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Bitcoin: Fad or the Future?

Unanswered questions

- ***How will law enforcement and the IRS cope with the anonymity of Bitcoin transactions?***
- ***How might regulatory changes such as the IRS tax decision affect Bitcoin values, both short term and long term?***
- ***Will security and stability issues continue, and will they compromise confidence in the system?***
- ***Will Bitcoin have to compete with other emerging virtual currencies for dominance?***

If someone told you about an investment that has made some people millionaires overnight and has both a number of high-profile supporters and a global reach, would be be tempted to invest? If you were then told that the same investment also could lose most or all of its value almost overnight, and you might not have access to your money when you need it, how would it sound now?

You've just confronted the debate surrounding the digital phenomenon known as Bitcoin. An alternative currency that exists strictly as digital code, Bitcoin has received a lot of attention. But is it an investment? A network of computers? An underground economy? The future of currency? If you're wondering what all the fuss is about, here's a brief introduction to Bitcoin, how it works, and some of the potential pitfalls it presents.

Bitcoin as currency

Bitcoin isn't a company but rather a virtual currency supported by a peer-to-peer, computer-based electronic cash system first outlined in 2009 by an anonymous person or group using the name Satoshi Nakamoto. Unlike printed currency or coins that are minted, Bitcoin is created by "mining" — using complex software to solve complicated mathematical computations (or contracting with a mining company to do it for you). Solving a problem creates a so-called "block," and the computer that solved it is rewarded with a set number of digital bitcoins, each of which is simply a set of one public and one private cryptographic key. (The units are generally "bitcoins," while the general system is "Bitcoin.") The number of solutions that can be discovered globally per hour (and thus the number of "blocks" created and bitcoins mined) is limited by the system's software code. The total number of bitcoins available to be mined eventually is said to be limited to 21 million. However, most users acquire bitcoins either by buying them with physical currencies such as dollars or accepting them as payment for goods and services.

Advocates argue that the advantages of the system are: (1) it's not controlled by any government's central bank, (2) a global virtual currency facilitates global commercial transactions, (3) every block and Bitcoin transaction is recorded in a public ledger known as "the blockchain," and (4) the payer and payee are anonymous, much like a cash transaction, though recorded transactions are visible to anyone. However, that anonymity has attracted charges that its chief use so far has been for illegal activities such as money laundering; in October 2013, the FBI shut down the Silk Road Bitcoin exchange and seized its assets.

How does a Bitcoin payment work?

Just as a physical wallet holds paper money and change, a digital wallet stores the private software keys that are bitcoins. It makes or receives payments by communicating with the network of other Bitcoin wallets. A growing number of well-known merchants and services now accept Bitcoin as payment. Physical bitcoins, with embedded software keys, are also being minted. However, acceptance of bitcoins as payment is entirely at a seller's discretion; there is no guarantee you'll be able to spend them where you want to or get the value you expect. Also, as outlined below, problems at some exchanges have sometimes impeded access to Bitcoin funds.

Note: *Bitcoin payments are irreversible. Once you complete a transaction, it cannot be reversed. Purchases can be refunded, but that depends solely on the willingness of the establishment to do so.*

Speculating in Bitcoin

Bitcoin's usage as a currency is a ripple compared to the tidal waves of investment speculation it has fueled. "Investing" in bitcoins simply means acquiring them through one of the methods outlined above. However, to say that Bitcoin as an investment is volatile is an understatement. Its value has fluctuated wildly as speculation and confidence in it have ebbed and surged. At the beginning of 2017, one bitcoin was worth about $1,000, and in March 2021 the price topped $60,000 for the first time. In between, Bitcoin

There are still plenty of Bitcoin skeptics, some of whom are concerned about the environmental impact. (Mining enough Bitcoin to maintain the blockchain consumes massive amounts of electricity.) Janet Yellen, the U.S. Treasury Secretary, has called Bitcoin "an extremely inefficient way of conducting transactions." But she also said it "makes sense" for central banks to consider a digital dollar, which could lead to "faster, safer and cheaper payments" — a statement that could open the door to crypto regulation by the Fed in the coming years.

