific guidance as to whether or not it is a taxable event for a taxpayer to retrieve, through wallet software, a free "fork" or "airdrop" of cryptocurrency. For example, individuals who held bitcoin (BTC) in certain types of software wallets as of Aug. 1, 2017, are able to use software to retrieve an equal amount of bitcoin cash (BCH). If the IRS specifically determines that cryptocurrency retrieved from a fork is not a taxable event, then taxable gain will not be realized until the forked cryptocurrency has been sold or exchanged. If the IRS determines that cryptocurrency received from a fork or airdrop is a taxable event, it is possible that the IRS could deem ordinary income to be realized for the "fair market value" of the coin on the date of retrieval of the cryptocurrency.

Securities Regulation

The Securities and Exchange Commission (SEC) has regulatory authority over the issuance or resale of any token or cryptocurrency that has the characteristics of an "investment contract." Under Securities Act § 2(a)(1) and Securities Exchange Act § 3(a)(10), a security includes "an investment contract." *See* 15 U.S.C. §§ 77b-77c. An "investment contract" has been defined by the U.S. Supreme Court as an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *See SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

In making a determination as to whether a token is an "investment contract," both the SEC and the courts look at the substance of the transaction, instead of its form. In 1943, the U.S. Supreme Court determined that "the reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a 'security.'" *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). In 1990, the U.S. Supreme Court determined that "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

The chairman of the SEC has taken the position that even if a cryptocurrency token issued in an initial coin offering (ICO) has "utility," the token can be still be deemed a security that is regulated under the Securities Act. On Feb. 6, 2018, in written testimony to the U.S. Senate Banking Committee, the chairman of the SEC stated as follows: "Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."

Commodities Regulation

On Sept. 17, 2015, the Commodities Futures Trading Commission (CFTC) ruled that "virtual currencies" are commodities subject to CFTC regulation. The Commodities Exchange Act (CEA) provides the CFTC with enforcement jurisdiction to investigate and conduct civil enforcement action against fraud and manipulation in both cryptocurrency derivatives markets and in underlying cryptocurrency spot markets. *See* 7 U.S.C. § 9(1) and (3).

On March 6, 2018, a U.S. district court upheld the authority of the CFTC under 7 U.S.C. § 9(1) to take enforcement action against a contract of sale of a virtual currency in interstate commerce. *See CFTC v. CabbageTech Corp.*, No. 18-CV-361 (E.D.N.Y. March 6, 2018).

Anti-Money Laundering Regulation

Under the Bank Secrecy Act (BSA), a money services business (MSB) is subject to the federal anti-money laundering regulations of the Financial Crimes Enforcement Network (FinCEN). In addition, the Internal Revenue Service (IRS) has the authority to examine MSBs with respect to their compliance with FinCEN's anti-money laundering regulations. A "money transmitter" is a type of MSB that is regulated by FinCEN.

On March 18, 2013, FinCEN deemed a "money transmitter" to include (1) a virtual currency exchange and (2) an administrator of a centralized repository of virtual currency who has the authority to both issue and redeem the virtual currency. FinCEN issued guidance that stated as follows: "An administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter under FinCEN's regulations, unless a limitation to or exemption from the definition applies to the person." *See* FIN-2013-G001, Application of FinCEN's Regulations to Person's Administering, Exchanging or Using Virtual Currencies (March 18, 2013).

An MSB that is a money transmitter must conduct a comprehensive risk assessment of its exposure to money laundering and implement an anti-money laundering (AML) program based on such risk assessment. FinCEN regulations require MSBs to develop, implement and maintain a written program that is reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities. The AML program must (1) incorporate written policies, procedures and internal controls reasonably designed to assure ongoing compliance; (2) designate an individual compliance officer responsible for ensuring day-to-day compliance with the program and Bank Secrecy Act requirements; (3) provide training for appropriate personnel that specifically includes training in the detection of suspicious transactions; and (4) provide for independent review to monitor and maintain an adequate program. *See* 31 U.S.C. §§ 5318(a)(2) and 5318(h); 31 C.F.R. § 1022.21.

FinCEN requires a money transmitter's anti-money laundering program to identify its customers, report suspicious activities for transfers in amounts of $2,000 or more in a day, retain detailed records for transfers by a single customer in one day of $3,000 or more, keep records for at least five years, and file a Currency Transaction Report for single customer transactions that are more than $10,000 a day.

Additional information about U.S. cryptocurrency and digital asset law can be found at our website: ***blockchainlawguide.com***.

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