

Cryptocurrency—FinCEN and Discovery of Hidden Wealth

By Steven Toscher and Michel R. Stein

Steven Toscher and Michel R. Stein examine the criminal and regulatory aspects of cryptocurrency, with a particular focus on the BSA and FinCEN's regulations pertaining to the currency.



Cryptocurrency has been a frequent topic in the financial news. We have been writing about it, lecturing about it and analyzing many of the tax issues which will confront the Internal Revenue Service (“IRS”) in its mission to enforce the tax laws. What we have not yet focused on is the significant role that the IRS’s sister agency, the Financial Crimes Enforcement Network (FinCEN), has and will continue to play in its mission of enforcing the Bank Secrecy Act (“BSA”). In fact, of all the agencies which have been confronting regulatory and enforcement issues, FinCEN has been playing one of the more significant roles—and that makes sense. Cryptocurrency is at its core—a medium of exchange and regulating the exchange of value is at the core of the FinCEN mission.

Because of the lack of clear regulation and an ability to store large amounts of wealth, cryptocurrency has emerged as a threat to combatting unexplained or tainted wealth. Tainted wealth in sovereign currency that would occupy warehouses or would be detailed in records by bankers that are subject to “Know-Your-Customer” rules, can now be hidden away on a computer hard drive.

The cryptocurrency ecosystem has evolved into two worlds—an increasingly transparent, more-regulated space and an unregulated crypto underground likely to be exploited for illicit activity and in the dark web. It will be difficult at times to know the difference between the two worlds and that is where we all face unknown risk.

This article addresses the criminal and regulatory aspects of cryptocurrency, with a particular focus on the BSA and FinCEN’s regulations pertaining to the currency.

What Is Cryptocurrency?

Cryptocurrency is a digital asset designed to work as both a medium of exchange and store of value that uses cryptography to secure its transactions, to control the creation of additional units, and to verify the transfer of assets. It is based on “blockchain” technology.

Cryptocurrencies are a form of digital currencies, alternative currencies, and virtual currencies. Cryptocurrencies use decentralized control as opposed to

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centralized electronic money and central banking systems. As an investment asset it has been highly volatile.

Types of Cryptocurrencies

There are almost 2,000 types of cryptocurrencies reported on Coinmarketcap.com with present total market cap of around \$225 billion. The value was over \$800 billion at its peak in December 2017. Leading cryptocurrencies are Bitcoin and Ethereum. Bitcoin market cap is around \$110 Billion. At its peak value in January 2018, the market cap was approximately \$310 Billion. Ethereum Market Cap is around \$24 Billion, with Ripple with a Market cap of around \$23 Billion and it goes down from there.

A Little Cryptocurrency History

Cryptocurrencies were born out of the “Cypherpunk” movement—people who believed that private key encryption based on cryptography would promote social change, ensuring privacy, anonymity and the prevention of censorship. Yes—this is all about cryptography. Remember famous British scientist Alan Turing and the Enigma machine during World War II. Until 1970s, cryptography was mainly used by the military and spy agencies—became more mainstream in 1992 when a group of individuals developed a forum combining the topics of cryptography, computer science, mathematics, politics and philosophy.

The ideas of the Cypherpunks spread and led computer scientist Nick Szabo to create a mechanism for a decentralized digital currency—he called it Bitgold.

In October of 2008, Bitcoin was released by the spiritual successor to the Cypherpunks “metzdowd.com” as a Peer to Peer Electronic Cash System, with a white paper written under an alias known as Satoshi Nakamoto—no one knows for sure who Satoshi really is.

The first notable transaction came on May 22, 2010, when Laszlo Hanyecz bought two Papa John pizzas for 10,000 Bitcoins. Even at today’s prices, those two pizzas sold for over \$60 million.¹

Is Crypto Currency a Means to Hide Unexplained or Tainted Wealth?

The Joint Chiefs of Global Tax Enforcement Consisting of Tax Authorities in the United States, United Kingdom, Canada, Australia, and the Netherlands all believe cryptocurrency is a threat. They have formed the J5—an alliance against transnational crime and money laundering. The common threats they face, include well-resourced

criminal organizations seeking to conceal and legitimize gains through the global financial system.²

The J5 recently announced that one of its key priorities is the growing cryptocurrency market, which allows parties to transfer value without using banks or other traditional intermediaries. Estimates place cryptocurrency-related tax liabilities for 2017 at \$25 billion in the U.S. Anonymity associated with cryptocurrencies make them well suited for those who wish to launder money or engage in other illegal transactions.

