



# Bitcoin

## for Kentucky Lawyers: A Primer

BY: R. MORGAN SALISBURY

## Bitcoin

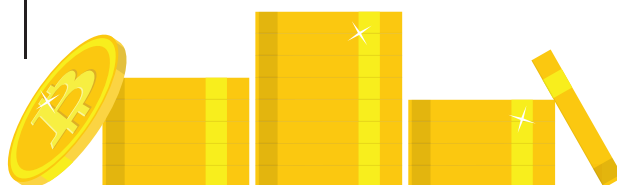
is growing in popularity and usage and has already made at least one appearance in Kentucky<sup>1</sup> state court. In May 2017, Bitcoin reached a new all-time high at a price of over \$1,800 per Bitcoin. In June, it was traded at nearly \$3,000. This “cryptocurrency” made international news when computer hackers seized control of hundreds of thousands of computers across the globe and demanded a ransom consisting not of cash, but of Bitcoin. Bitcoin (and cryptocurrencies like it) are undoubtedly the chosen medium of exchange for hackers and online “dark web” contraband. It is also the favorite pet of finance geeks and computer nerds the world over.

In December, 2017, Bitcoin became a household name as even moderately-savvy investors were drawn to it as the price skyrocketed to nearly \$20,000. While Bitcoin’s market value far exceeded that of an ounce of gold in 2017, Bitcoin’s longterm usefulness is less clear than gold’s. The usefulness of gold will undoubtedly be familiar to readers. However, the usefulness or value of Bitcoin is probably unclear to most. As Bitcoin grows in popularity and becomes more common, it is important for Kentucky lawyers to be aware of this digital form of money and how it may affect your practice areas.

### WHAT IS BITCOIN?

According to the Internal Revenue Service (IRS), Bitcoin is property. According to the Commodity Futures Trading Commission (CFTC), Bitcoin is also a commodity.<sup>2</sup> According to its users, Bitcoin is *money* or, at least, a store of value like gold. Because of how Bitcoin and other cryptocurrencies are commonly used, it is perhaps easiest for the uninitiated to think of Bitcoin as money. Instead of paper notes or metallic coins, Bitcoin is entirely digital—truly a “virtual currency.” However, Bitcoin does not enjoy legal tender status in any jurisdiction.

Unlike other currencies like U.S. dollars, Bitcoin is not currently regulated, sponsored, or controlled by any government or central bank. Instead, it is controlled essentially by its users. Unlike traditional fiat currencies like U.S. dollars, there is a finite number of Bitcoins that will ever exist. The total number of Bitcoins in existence is set to increase slowly based on pre-set parameters but is set at a maximum of just 21 million Bitcoins. To compare, there are currently \$1.63 trillion U.S. dollars in circulation.<sup>3</sup> Ideally, this means Bitcoins are not subject to currency manipulation, “quantitative easing,” inflation, or deflation like our modern dollars or other major world currencies.



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## HOW DOES BITCOIN WORK?

It's complicated. A useful but simplified illustration is to think of Bitcoin users each as their own, personal bank. All users work with the same set of recorded Bitcoin transactions, known as the "blockchain." Think of the blockchain as a public ledger recording all transactions and ownership of every Bitcoin in circulation. If a user wants to transfer a Bitcoin (or yes, even a very small fraction of a Bitcoin) to another user, that transaction is recorded on the public blockchain—just like an entry in your checkbook or bank statement. The difference is that the blockchain notation is then shared with all other users of the blockchain, who can verify that the transaction was in fact made.

