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# Coining Terms and Creating Rules for Taxing Cryptocurrencies

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The views expressed are solely those of the author and do not necessarily reflect the views of the European University Institute.

In this article, the author considers the challenges that tax administrations face as they attempt to classify and tax cryptocurrency coins.

Technological advances and the digitalization of the traditional ways of doing business have led to a paradigm shift that has substantially affected the way multinational entities operate, trade, and provide services on a cross-border basis. This change has led to a reevaluation of the tax allocation rules for international transactions, prompting many experts and policymakers to call for the allocation of taxing rights according to the origin-of-wealth principle.

The call to redefine tax allocation rules for the digital economy centers, broadly speaking, on three main arguments:

(i) the need to rethink general international tax principles to redefine source and residence tax allocation rules for business income by creating new taxing parameters — for instance, a digital permanent establishment;

(ii) the fight against base erosion and profit shifting; and

(iii) efforts to mobilize development resources and generate new sources of revenue to meet the sustainable development goals envisaged by the United Nations' 2030 Action Agenda.

One could argue that the cryptocurrency market — along with other markets based on a virtual financial market, including initial coin offering (ICO) systems — grow out of concerns (ii) and (iii), reflecting tighter financial regulatory standards and higher transparency thresholds in the traditional market that have made it harder to disguise illegitimate capital flows and to hold previously untaxed income in a foreign jurisdiction. These more stringent regulatory standards may have inspired the development of a parallel deregulated financial market — a market that many believe now requires greater regulatory scrutiny as part of the BEPS project and related efforts. These new measures should provide parity in the taxation of digital and non-digital financial markets and hence increase countries' ability to collect revenue.

Cryptocurrency markets are, of course, not all based on illicit or illegitimate activity. They are a new mechanism that genuinely seeks to reduce transactional costs and make capital flows more mobile. The problem — or, to put it in a better light, the challenge — facing legislatures is not simply the existence of these new ways of doing business; rather, it is rooted in policymakers' failure to fully understand how these businesses function, keep pace with their ongoing development, and tax them accordingly.

The lack of regulation in these new digital markets has put many of the transparency achievements from multiparty initiatives, including the G-20/OECD Global Forum and the BEPS initiative, at risk because it creates opposing standards for two markets that basically deal in the same instruments — monetary and financial products.

This article will explore these topics more thoroughly.

## Coins: An Overview of the Business Model

As the European Banking Authority (EBA) noted in its 2014 "Opinion on Virtual Currencies" (EBA/Op/2014/08) (EBA opinion), cryptocurrencies existed long before the upsurge of decentralized systems. Loyalty programs in which the user accumulates air miles, Facebook credits, or "e-gold" are all examples of centralized cryptocurrency systems. These currencies — which users could not convert into financial currency — exist in a closed community and serve specific users who participate in, for example, a frequent-flyer program, a video game community, or a specific database. The currencies reward individual participants for their performance or their loyalty to the program and also enable other financial transactions between the user and the issuer.

The newer cryptocurrencies that are the focus of this article operate using a decentralized virtual currency platform called a blockchain. A blockchain is a public register or distributed ledger that contains all transactions in that particular virtual currency, and all transactions are remotely authenticated by all of the users of the system.[1] There are two types of currency in circulation: coins and tokens. This article focuses on the former.

Coins are a type of cryptocurrency that can be exchanged for a widely circulated denominated fiat currency such as the U.S. dollar or the euro. There are over 1,600 coins in circulation. As of September 24, Coin Market Cap lists Bitcoin, Tether, and Ethereum as the top three coins in circulation.[2]

Notably, a coin is a product created by a private party to substitute for a fiat currency. This is the feature of the decentralized ledger business model that generates the most juridical and economic uncertainties intrinsic to this market. That is because the person issuing the virtual currency is not responsible for evaluating the issued cryptocurrency: The issuer's obligations to the buyer are limited to the terms of the private instrument that regulate the transaction, which can be null.

## Understanding Coins

### Conceptual Approach

The OECD, the Financial Action Task Force, and the European Central Bank have each defined virtual currencies, and their respective definitions seem to coincide. Some key characteristics that seem to be implied in all of the definitions include:

- medium of exchange;
- unit of account;
- ability to be transferred, stored, or traded;
- absence of legal-tender status;
- absence of guarantee or backing by any one government; and
- conceptually distinct from e-money.