Cryptocurrency Used for Tax Evasion

The IRS, both Criminal and Civil Divisions, are investigating whether and how cryptocurrencies are used for tax evasion purposes. There is a dedicated IRS Criminal Investigation Unit focusing on international tax crimes, including cryptocurrencies. Don Fort, Chief of the IRS Criminal Division and a Member of the J5 has stated that “Its possible to use Bitcoin and other Cryptocurrencies in the same fashion as foreign bank accounts to facilitate tax evasion.”³ While the agency has not charged anyone yet, Fort said the cases will come.

On November 28, 2017, the U.S. District Court for the Northern District of California ordered Coinbase to produce documents on approximately 14,000 of its customers, in response to the IRS’ petition to enforce its summons.⁴ In support of its summons enforcement petition, the IRS submitted the declaration of a Revenue Agent who stated that while Coinbase (America’s largest platform for exchanging Bitcoin in U.S. dollars) had 5.9 million customers and served \$6 billion exchanges in Bitcoin, the IRS only had record of 800 to 900 persons who electronically filed a Form 8949 that included a property description that likely related to Bitcoin. This resonated with the Judge, who ordered Coinbase to produce accounts with at least the equivalent of \$20,000 in any one transaction type (Buy, Sale, Send, or Receive) in any one year between 2013 and 2105, and to include: (1) Taxpayers’ identification number; (2) name; (3) birth date; (4) address; (5) record of account activity; and (6) all periodic statements of account.

The ordered release of this information is clear warning to all cryptocurrency customers that the IRS has the tools, means and fortitude to seek out and make an example of those who are not in compliance. We expect that the IRS will be conducting civil examinations to determine the level of non-compliance.

U.S. Regulation of Cryptocurrencies

U.S. Regulation of cryptocurrency has been limited and primarily under the BSA through the Treasury

Department's FinCEN. The U.S. Securities Exchange Commission ("SEC") (for securities) and Commodity Futures Trading Commission ("CFTC") (for commodities) have also become more active recently.

There is no regulation of private transactions or users—exchanging one cryptocurrency for another cryptocurrency or using cryptocurrency to purchase a car or a home. However, a third party “exchanger” or “administrator” involved in a cryptocurrency transaction are subject to regulation under the BSA and subject to substantial civil and criminal penalties for violations.

FinCEN's Regulation of Cryptocurrencies

FinCEN's regulations define currency (also referred to as “real” currency) as “the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates, and [iii] is customarily used and accepted as a medium of exchange in the country of issuance.”⁵ In contrast to real currency, “virtual” currency is a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. Virtual currency does not have legal tender status in any jurisdiction.

Virtual currency exchangers and administrators have been subject to the BSA's money transmitter requirements since 2011.⁶ Regulations implementing the BSA apply to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies.⁷ Such persons are referred to as “users,” “administrators,” and “exchangers,” all as defined below.

A mere “user” of virtual currency is not subject to FinCEN's regulations and therefore is not subject to Money Service Businesses (“MSB”) registration, reporting, and recordkeeping regulations. A “user” is a person that obtains virtual currency to purchase goods or services. Such activity, in and of itself, does not fit within the definition of MSB, and therefore is not subject to FinCEN's registration, reporting and recordkeeping regulations for MSB.

However, an administrator or exchanger is subject to FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person.⁸ An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency. An administrator is a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency. The definition of a money transmitter does

not differentiate between real currencies and convertible virtual currencies. Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the regulations implementing the BSA.⁹

In 2014, FinCEN, working with its delegated examiner, the IRS Small Business/Self-Employed Division, began to implement comprehensive, periodic examinations of exchanges and administrators.¹⁰ As of February 2018, FinCen examined a third of the 100 virtual currency exchangers and administrators registered with FinCEN. FinCEN has also initiated enforcement actions against exchangers such as Ripple Labs (2015) and BTC-e (2017), and against individuals that operate exchangers such as Alexander Vinnik (2017). FinCEN continues to face significant challenges to investigating foreign virtual currency businesses, because most jurisdictions do not regulate and supervise virtual currency businesses and do not require them to maintain customer records. Nevertheless, FinCEN will work to identify foreign-located money transmitters that may be enabling financial crime, and evaluate them for potential enforcement actions when they violate U.S. law.