Bitcoin's blockchain is not currently believed to be susceptible to manipulation because the blockchain ledger is public, recorded, and copied over and over on users' own computers. A clever computer guru

could not simply create counterfeit Bitcoins and then pass them off to others because there would be no record of those Bitcoins existing on the blockchain "ledger." When a transaction is submitted to the blockchain, it is essentially cross-checked against other copies of the ledger existing on other users' computers. Ideally, any forged Bitcoin would not be verified when legitimate copies of the blockchain ledger were referenced. The fake Bitcoin would be rejected and the fraud revealed as soon as the public blockchain ledger was referenced, which is done as part of any transaction. Many experts believe that the blockchain technology that makes Bitcoin "work" is where the true value of Bitcoin lies. The reasons for that belief are speculative and mostly outside the scope of this article, though some are mentioned at the end.

## WHAT KENTUCKY LAWYERS SHOULD KNOW

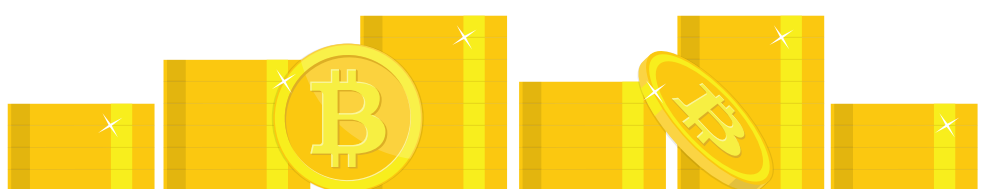
### BITCOIN IS ALREADY IN KENTUCKY.

Think Bitcoin will never make its way to Kentucky? Think again. It's already here! In 2013, Fox News reported that both the mayor and police chief in Vicco, Ky., were being paid in Bitcoin.<sup>4</sup> Kentucky's United States Senator Rand Paul accepted Bitcoin donations as part of his fundraising efforts in 2015.<sup>5</sup>

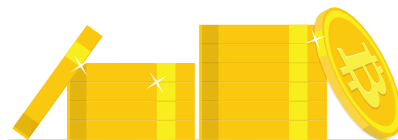
Bitcoin is in Kentucky courts, too. The Breathitt Circuit Court made headlines in 2015 when it granted summary judgment to a Plaintiff seeking to recover over \$67,000 after the defendant failed to repay a loan consisting entirely of Bitcoins.<sup>6</sup> When defendant failed to repay the loan,

the plaintiff went through an arbitration process and then sought to enforce the arbitration award.<sup>7</sup> Lexington attorney Kevin Palley believes he may be the first attorney in the United States to obtain a judgment based on a Bitcoin loan.<sup>8</sup>

Kentucky lawyers would do well to recognize that Bitcoin is no longer reserved for computer hackers or techies in Silicon Valley. Technologically savvy Kentuckians are already using Bitcoins—you just may not have realized it. As the value of Bitcoin continues to rise, its appearance in more Kentucky courtrooms is more and more likely.



## WHAT KENTUCKY LAWYERS SHOULD KNOW



### **BITCOIN IS NOT ILLEGAL.**

Often, Bitcoin is mentioned in news stories in relation to illegal drug deals, computer hacking stories, money laundering arrests, or other unsightly transactions. Bitcoin advocates would be quick to point out that traditional, paper cash is also used often in drug and other criminal transactions. Of course, Bitcoin is also used for perfectly legal transactions. For example, the popular online retailer Overstock.com and travel website Expedia.com each accept payment in the form of Bitcoin. Others are slowly starting to accept it as payment as well.

Kentucky lawyers should understand that while Bitcoin is sometimes used for illegal transactions, it is not illegal merely to possess Bitcoin or to use it as a medium of exchange in the United States.

