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Tax Alert



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Bitcoin Is Biggest Loser In Silk Road Meltdown---IRS Wins Big

The biggest loser in the [Silk Road arrest](#)? Probably Bitcoin. The biggest winner may be the IRS, although right now the FBI must be feeling pretty good too. For the last two years, an alleged drug kingpin who called himself the [Dread Pirate Roberts](#) could do what he wanted in secret. Now he is in custody and his Silk Road site is shuttered with an FBI and IRS Criminal Investigation Division label.



(Photo credit: zcopley)

The FBI arrested 29-year-old Ross William Ulbricht. The [criminal complaint](#) charges money laundering, narcotics trafficking conspiracy and computer hacking. The DOJ seized the website and a large quantity of Bitcoins, the now über-digital currency. But for how Silk Road could exist selling illegal drugs and more for several years, you need to be very tech savvy or to read [Everything You Need to Know About Silk Road, the Online Black Market Raided by the FBI](#).

Forbes may even have played a part in the Dread Pirate Roberts' undoing, since he gave his [first extended interview to Forbes](#). The criminal complaint against Mr. Ulbricht states that Silk Road turned over \$1.2 billion in revenue, generating \$80 million in commissions. It's not clear if that was tax-free. But what is clear is that Bitcoin features very prominently in the [criminal complaint](#).

Given all the encryption, layers upon layers and stealth at Mr. Ulbricht's disposal, the FBI has not revealed how it nabbed him. However, the criminal complaint mentions a mailed package seized by U.S. Customs and Border Patrol. It contained nine IDs with different names and Mr. Ulbricht's photograph. The San Francisco address on the package pointed to Mr. Ulbricht.

But security gaffes are referenced in the complaint too, and some commentary suggests that Mr. Ulbricht was talking too much. And Bitcoin, meanwhile, must be feeling a bit giddy but mostly seeing a dark cloud on the horizon. Bitcoin miners and users must see it too. For it seems inevitable that this episode and all that will follow will embolden the IRS and FinCEN to target the cryptocurrency.

As noted in [IRS Takes A Bite Out Of Bitcoin](#), Bitcoin doesn't obviate taxes. Some argue that given the anonymity of the upstart digital currency, they can [evade taxes](#) and the IRS won't catch them. But that doesn't mean there's no income, and the Silk Road seizure puts volume and compliance on the front burner.

From an IRS perspective, transactions in Bitcoin could be property, barter, foreign currency, or a financial instrument. Barter seems the most logical treatment, but not everyone agrees. And investing excitement doesn't encourage calm reflection. There's plenty of excitement about Bitcoin, even by the Wall Street Journal. See [The Mess the WSJ Made: Famed trader Joe Lewis not Investing in Bitcoins](#).

In fact, if the [The Graduate](#) were remade today, the "One Word: Plastics" might be Bitcoin. Former Facebook claimants Tyler and Cameron Winklevoss became [The People Making Real Money On Bitcoin](#) when they [announced](#) an SEC filing for the "[Winklevoss Bitcoin Trust](#)." It would allow institutional investors to dabble in the virtual currency without having to buy it directly from a Bitcoin Exchange. See [Overview](#).

But the allure of avoiding taxes is like a siren song. In [Is Bitcoin the New Tax Haven?](#), TaxProf Paul Caron quotes from [Omri Y. Marian's](#) paper [Are Cryptocurrencies 'Super' Tax Havens?](#) Mr. Marian notes the pressure facing financial institutions to hand over information on account holders and withhold taxes from their accounts. The fight against offshore evasion is raging. And although FATCA was enacted in 2010, the dreaded law is just now coming into its own.

Think of Bitcoin like unmarked, non-sequential bills. Bitcoin is not dependent on the existence of financial intermediaries. Mr. Marian suggests that much more government regulation is coming once the authorities recognize Bitcoin's potential for serious tax evasion. Surely he is right, and that was before Silk Road and Mr. Ulbricht were splashed across every paper and news site.

Virtual currencies raise obvious tax compliance problems. What should the IRS do? Regulate it, says GAO. See [GAO: IRS Needs to Keep an Eye on Virtual Currencies](#). The Treasury unit called FinCEN, the Financial Crimes Enforcement Network, already has [rules about Bitcoin](#) and the IRS is likely to follow. Post Silk Road, that could be much sooner.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.