Source: The New York Times, February 22, 2021

investors have been tested — over and over — by gut-wrenching price declines.[1]

For the 12-month period through March 13, 2021, the price of Bitcoin rose more than 1,000%, driven, in part, by a stimulus-fueled surge of trading through brokerage accounts and investing apps.[2] But there was also a noteworthy increase in interest and demand from mainstream U.S. corporations and financial institutions. For example, one long-established U.S. bank announced that it will hold and transfer Bitcoin and other cryptocurrencies on behalf of clients, a major credit-card processor is incorporating cryptocurrencies into its network, and several widely used payment and banking apps already provide various crypto services.[3]

Despite its current lack of connection to any central bank, Bitcoin has been vulnerable to actions by individual governments. In 2013 and 2017, Chinese regulatory crackdowns were accompanied by drastic declines that cut Bitcoin's value in dollars by more than half.[4] In January 2018, regulators ordered the closing of mining operations that were creating more than three-fourths of the world's supply of Bitcoin.[5]

Extreme volatility has led to problems for people trying to make payments in bitcoins. It's hard to use a currency when you're not sure from day to day whether the amount in your virtual wallet is worth enough to buy a Tesla or a tank of gas. Complicating the issue is the fact that the value can vary on different Bitcoin exchanges.

Worse than not knowing how much your bitcoins will buy is not knowing whether they're available to buy anything at all. Cryptocurrency has been subject to cyberattacks that have halted trading briefly on several exchanges. And at one point, one of the largest exchanges abruptly declared bankruptcy and announced that nearly half a billion dollars' worth of bitcoins held there had vanished (though a portion of that amount was subsequently said to have been located). In addition, law-enforcement scrutiny of digital transactions to combat money laundering could interfere with the ability of Bitcoin holders to spend or exchange their funds. If the assets of a digital platform or exchange are seized, as they were with Silk Road, access to digital wallets could be restricted.

The Wild West rides again

So far, regulatory oversight of Bitcoin has been spotty. The currency is not backed by either a government or any physical asset such as gold. Major exchanges are located around the world, and the decentralized nature of the system makes it more challenging for government regulators to get a handle on it. Unlike accounts at FDIC-insured banks, there is no protection for possible loss from a digital wallet. Moreover, a fraudster could pose as a Bitcoin exchange, intermediary, or trader in an effort to lure victims to send money, which is then stolen.

The Internal Revenue Service has said it will treat Bitcoin holdings as property rather than as a currency for tax purposes. That means the sale or exchange of bitcoins that have gained in value since they were acquired could potentially trigger a tax liability. Also, payments made in bitcoins are subject to the same information reporting requirements as any other payments made in property. And wages paid in bitcoins must be reported on a W-2 form and are taxable as income, like any other wages.

Speculation hasn't been limited to the currency itself. Much as the Internet did in its early days, Bitcoin also has spawned an entire ecosystem of startup companies and venture capitalists that want to be part of building out the technology and infrastructure involved in creating and transferring it. In addition to multiple exchanges, companies have begun providing data on the virtual currency's price and status and creating Bitcoin-based products. As with early Internet companies, such ventures are likely to involve a high degree of uncertainty and risk.

Obviously, virtual currency still faces a lot of challenges. If you're considering exploring Bitcoin, either for transactions or as a speculative investment, you should become far more familiar with it than simply relying on this discussion. And because of the issues outlined above, you should be prepared for dramatic price swings and only use money that you aren't relying on for something else.

1-2) Yahoo! Finance, March 17, 2021

3) *The Wall Street Journal,* February 19, 2021

4) *The Wall Street Journal,* February 2, 2018

5) *The Wall Street Journal,* January 11, 2018