### **BITCOIN HAS IMPORTANT TAX IMPLICATIONS.**

In 2014, the Internal Revenue Service (IRS) published Notice 2014-21 to assist tax preparers in applying existing tax principles to transactions involving virtual cryptocurrencies like Bitcoin (yes, Bitcoin is the best known of a number of cryptocurrencies). According to the Notice, Bitcoin is to be treated as property that should not be treated as a foreign currency whenever there is a gain or loss in its value. The IRS also acknowledged that Bitcoin was being used to trade for goods and services and held for investment purposes. The IRS Notice suggested that tax preparers should compute the fair market value of the Bitcoin as measured in U.S. dollars on the date it was received. The IRS also suggested that a taxpayer “generally realizes ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer.”<sup>9</sup>

Notably, Kentucky was among the first states in the nation to also issue tax guidance on Bitcoin. In June 2014, the Kentucky Department of Revenue’s Kentucky Sales Tax Facts, “A Revenue Publication for the Business Owner,” stated that Kentucky would follow the IRS guidance and added

that “[a]ny business that accepts Bitcoins as a form of payment must convert the Bitcoin into U.S. dollars, and charge six percent Kentucky sales and use tax on any taxable transaction for which Bitcoin represents the financial instrument of consideration. Documentation must be maintained to verify the value of Bitcoin at the time of the transaction.”<sup>10</sup>

In November, 2016, the New York Times reported that the IRS was investigating customers of Coinbase, a popular online Bitcoin marketplace or “exchange” based in the United States, to identify users who failed to report income from Bitcoin transactions.<sup>11</sup> An IRS agent swore in a related federal suit in California that only 802 taxpayers reported income from the sale of Bitcoin.<sup>12</sup> The IRS suspects there are many others who profited handsomely from sharp increases in Bitcoin’s value but who never reported those gains. Most popular Bitcoin exchanges do not provide convenient year-end forms detailing gains or losses like those sent to investors with retirement or brokerage accounts.

Clients might be tempted by the esoteric and relatively private nature of Bitcoin to underreport Bitcoin assets to the IRS, or not to report them at all. Their lawyers need to remind them that the gains and losses realized in Bitcoin trades must be reported and that the gains are, in IRS parlance, an accession to wealth clearly realized and are therefore taxable. For example, if you have a client who owned Bitcoin in October, 2016, that client likely recently enjoyed a nearly 300 percent or more increase in the value of those Bitcoins. If they were sold, that gain and the resulting income should probably be reported as income. The privacy afforded by Bitcoin and other cryptocurrencies paired with their volatile price could tempt your clients to underreport this income or the overall value of their assets. However, tax collectors at both the state and federal levels are already looking for these new, valuable digital assets.

### **GET EXPERT HELP LOCATING BITCOIN IN LITIGATION.**

Because Bitcoin users may serve essentially as their own bank, Bitcoin can be easy to hide. For example, an individual desiring to hide his or her assets might purchase Bitcoins and store them on a personal computer hard drive or even a common USB thumb drive, just as if the Bitcoins were cash stuffed under a mattress. Alternatively, the Bitcoins could be deposited with an online third-party exchange serving as a makeshift bank, though these third-party “banks” have little to no government oversight and many have a poor track record when it comes to security. Many of these exchanges are regulated as money transmitters rather than banks or traditional stock trading platforms, but more on that later.

There is no entity to subpoena or call upon to produce records of Bitcoin transactions. The blockchain ledger is public, but transactions are only identified by a long series of letters and numbers that is unintelligible that looks something like this: **1JC3etjG6oSA2AYZS5957B5zaZEWZbrMXW**—thus, Bitcoin is “semi-anonymous.” This can make tracking Bitcoin transactions and even specific “coins” possible, but difficult for the uninitiated. Enterprising companies are already developing ways to track transactions and identify users in order to make Bitcoin transactions less anonymous. If you’re intent on locating Bitcoin assets in discovery, it is probably prudent to engage an expert to guide you along the way.