According to the OECD's "Tax Challenges Arising From Digitalisation — Interim Report 2018":

> A crypto-currency is a digital asset used as a medium of exchange and which relies on cryptography to secure its transactions, to control the creation of additional units, and to verify the transfer of assets. It is a type of virtual currency, meaning a digital unit of exchange that are not backed by government-issued legal tender.

The definition in the Financial Action Task Force's June 2014 report "Virtual Currencies — Key Definitions and Potential AML/CFT Risks" reads:

[1] *See, e.g.*, European Securities and Market Authority, "Call for Evidence Investment Using Virtual Currency or Distributed Ledger Technology," ESMA2015/532 (Apr. 22, 2015). *See also* Tatiana Falcão, "A Token of Elucidation in the Taxation of Initial Coin Offerings," *Tax Notes Int'l*, Aug. 20, 2018, p. 791.

[2] Rankings taken from "Top 100 Cryptocurrencies by Market Capitalization," Coin Market Cap.

> Virtual currency is a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. "real currency," "real money," or "national currency"), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. E-money is a digital transfer mechanism for fiat currency — i.e., it electronically transfers value that has legal tender status. [Emphasis and internal citations omitted.]

Finally, in the July 2014 EBA opinion, the European Central Bank stated that cryptocurrencies:

> are defined as a digital representation of value that is neither issued by a central bank or public authority nor necessarily attached to a [fiat currency], but is used by natural or legal persons as a means of exchange and can be transferred, stored or traded electronically. . . . Although some of the features resemble activities or products that are already within the remit of the EU E-Money Directive, these products are not intended to be included here, as e-money is a digital representation of [fiat currency], which [cryptocurrencies] are not.

Most countries that have regulated the cryptocurrency market have followed a similar approach. Notably, the United States followed the general lines of the definitions proposed above in IRS Notice 2014-21, 2014-16 IRB 938, focusing on the fact that cryptocurrencies are mediums of exchange that may store value but lack legal-tender status. Other jurisdictions have followed the same approach to defining cryptocurrencies, albeit not in the context of tax treatment.

## Tax Treatment

There is, however, no international consensus as to the juridical classification of cryptocurrencies. In the EU and many of its member states, the tendency is for governments to classify cryptocurrencies as financial assets and tax them as capital gains. Generally, the European Central Bank holds that cryptocurrencies do not have the same status as fiat currencies of wide circulation — even though they may be used as a payment method — because they are not legal tender. Still, the EBA opinion acknowledges that cryptocurrencies may acquire the status of foreign currency in the future and become legal tender.

However, in the realm of indirect taxation, the Court of Justice of the European Union in *Skatteverket v. David Hedqvist*, C-264/14 (CJEU 2015), held that bitcoins in particular can be used directly or indirectly as a means of payment and are therefore comparable to a fiat currency. As a result, the Court ruled that cryptocurrencies are subject to VAT upon conversion into a fiat currency. The CJEU agreed with the opinion of Advocate General Juliane Kokott, who concluded that bitcoins are a means of pure payment since the only purpose for possessing them is to eventually reuse them as a means of payment. She wrote: "For the purposes of the chargeable event for VAT, therefore, they must be treated in the same way as legal tender."

Countries across the globe are starting to regulate this market. Brazil has followed in the footsteps of the EU and classified cryptocurrencies as financial assets, subject to declaration through the personal income tax system and taxable as capital gain.[3]

The U.S. Internal Revenue Service has classified cryptocurrencies as property. According to Notice 2014-21, all the principles that apply to the transactions involving a

[3]Brazilian Federal Revenue Service, "FAQ — Imposto sobre a Renda — Pessoa Física — Perguntas e Respostas" (2018).

property located in the United States should also apply to transactions using cryptocurrencies. Likewise, the IRS requires taxpayers to determine the fair market value of the virtual currency in U.S. dollars as of the date of payment or receipt. In contrast, the U.S. Commodity Futures Trading Commission has declared that cryptocurrencies (and bitcoins in particular) may, at least under some circumstances, be classified as commodities.[4]

Cryptocurrencies are considered a financial instrument in Germany[5] and an intangible asset in South Africa[6] and Israel.[7] Meanwhile, the United Arab Emirates deems cryptocurrencies a commodity, with its Financial Services Regulatory Authority stating:

