Bitcoin's development plagued by scandal and speculation

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Several sensational scandals in the United States and abroad have increased U.S. and foreign governments' scrutiny of bitcoin, an expanding digital currency that critics say is ripe for criminal abuse.

Last June, the U.S. Marshals Service auctioned off 29,657 bitcoins seized in the sensational October 2013 bust of Dread Pirate Roberts, the online name of Ross William Ulbricht.

From the San Francisco offices of his Silk Road firm, Ulbricht was allegedly using bitcoin in illegal drug trafficking on a hidden Internet service known as Deep Web because most search engines can't access it.

The Marshals Service received $18 million in its bitcoin auction from the Silk Road bust. For unknown reasons, the government kept 144,342 bitcoins, then worth $87 million but now down to $43 million. Ulbricht's trial starts Jan. 13.

In another spectacular case, Mt. Gox, a Tokyo-based exchange that was handling 70 percent of all bitcoin transactions worldwide by 2013, abruptly suspended trading, shut down its website and filed for bankruptcy last February. About 850,000 bitcoins, worth $450 million at the time, went missing and were feared stolen.

Bitcoin proponents say it's unfair to point to such scandals as proof of the currency's unreliability. They note that cash, credit cards and stocks are misused for nefarious purposes without losing their legitimacy.

In other words, people commit crimes - not bitcoins.

Jeff Garzik, a bitcoin "core developer" who helps run the worldwide network of computers that records the currency's transactions, said that in the Mt. Gox meltdown, the Tokyo exchange operators were authenticating each transaction with only one digital signature instead of using multiple signatures. That leads him and others to suspect the bitcoins disappeared because of theft, not a systemic malfunction.

The Mt. Gox scandal caused the bitcoin's value to plummet by 23 percent in one day. Other events, happy or sad, have sent it on a valuation roller coaster, from $97 in April 2013 to $1,068 eight months later, and from $635 in mid-2014 to its current worth of $298.

These scandals and volatility led the Internal Revenue Service to begin regulating the currency. Last March, the IRS issued its first guidance for taxpayers on reporting bitcoin transactions.

Unlike the German government, the IRS classified bitcoin not as a currency but as a type of property, to be handled for tax purposes like real estate, stocks or other commodities.

That ruling means taxpayers and bitcoin exchanges will have to keep track of how much money is gained or lost between the time bitcoin is obtained and the time it's spent - the equivalent of capital gains or losses for stock transactions.

While the IRS refusal to classify bitcoin as a currency upset some enthusiasts, Garzik thinks that, for now at least, the decision makes sense.

But he criticized the IRS for failing to exempt smaller transactions that entail miniscule changes in value, up or down.

"The IRS needs to develop a sense of scale," Garzik said. "If you just buy a Coke and a sandwich with bitcoin, there shouldn't be a paperwork requirement for filing taxes."

Garzik and the other bitcoin core developers are helping to boost compliance with the IRS requirement by updating the software so that the exact dollar value of each transaction is recorded in the public "blockchain" along with its 32-digit code and precise time and date.

"The value is being built in" to the software, Garzik said. "Bitcoin engineers like me are scrambling to keep up with the IRS guidance."