For example, the \$1.6 million worth of Bitcoins seized by federal law enforcement as part of the infamous “Silk Road” investigation and then auctioned to the public in August 2016<sup>13</sup> could conceivably be traced to the buyers and then to whomever received them, though the actual identity of the buyers and subsequent holders would be much more difficult to ascertain if the only evidence available looks like source code or an impregnable internet password. Bitcoin can be easy to hide, is semi-anonymous, and

is not connected to any traditional bank. Lawyers interested in locating, tracking, seizing, or calculating an individual's assets would do well to be mindful of Bitcoin (or other cryptocurrencies) as a store of wealth. If you are not already searching computer hard drives, smartphones, tablets, and e-mails for evidence of virtual currencies like Bitcoin, then it may be good to include inspections in your next set of discovery requests or deposition questions.<sup>14</sup> At a current market price of nearly \$7,000 per Bitcoin, the extra step could be well worth your while.

### **BITCOIN PRESENTS PRACTICE OPPORTUNITIES.**

Perhaps more accurately, the blockchain (or "ledger") technology that makes Bitcoin work could change the legal profession. For example, primarily alternative cryptocurrencies have proposed "smart contracts," whose aim is to make contractual agreements work with the accuracy of a computer program. Essentially, parties would record a public, transparent but semi-anonymous computer code to a public blockchain that can trigger a payment or series of payments once other, predetermined events take place. To illustrate, a "smart contract" may assure that a payment is made once a certain date is reached (*e.g.* automatic rent payments or property closings) or when a publicly traded stock reaches a certain price. Ordinarily, these type of contracts would require an expensive lawyer or financial services professionals to perform and verify. "Smart contracts" promise to eliminate some of the middlemen—at least in theory. Last summer, insurance giant American International Group (AIG) reported that it was partnering with IBM to "develop a 'smart' insurance policy that uses blockchain to manage complex international coverage[.]"<sup>15</sup> Many other large companies are experimenting with similar technology as well.

Bitcoin's blockchain technology could change property law as well. Blockchain "tokens" promise to be able to replace real estate or other title records with public, digital "tokens" that are recorded on a public blockchain. Basically, it works like this: a digital "token" serves as the title. If you

possess the token, then you have title. This isn't *just* speculative theory. In February 2017, the Republic of Georgia "committed in a signing ceremony ... to use the bitcoin network to validate property-related government transactions."<sup>16</sup> The technology was tested there first using land title registrations but is presently being expanded "to purchases and sales of land titles, registration of new land titles, demolition of property, mortgages and rentals, as well as notary services."

To be sure, Bitcoin and the blockchain technology behind it are still far from changing Kentucky's real estate transaction recording process. However, the value of having a public ledger with title transfers recorded on the blockchain for anyone to view and inspect or transfer may be what the future of land and automobile title records looks like. Imagine transferring an automobile or real estate with the click of a button on your smartphone and for others to be able to immediately verify that transaction from anywhere in the world, nearly simultaneously. That technology is already being tested. We lawyers may have some catching up to do.

### **REGULATION IS COMING.**

Though Bitcoin has enjoyed what some would consider a "wild west" atmosphere

of no regulation or oversight, regulation is coming. Currently, regulators struggle to fit Bitcoin and other cryptocurrencies into existing regulatory framework. Is cryptocurrency a commodity or a security?

The U.S. Securities and Exchange Commission (SEC) has already indicated that it views "initial coin offerings" (ICOs) as traditional securities and is enforcing existing laws against companies offering and trading them.<sup>17</sup> Generally, ICOs are new, alternative cryptocurrencies similar to Bitcoin that are created new but initially controlled by a single person or business and then sold to raise capital for a variety of businesses and projects.

