What You Should Know About Virtual Currencies

Virtual currencies have been around almost as long as the Internet and in the last few years they have evolved rapidly towards a product suitable for the financial mainstream. With that rapid evolution has come many questions—legal, practical, technological and otherwise—about the promise and potential of virtual currencies. This bulletin is intended to provide the basics of virtual currency: what they are and the risks to contemplate if you're considering exchanging and investing in virtual currencies.

What are virtual currencies?

Virtual currencies (also called crypto-currencies, virtual money, or digital cash), are essentially unique, typically encrypted, computer files that can be converted to or from a government-backed currency to purchase goods and services from merchants that accept virtual currencies. You can buy these virtual currencies online using a virtual "wallet" on your PC or smartphone and, in some states, at kiosks and stores. Virtual currency is accepted as currency by some businesses, exchanged for cash by others, and even purchased as an investment.

What are the risks involved with using and investing in virtual currencies?

Exchanging Virtual Currencies

Virtual currency transactions are considered high-risk due to the vulnerability to cyber-attacks—of which there have been many. In March 2014, "Mt.Gox," the largest and best-known exchanges announced that Bitcoins (a prominent virtual currency) worth $409 million had been hacked and stolen. Mt.Gox abruptly declared bankruptcy, leaving more than one million people around the world unable to recover their funds. Virtual currency exchanges are unregulated, meaning there is little recourse to recover lost funds and, unlike deposits in insured banks and insured credit unions, there is no deposit insurance.

Investing in Virtual Currencies

As with many new investment opportunities, fraud potential is high. Some virtual currencies are held anonymously, which may facilitate fraudulent transactions and make recovering investment losses nearly impossible. There may also be challenges to verify receipt of transfers, to gain access to locked accounts, or to resolve stopped trades.

Other risks associated with virtual currencies:

- Few consumer protections without licensing. Virtual currencies are not regulated by a government. California has been working with virtual currency industry leaders and other state and federal regulators to evaluate businesses engaging in virtual currency transactions for possible licensing.
- Difficult to recover if stolen. Unlike a stolen credit card, if you are using the virtual currency like Bitcoin and it is stolen or stored on a personal computer or smartphone that is stolen, lost or destroyed by accident, there is no way for you to identify and recover them.
- Emerging technology. Virtual currency technologies are evolving rapidly and a currency used today could be obsolete tomorrow. Technical problems and glitches have not been uncommon with many types of virtual currency.
- Value fluctuates. For example, between March 2013 and March 2014, the value of the virtual currency Bitcoin fluctuated between $100 and $1200.
- Uncertain tax implications. Under a recent IRS ruling, all virtual currencies will be treated as property for tax purposes and any value gains must be declared (and taxed) as a capital gain—a complicated calculation given the fluctuating value.
- Association with criminal enterprises. Some virtual currencies have been used for illegal drug transactions, arms trading, money laundering, and other criminal activity. To the extent these types of exchanges are associated with a form of virtual currency, users of that virtual currency risk having their investment lost if authorities shut them down.

Consumers should be wary of investment opportunities that promise high rates of return with little or no risk. Always thoroughly research any investment opportunity or offer.

RESOURCES

FinCEN guidance

The Financial Crimes Enforcement Network (FinCEN), a bureau of the United States Department of the Treasury, has issued guidance clarifying the applicability of the Bank Secrecy Act to persons creating, exchanging and transmitting digital or virtual currency. FinCEN also issued guidance regarding virtual currency and investors. See www.fincen.gov.

Internal Revenue Service

The Internal Revenue Service (IRS) has provided guidance on how existing general tax principles apply to transactions using virtual currency. See. www.irs.gov.

Consumer Services Office

Contact the Department of Business Oversight to determine the license status of any financial institution, company or individual and to determine whether disciplinary actions have been issued.

Ask a Question or File a Complaint

Help us protect consumers! If you are a victim or you suspect a licensee of the Department has violated the law or is involved in financial or investment fraud, please file a complaint. Call the Department of Business Oversight Consumer Services Office at 866-275-2677 for a complaint form or file online.