> Virtual currencies, unlike fiat currencies, are not legal tender. However, virtual currencies have "value" in that they can be exchanged for other things of value, with that value being dependent on considerations of supply and demand. In this respect, virtual currencies have much in common with physical commodities such as precious metals, fuels and agricultural produce. Therefore from a regulatory perspective, virtual currencies are treated as commodities, which are not Specified Investments as defined under the FSMR. This means that a "mining" or spot transaction in virtual currencies will not constitute a Regulated Activity in itself.[8]

The United Kingdom has not issued final regulations on this topic. However, HM Revenue & Customs issued a white paper suggesting that, depending on the facts and circumstances, cryptocurrency could be comparable to and taxed like: a highly speculative investment, such as gambling; an instrument from which trading profits are derived; or a capital investment subject to capital gains tax.[9]

Some countries, including Bolivia, Russia, and Thailand, have either temporarily or permanently banned trading in cryptocurrencies until they can regulate the market.[10] As the EBA opinion notes, other countries have prohibited financial institutions authorized to transact business in the country from operating in the cryptocurrency market. China, for example, banned financial institutions registered in China from operating in virtual currencies.

The lack of uniformity in the regulation of cryptocurrencies is clear. This disarray can lead to increased tax evasion and avoidance, particularly to the extent it adds to the list of instruments subject to hybrid mismatch arrangements.

As expected, the first steps toward a coordinated approach to cybercurrencies are emerging from the developed world. On July 2, the leaders of tax enforcement authorities from Australia, Canada, the Netherlands, the United Kingdom, and the United States established a joint operational alliance, the Joint Chiefs of Global Tax Enforcement (J5). The J5's goal is to increase cooperation in the fight against international and transnational tax crime and money laundering. One of the J5's primary concerns is the growing proliferation of cryptocurrencies, which show no respect for national borders.[11] The announcement of the J5's formation followed the G-20 meeting in March at which illicit cryptocurrency activity was a prominent topic of discussion. The G-20

[4] U.S. Commodity Futures Trading Commission, "CFTC Orders Bitcoin Options Trading Platform Operator and Its CEO to Cease Illegally Offering Bitcoin Options and to Cease Operating a Facility for Trading or Processing of Swaps Without Registering," 7231-15 (Sept. 17, 2015).

[5] BaFin — German Financial Supervisory Authority, "Virtual Currency" (no date).

[6] South African Revenue Service, "SARS to Apply Normal Tax Rules to Cryptocurrencies" (Apr. 6, 2018).

[7] William Hoke, "Bitcoin Not a Currency for Purposes of Israeli Tax Law," *Tax Notes Int'l*, Feb. 26, 2018, p. 851.

[8] Financial Services Regulatory Authority (UAE), "Supplementary Guidance — Regulation of Initial Coin/Token Offerings and Virtual Currencies Under the Financial Services and Markets Regulations" (Oct. 9, 2017) (English version accessible through the Abu Dhabi Global Market website).

[9] HMRC, "Tax Treatment of Activities Involving Bitcoin and Other Similar Cryptocurrencies," Revenue & Customs Brief 09/14 (Mar. 3, 2014).

[10] "Top 10 Countries in Which Bitcoin Is Banned," CCN (May 27, 2015). *See also* Stephanie Soong Johnston, "A Many-Sided Coin: The Tax Implications of Bitcoin," *Tax Notes Int'l*, Mar. 17, 2014, p. 971.

[11] Joint Chiefs of Global Tax Enforcement, "Tax Enforcement Authorities Unite to Combat International Tax Crime and Money Laundering" (July 2, 2018). *See also* Nana Ama Sarfo, "The J5 and International Tax Enforcement," *Tax Notes Int'l*, July 23, 2018, p. 331.

specifically slated cryptocurrency issues as a topic for further action by July.[12]

The global nature of this market requires international coordination to ensure consistent tax treatment and legal characterization, both of which will help continue the efforts to prevent BEPS in cross-border transactions.

## Valuation for Tax Purposes

Given the price volatility of virtual currencies, a second issue is to select the appropriate moment to conduct a valuation of the cryptocurrency for tax purposes. I propose four options from a policy perspective:

- *For cryptocurrency to be used as a means of payment*: Conduct the valuation and tax assessment on the date of acquisition or upon receipt of the cryptocurrency from third parties.
- *For cryptocurrency to be used as a means of payment*: Conduct the valuation upon conversion into fiat currency.
- *For cryptocurrencies acquired for investment purposes*: Conduct a valuation on the date of acquisition or receipt, followed by a reassessment at the end of the fiscal year. Tax the gain verified in the tax year.
- *For cryptocurrencies acquired for investment purposes*: Conduct the valuation upon conversion of the cryptocurrency into another payment or investment instrument, such as a token, gold, fiat currency, or another digital currency.