Regulation of more popular cryptocurrencies like Bitcoin has been more of a challenge. Regulators from both the SEC and the Commodity Futures Trading Commission testified before a Senate committee in February, 2018.<sup>18</sup> They signaled their intention to treat Bitcoin exchanges as "money transmitters," which must observe federal prohibitions on money laundering and the financing of terrorist organizations.<sup>19</sup> A few states (not Kentucky, not yet) require licenses for Bitcoin exchanges housed there—not something the novice cryptocurrency user will be overly concerned about. Many others provide no

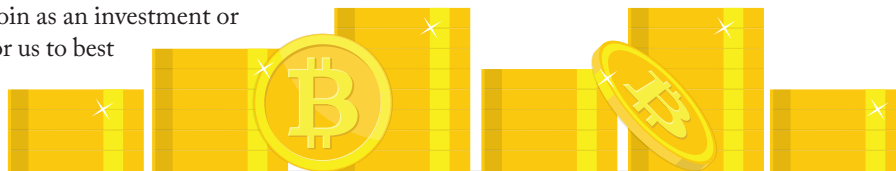


oversight. Many popular cryptocurrency exchanges are headquartered in other countries also struggling to fit cryptocurrencies into their existing regulatory framework.

Utilizing ICOs or other cryptocurrencies to raise capital could subject entrepreneurs to federal banking regulations and securities laws. The regulatory environment of simply trading cryptocurrencies like Bitcoin is expected to be regulated in the near future, but until then,  *caveat emptor*  (“buyer beware”).

## CONCLUSION

Bitcoin and the blockchain technology are changing our world. As lawyers, we must recognize these changes and be prepared for them. Even if we aren't quite ready to dive into the world of cryptocurrencies ourselves, understanding that clients or opposing parties may be using Bitcoin as an investment or as “money” is important for us to best do our job effectively. **BB**



## ABOUT THE AUTHOR

**R. MORGAN SALISBURY** is an associate attorney in the Fort Wright, Ky., office of Lewis Brisbois Bisgaard & Smith. He is licensed in both Indiana and Kentucky and his practice focuses on civil litigation. Salisbury earned his law degree from the Salmon P. Chase College of Law at Northern Kentucky University, where he graduated *cum laude*. While in law school, he served on the editorial board of the Northern Kentucky Law Review. He also holds a Bachelor's degree in history from Morehead State University, where he graduated *magna cum laude*. Salisbury closely follows innovative technological trends, including the recent rise of cryptocurrencies such as Bitcoin.



## ENDNOTES

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6. *See De Souza v. Kerley*, Breathitt Circuit Court Case No. 15-CI-055; Cyrus Farivar, *After Bitcoin loan goes south, judge rules man must repay over \$67,000*, ARSTECHNICA June 19, 2015 available at <https://arstechnica.com/tech-policy/2015/06/after-bitcoin-loan-goes-south-judge-rules-man-must-repay-over-67000>.
7. Cyrus Farivar, *After Bitcoin loan goes south, judge rules man must repay over \$67,000*, ARSTECHNICA June 19, 2015 available at <https://arstechnica.com/tech-policy/2015/06/after-bitcoin-loan-goes-south-judge-rules-man-must-repay-over-67000>.
8. Read more at Kevin Palley's website at <https://www.kevinpalley.com>.
9. *See* IRS Notice 2014-21.
10. Ky. Dep't of Rev. Sales Tax Facts (June 2014) available at <http://revenue.ky.gov/News/Publications/Sales%20Tax%20Newsletters/SalesTaxFacts-June2014.pdf>.
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12. Jeff John Roberts, *Only 802 People Told the IRS About Bitcoin-Lawsuit*, FORTUNE, March 19, 2017 available at <http://fortune.com/2017/03/19/irs-bitcoin-lawsuit/>.
13. *See* Justin Pot, “The U.S. government is selling \$1.6 million worth of seized bitcoins this month” DIGITAL TRENDS (Aug. 9, 2016) available at <https://www.digitaltrends.com/computing/us-government-auctions-off-2700-bitcoin/>.
14. Many cryptocurrency users have accounts with private third-party exchanges to buy and sell cryptocurrencies that operate much like stock trading websites – but without the regulation. Popular exchanges to be mindful of when investigating include Coinbase, GDAX, Kraken, BitStamp, CEX.io, LocalBitcoins, Bittrex, Binance, and many more.
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## ADDITIONAL ARTICLE

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