FinCEN and Cryptocurrency Mining Activity

FinCEN, in its administrative ruling FIN-2014-R001 (January 30, 2014), considered the application of FinCEN's regulations on a company's mining operation. The ruling notes that how a user obtains virtual currency (either through mining, exchanging or purchasing) is not material to the legal characterization under the BSA process or to the person engaging in the transmitting of the virtual currency. Instead, what is material to the conclusion is not the mechanism by which a person obtains the virtual currency, but what the person uses the virtual currency for, and for whose benefit. To the extent a user mines currency solely for the user's own purposes and not for the benefit of another, the user is not an MCB under FinCEN's regulations, because these activities do not involve either “acceptance” or “transmission” of funds under the rules. Furthermore, a user's conversion of virtual currency into real currency or another virtual currency does not in and of itself make the user a money transmitter.

U.S. Regulation of Cryptocurrencies-ICOs

An initial coin offering (ICO) is a means of crowdfunding centered around cryptocurrency, which can be a source of

capital for startup companies. In an ICO, a quantity of the crowdfunded cryptocurrency is pre-allocated to investors in the form of “tokens,” in exchange for legal tender or other cryptocurrencies such as Bitcoin or Ethereum. These tokens supposedly become functional units of currency if or when the ICO’s funding goal is met and the project launches. The regulation and tax treatment of ICOs under U.S. securities and tax law is uncertain and evolving.

In February 2018, in FinCEN’s letter to Senator Wyden responding to a request for information relating to its oversight and enforcement of virtual currency, FinCEN for the first time indicated that it will apply its regulations to developers and exchanges involved in the sale ICO-derived cryptocurrencies. These persons would be liable to register as a money transmitter and comply with anti-money laundering (“AML”) and know-your-customer rules.

FinCEN said that the obligations of participants in ICOs will depend on the nature of the of the financial activity involved in any ICO and is a matter of the facts and circumstances in each case. However, generally under existing regulations and interpretations, a developer that sells convertible virtual currency, including in the form of ICO coins or tokens, in exchange for another type of value that substitutes for currency is a money transmitter and must comply with the AML requirements that apply to this type of MSB. An exchange that sells ICO coins or tokens, or exchanges them for other virtual currency, fiat currency, or other value that substitutes for currency, would typically also be a money transmitter.

FinCEN Enforcement Example-BTC-e

BTC-e was an internet-based foreign-located money transmitter doing business in the United States—one of the largest virtual currency exchanges in the world by volume—that exchanged fiat or sovereign currency and cryptocurrencies such as Bitcoin, Ethererum, Dash, Litecoin, Namecoin, Novacoin, and Peercoin. BTC-e conducted over \$296 million in transactions in Bitcoin and tens of thousands of transactions in other cryptocurrencies.

BTC-e facilitated transactions involving ransomware, computer hacking, identity theft, tax refund fraud schemes, public corruption and drug trafficking. It also processed transactions involving funds stolen from one of the world’s largest Bitcoin exchanges—Mt. Gox.

Under U.S. law, because BTC-e was doing business in the U.S. sending funds to and from customers within the United States—regardless of where BTC-e was located, it was required to comply with AML laws, regulations of foreign-based MSB, registration, suspicious activity reporting and recordkeeping requirements.

In July of 2017, FinCEN, in conjunction with the U.S. Department of Justice, the IRS, the Federal Bureau of Investigation and Department of Homeland Security, assessed a civil monetary penalty of \$110,003,314 against BTC-e and one of its operators was arrested in Greece.¹¹

FinCEN and Foreign Financial Asset and Bank Account Reporting

U.S. persons are required to file an FBAR includes those with a financial interest in or signature authority over at least one financial account located outside of the United States if the aggregate value of all foreign financial accounts exceeded \$10,000 at any time during the calendar year. The reporting obligation may exist even if there’s no associated taxable income. If one fails to file an FBAR, you risk hefty penalties: up to \$10,000 per violation for non-willful violations and up to \$100,000 or 50% of the balance in the account for willful violations.

For purposes of the FBAR, a financial account is defined as a bank account, such as a savings, demand, checking, deposit, time deposit, or any other account maintained with a financial institution or other person engaged in the business of a financial institution. It also includes an account set up to secure a credit card account; an insurance policy having a cash surrender value is an example of a financial account; securities, securities derivatives, or other financial instruments account; mutual funds and similar accounts in which the assets are held in a commingled fund and the account owner holds an equity interest in the fund.

