Bitcoin Basics for the Family Law Practitioner

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Bitcoin was first introduced in 2009 by Satoshi Nakamoto, a pseudonym for an unknown individual.[1] Since its introduction in 2009, there are now approximately 14,000,000 bitcoins in circulation.[2] Despite the growth and prevalence of bitcoins, no government entity has established definitive standards for Bitcoin regulation and taxation.[3]

If you think Bitcoin only applies to a select techy few engaged in surreptitious or nefarious activities, think again. Bitcoins are now being used by more and more people to purchase items on the internet, purchase merchandise at brick-and-mortar stores, transact business and even, buy houses. There are now sites like CoinMap.org that offer visual ways to locate stores accepting bitcoins, and new businesses continue to be added to these sites.

As Bitcoin popularity has increased, it has ushered in the growing use of digital and virtual technology to deprive a spouse of marital assets and income.

What Exactly is Bitcoin?

Bitcoin is a virtual currency, existing solely in electronic form.[4] What makes Bitcoin different from other virtual currencies is its adoption of peer-to-peer networking and cryptography.[5] As the first cryptocurrency, Bitcoin is entirely decentralized.[6] It was created in response to growing concerns about the level of control governments have over traditional currencies.[7] By allowing other developers to review and update the code, Satoshi Nakamoto ensured that no particular user could ever control the Bitcoin network.[8] Bitcoin can only operate if all users agree on the protocol, which creates a strong sense of community, strengthening the idea that people control Bitcoin, not the government.[9] It derives its value solely from public perception and the open marketplace, making it far different from traditional currencies, which governments regulate and value using monetary policy.[10]

People obtain bitcoins by either "mining" for them or purchasing them.[11] In the mining process, miners are paid in bitcoins for executing complex computations after they download a software program that allows them to connect to the Bitcoin network.[12] The Bitcoin algorithm is programmed to release bitcoins in deceasing amounts up to a total of 21 million bitcoins.[13] Once this number is reached, no more bitcoins can be created.[14] The miners' work ensures that no users are spending their bitcoins more than once, which creates a system of self-regulation.[15] For those purchasing bitcoins, they can be purchased from an online Bitcoin exchange, through peer-to-peer transfers or as payment for a product or service.[16]

Once bitcoins are obtained, people can then spend the virtual currency in two ways: (1) run a program on their own personal computer or (2) use an account on a website that holds their Bitcoin "wallet."[17] Not all of these websites that hold wallets can be trusted, as recent articles have revealed that some of these websites have actually wrongfully taken the contents of account holders' wallets and left them with very little recourse in the world of cyberspace. The wallets use sets of encrypted keypairs—a public key and a private key—for security.[18] These keys are relevant to how spouses can hide wealth in divorce planning and in later dissolution actions. The public key provides or receives payments while the buyer or seller retains the private key.[19] The public key acts as an address and provides information that a Bitcoin user can access, but only a Bitcoin user's private key can actually approve transactions.[20] Though the public key is traceable, it does not contain any user information.[21] Therefore, by using solely the public key for transaction records, the owners of the addresses remain anonymous.[22] Other than an account number, no personal information is recorded in the Bitcoin ledger.[23] Nor is personal information made available by cross-referencing account numbers.[24] This makes transferring bitcoins a lot like exchanging cash, except that it is being done over the internet, allowing bitcoins to be transferred to anyone, anywhere in the world at any time nearly anonymously.[25]

The United States has yet to clearly state whether Bitcoin users may use bitcoins as currency.[26] In United States v. Ulbricht,[27] which is the well-

continued, next page

Bitcoin Basics
from preceding page

known "Silk Road" case, the court found Bitcoin was money for the purpose of satisfying a criminal charge of money laundering. The Internal Revenue Service, on the other hand, classified Bitcoin as property, which will be discussed further below.[28]

Bitcoin Issues in Your Family Law Case

As briefly referenced above, Bitcoin can be used by spouses to hide wealth. Spouses can transfer the currency between online wallets to friends, family and/or areas outside the legal jurisdiction. These transactions will be virtually without record. The only indication you or your client may possibly have of some type of virtual currency mischief, may be a possible initial withdrawal from a checking, savings or other account possibly used to purchase bitcoins and then a lack of recorded activity afterward to account for that amount. Make sure you consider digital and virtual currencies while engaged in the discovery process. Specifically include digital and virtual currencies in your requests for production and supplemental interrogatories.

A problem area to be aware of involves a spouse who owns a business and was compensated in Bitcoins without any invoice. There would be no record of the transaction.[29] You would want to start with the website for the spouse's business to see if it openly advertises the acceptance of bitcoins.[30] If the site does not, you can go to directory websites such as SpendBitcoins or BitPay to see if the business is listed as a company accepting bitcoins for payment.[31] If you find that the company does accept bitcoins, you may want to prepare a corporate request for production, in which you request all documents regarding all virtual currency assets in the company's possession, custody or control, including, but not limited

to, all documents related to wallets, offline or "cold storage" (this refers to keeping a reserve of Bitcoins offline, not present on the web server or any other computer), websites/web services wherein the company stores or holds virtual currency asset and all documents evidencing any transfers of virtual currency made by the Company to and/or from any third party during the marriage. You will also want to request all documents demonstrating, indicating or listing all public IDs or public and/or private keys the company has used to transact any business in virtual currency. If you think the company may be mining Bitcoin, you will want to request all documents related to the purchase of equipment or software of any kind used to mine virtual currency, as well as all documents related to the amount of virtual currency the company acquired, owned or held at any time through mining. These are just a few of the documents you want to specifically request.