Domestic regulation of this issue is sparse. The United States appears to be one of the front-runners, having set the receipt of the cryptocurrency as the taxable moment. As the answer to question 7 of Notice 2014-21's details, the character of the gain or loss depends on whether the virtual currency is a capital asset in the hands of the taxpayer. For mined virtual currency, the answers to questions 8 and 9 explain that taxpayers should determine the FMV on the date of receipt and should include it in gross income. If the mining of cryptocurrency constitutes a trade or business, then the net earnings from mining are self-employment income and subject to the self-employment tax. Moreover, the U.S. legislation does not distinguish between mediums of payment for the remuneration of services. Therefore, any remuneration paid to an employee in cryptocurrency will constitute wages for employment purposes.

The Netherlands includes bitcoins (in particular) within the array of assets that a taxpayer must declare on the tax return in box 3, which encompasses taxable income from savings and investments.[13] Thus, cryptocurrency is subject to net taxation, and the Dutch authorities apply a fixed tax rate on the presumed (nominal) gains verified over the course of the taxable year. Losses cannot be offset against future gains.

Notably, none of jurisdictions surveyed for this article have laws that address the taxation of a gain or loss upon the conversion of a cryptocurrency into a derivative instrument, such as a token. Jurisdictions that have more advanced legislation on cryptocurrency, such as the United States, do a good job regulating cryptocurrencies when the transactions are as means of payment, comparable to a fiat currency. But neither the keeping of cryptocurrencies for investment purposes nor the exchange of cryptocurrency for a derivative instrument, such as a token, is regulated or even considered in detail by any of the surveyed jurisdictions. This is just one example demonstrating that there is still ground to be covered on the cryptocurrency front, even in some of the most advanced tax systems

## Conclusion

The delayed regulation of the cryptocurrency market may cause significant losses of revenue in jurisdictions where personal income tax is an important part of the national tax mix — including most of the developed world and many

[12] G-20, "Communiqué Annex: Issues for Further Action" (Mar. 20, 2018).

[13] Belastingdienst [Dutch Tax and Customs Administration], "Overige Bezittingen" (in Dutch). *See also* Khadija Baggerman-Noudari, "Netherlands — Individual Taxation," Country Analyses IBFD (accessed May 21, 2018).

emerging economies.[14] This risk may increase significantly if cryptocurrencies outgrow their initial experimental status and become a popular way to pay salaries. Without proper regulation identifying how to tax the underlying revenue, the inherent volatility of the cryptocurrency might spill over to affect individual taxpayers and national budgets alike, potentially putting tremendous strains on the welfare state.

The absence of regulation may also increase the potential for illicit financial flows, tax evasion, and avoidance using blockchain technologies. The anonymity of the parties involved in blockchain transactions may make it difficult for tax authorities to identify the effective beneficiary of income or even simply trace the transaction back to one person or country.

Illicit and criminal activities involving cryptocurrency, including the untapped flow of financial resources arising from corruption and money laundering, may increase. This potential is evident in the indictment that the U.S. government presented to the United States District Court for the District of Columbia[15] on July 13 accusing 12 conspirators of using a variety of means to hack the email accounts of volunteers and employees of Hillary Clinton's U.S. presidential campaign, including the email account of the Clinton campaign's chairman. The indictment alleges that the conspirators used a network of computers located around the world to avoid detection and paid for this infrastructure using cryptocurrency.

The characterization, taxation, and regulation of cryptocurrencies and cryptocurrency markets are policy issues that require urgent consideration. Taxation is just one of the legal arenas that will be affected by these new rules, making cryptocurrency regulation a topic that requires interdisciplinary cooperation to produce a coordinated result. ■

[14] Income taxes — both corporate and individual — remain the most important source of revenues for tax administrations in 17 OECD economies. In nine of those countries — Australia, Canada, Denmark, Iceland, Ireland, Mexico, New Zealand, Switzerland, and the United States — income tax provides more than 40 percent of total tax revenue. OECD, "Revenue Statistics 2017 — Tax Revenue Trends in the OECD" (2017).

[15] U.S. District Court for the District of Columbia, *United States v. Viktor Borisovich Netyksho and others*, 1:18-cr-00215-ABJ (July 13, 2018).