During a 2014 webinar, Ron Lundquist, a senior program analyst for the IRS Small Business/Self-Employed Division, indicated Bitcoins were not reportable for the then current (2013) season, but left open the question for future years. He followed up by saying that “FinCEN has said that virtually currency is not going to be reportable on the FBAR, at least for this filing season.” No further guidance has been provided. The income tax treatment of assets is not the same as the reporting requirements for FBAR purposes.

There are several ways to hold virtual currency in a “foreign account,” two main approaches include using an online wallet and through a bank or exchange account. Online wallets allow the storage of personal virtual currency keys providing a way to quickly access your currency using a smartphone or computer so you can use them to purchase or trade. The virtual currencies themselves remain in the owner’s possession. In contrast, a Bitcoin bank or exchange allows personal Bitcoins to be deposited and withdrawn as needed to transact business. The significant difference between the two systems is virtual currency are

deposited and withdrawals are not the same Bitcoins as you deposited. Bitcoin banks and exchanges treat the individual Bitcoins as fungible.

Lundquist's comments are not to be considered official guidance. In fact, there isn't yet any official written guidance. The IRS has been slow to issue definitive guidance on both the taxation and reporting of Bitcoin, which has been confusing for taxpayers. And it could get more confusing; Lindquist cautioned that FBAR reporting requirements for virtual currency could change "as we monitor what happens in the future."

For FBAR purposes, those virtual currencies held individually in a wallet should not be reportable. Think of it like gold: Gold coins, other precious metals or foreign currency held directly are not reportable for FBAR purposes.

Virtual currency exchange accounts situated in a foreign country do need to be reported. This would be consistent with the IRS treatment of gold and foreign currency held in accounts. Converting those assets from directly held assets to accounts makes them reportable.

This nuance is important when it comes to the rules for precious metals and similar assets and it likely extends to virtual currency.

Conclusion

No one knows for sure the long-term future of cryptocurrency and the role it will play in our economic lives—whether as an investment or as a medium of exchange. The question many financial institutions should be asking itself is what additional steps should they and other businesses take to insure they are not in violation of law when dealing with a cryptocurrency transaction. Certainly, worldwide government's need to take additional steps to regulate cryptocurrencies. Exchanges engaged in assisting the type illegal activities like BTC-e, will find themselves subject to large civil penalties and criminal prosecution.

It appears however that for the foreseeable future, the use of cryptocurrency will continue to become more commonplace and regulators and law enforcement will be increasing their oversight and enforcement efforts. As established banks continue to "de-risk," the use of cryptocurrency is likely to grow. Professionals need to be cognizant of the new and increased risks we will face in this new era. Thank you Alan Turing.

ENDNOTES

¹ See Fortune Article, *Crypto Legend Who Bought Pizza With 10,000 Bitcoin Is Back At It* (Feb. 27, 2018).

² See Forbes Article, *IRS-CI Joins International Effort to Fight Tax, Cryptocurrency and Financial Crimes*, Kelly Phillips Erb (July 2, 2018).

³ See Bloomberg Article *IRS Cops Scouring Crypto Accounts to Build Tax Evasion Cases*, by David Voreacos (Feb. 8, 2018).

⁴ See *Coinbase, Inc.*, 2017 U.S. Dist. LEXIS 196306, Case Number 3:17-cv-01431-JSC, November 28, 2017.

⁵ 31 CFR §1010.100(m); See also FIN-2013-G001, FinCEN Interpretive Guidance on Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies.

⁶ Amendments to BSA Regulations; Definitions and Other Regulations Relating to Money Services Businesses, 76 FR No. 140 (Jul. 21, 2011).

⁷ FIN-2013-G001, FinCEN Interpretive Guidance on Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies.

⁸ FIN-2013-G001, FinCEN Interpretive Guidance on Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies.

⁹ 31 CFR §1010.100(ff)(5)(i)(A).

¹⁰ See FinCEN's Letter to Raking Member of Committee on Finance, Honorable Ron Wyden (Feb. 13, 2018).

¹¹ See Press Release of July 27, 2017, Financial Crimes Enforcement Network, FinCEN Fines BTC-e Virtual Currency Exchange \$110 Million for Facilitating Ransomware, Dark Net Drug Sales.

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