If bitcoins are a substantial enough issue in your case, work with a specialist or expert from the beginning. Use your expert to understand virtual currency transactions. Get very familiar with new terms and technology, like blocks, block chain, wallet, and mining, among many others. Figure out how to subpoena information in the block chain. Have an idea of how the spendable balances of the wallets are calculated and how and where those balances can be spent. Then move swiftly when filing the court action to seek temporary injunctions precluding any transactions in the wallets upon filing the case. Note that discovery, enforcement of discovery orders and collecting on a judgment awarding bitcoins becomes more problematic with overseas companies or parties. Countries encouraging and welcoming Bitcoin innovation and growth are Estonia, South Korea and Finland, all led by a current booming growth in China. Another issue to be aware of is tax evasion.[32] Bitcoin has great potential for facilitation of tax evasion. There are two basic ways bitcoins can generate income: (1) bitcoins can be sold at higher values than the original purchase price, generating a net gain for the seller; or (2) bitcoins can be received by merchants as payment for goods and services and therefore be taxable as if the merchant had received more traditional currency, like dollars.[33] However, because of the anonymity provided by Bitcoin, individuals may choose not to report Bitcoin-related income and instead evade taxes.[34] Pursuant to IRS Notice 2014-21, "if the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has a taxable gain…"[35] In addition, pursuant to IRS Notice 2014-21, a taxpayer who receives virtual currency as payment for goods or services "must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received."[36] If you represent a spouse who is not involved with bitcoins, but whose husband or wife is, you should advise him or her of this potentiality so your client can make a better informed decision as to the signing and filing of any joint tax returns, as well as the future use of Innocent Spouse Relief, and advise your client to seek the advice of a tax attorney certified before the United States Tax Court.

Stay Informed

Cases involving substantial and complex Bitcoin issues require careful evaluation of the complexity, litigation fees, costs and the likelihood of fully collecting the benefits of any favorable court order. Family law practitioners should get informed about Bitcoin and continue to learn about developments in the area of cryptocurrencies. For example, a number of alternative cryptocurrencies, sometimes referred to as altcoins, have now been created. Taking inspiration from Bitcoin's code, some of these alternative cryptocurrencies have formed distinct communities that continue to push their development. There are some that use the same hashing algorithm as Bitcoin, such as Peercoin, Devcoin, Terracoin and Bytecoin, while others use a scrypt algorithm, such as Litecoin, Novacoin, FeatherCoin and WorldCoin.

Case law is also developing. In Florida, the recent case of Florida v. Espinosa, Case No. F14-2923 (Fla. 11th Cir. Ct. July 22, 2016), is an interesting read. There, a Miami judge dismissed charges against a Florida-based bitcoin seller after he was indicted on illegal transmission and money laundering charges. The court found that bitcoin is not a form of money within the confines of Florida's legal system. Some attorneys have suggested that this case may lead Florida's legislators to finally address Bitcoin and consider its potential for abuse.

With all of these recent developments, family law practitioners should be encouraged to learn as much as possible about Bitcoin so they can identify, respond and protect their client as much as possible when cryptocurrency issues arise.

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Endnotes

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4 Matthew Kien-Meng Ly, Coining Bitcoin's "Legal-Bits": Examining the Regulatory Framework for Bitcoin and Virtual Currencies, 27 Harv. J.L. & Tech. 587 (Spring, 2014).

5 Alice Huang, Reaching Within Silk Road: The Need for a New Subpoena Power that Targets Illegal Bitcoin Transactions, 56 B.C. L. Rev. 2093 (November, 2015).

6 *Id.*

7 *Id.*

8 *Id.*; *see also* IRS Notice 2014-21.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 Matthew Kien-Meng Ly, Coining Bitcoin's "Legal-Bits": Examining the Regulatory Framework for Bitcoin and Virtual Currencies, 27 Harv. J.L. & Tech. 587 (Spring, 2014).

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23 Matthew Kien-Meng Ly, Coining Bitcoin's "Legal-Bits": Examining the Regulatory Framework for Bitcoin and Virtual Currencies, 27 Harv. J.L. & Tech. 587 (Spring, 2014).

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27 United States v. Ulbricht, No. 14-cr-68 (KBF), 2014 U.S. Dist. LEXIS 93093 (S.D.N.Y. July 9, 2014)

28 *Id.*

29 Robert Pagliarini, http://www.dailyfinance.com/2014/06/16/bitcoin-high-tech-way-hide-assets-divorce/

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34 *Id.*

35 IRS Notice 2014-21 (*citing* Publication 544, *Sales and Other Dispositions of Assets*).

36 IRS Notice 2014-21 (*citing* Publication 525, *Taxable and NonTaxable Income*).