A toss of a (bit)coin: The uncertain nature of the legal status of cryptocurrencies

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3 July 2019

Introduction

- Bitcoins are by far the most popular cryptocurrency, but many others exist. The popular “coins” fluctuate dramatically in “prices”, where realised and unrealised gains are being made by coin-holders.
- The economic substance of cryptocurrencies give them value, but to date the law has not definitively defined this substance. The difficulty is that the transfer of value between the parties involves the transfer of a unique digital file that in itself has no intrinsic value.
- Defining the legal nature of cryptocurrencies and in turn ascertaining what gives them value is important for many reasons. At its most fundamental level the answer to these matters will determine the regulatory framework within which trading in cryptocurrencies may or may not occur.

Introduction

- In regard to the latter matter, at one end of the spectrum, China has effectively banned ICO in cryptocurrencies, particularly Bitcoin.
- Japan, by contrast, has taken the polaristic view that cryptocurrencies are "currency" and sought to support and foster trading in same.
- As to which way a government might turn is anyone's guess: A toss of a (bit)coin!

A toss of a (bit)coin

- Taxation consequence?
- As property, not only will transactions made in the ordinary course of business be subject to tax as ordinary/business income, but non-business tradings may also be subject to income/capital gains tax. The umbrella of transactions caught under this approach may not only include the purchase of cryptocurrencies with the purchase of profit to ad hoc dabblings in such trading.
- Are they a form of tangible or intangible property? Are they a financial product? What are their GST/ VAT implications in such context?
- As to which way a government might turn is anyone’s guess: A toss of a (bit)coin!

Objective of this study

- The current analysis is confined to Australia, United Kingdom, New Zealand and Canada. These nations have been specifically selected as they represent very different positions that have been taken in this context.

Objective of this study

- New Zealand has strongly stated that cryptocurrencies are not currency; not akin to local or foreign currency
- They are a commodity akin to gold bullion and thus subject to taxation under, inter alia, s CB4, and the GST regime
- It is a final product that is subject to the financial markets regulatory regime
- Canada has taken the same approach, being consistent in its tax treatment of cryptocurrencies

Objective of this study

- Australia is schizophrenic
- For CGT purposes it is treated as a commodity
- For GST it is a financial product/money
- For ASIC regulation it is not a financial product

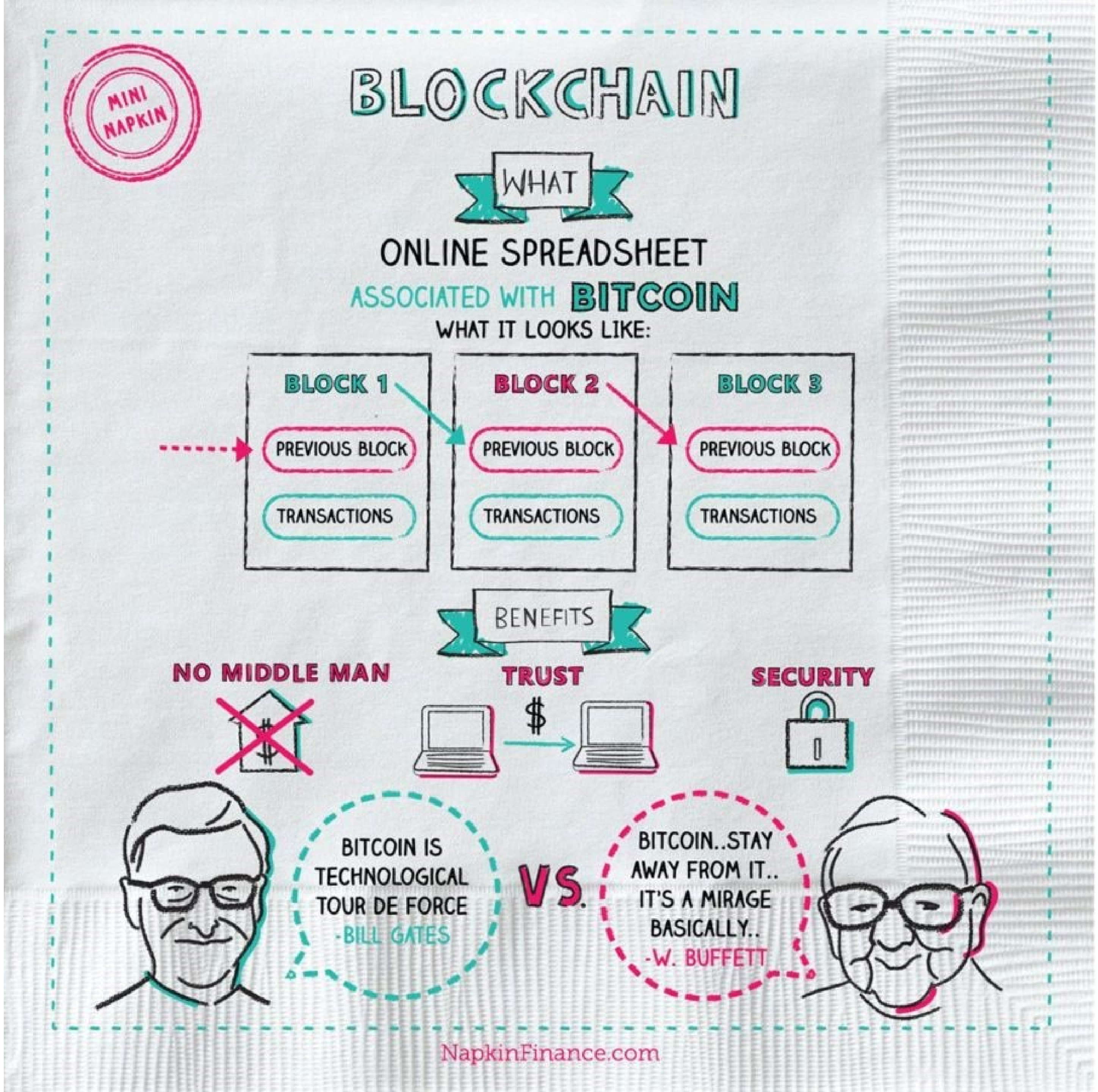
- Equally in the UK it is treated as a commodity for corporations and CGT legislation
- But is treated as currency for VAT purposes

A Brief Technical Outline of Cryptocurrencies

- There is no clear and authoritative definition of Cryptocurrency. The best way to understand cryptocurrencies is to highlight its unique features.
- First, cryptocurrencies such as Bitcoin, are entirely digital. Cryptocurrencies have no physical form. Their foundation lies in no more than the data strings that represent each ‘coin’. A 64-character long identifier represents each coin. The final coin is a ‘chain’ of data strings as each transaction is recorded, adding a new link to the chain. By contrast, other forms of electronic representation of money, known as fiat currencies, may be involved in digital environment, but they still have a physical form, namely coins and notes.

Outline of Cryptocurrencies (cont’d)

- A second feature of cryptocurrencies is the use of cryptography- the crypto prefix.
- Cryptocurrencies are “an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.”
- Each Bitcoin is effectively the solution to a complex algorithm. The solution to the encryption is partially in a public key, and partially in the owner’s private key. These keys are both required to confirm the validity and ownership of a Bitcoin. In turn, you must have the private key, like a pin code, to transfer a Bitcoin. While the private key is needed as proof of ownership, ultimately the system is based on cryptographic proof alone it provides a system of, albeit recorded, anonymity.


MINI NAPKIN
BLOCKCHAIN
WHAT
ONLINE SPREADSHEET
ASSOCIATED WITH BITCOIN
WHAT IT LOOKS LIKE:
BLOCK 1
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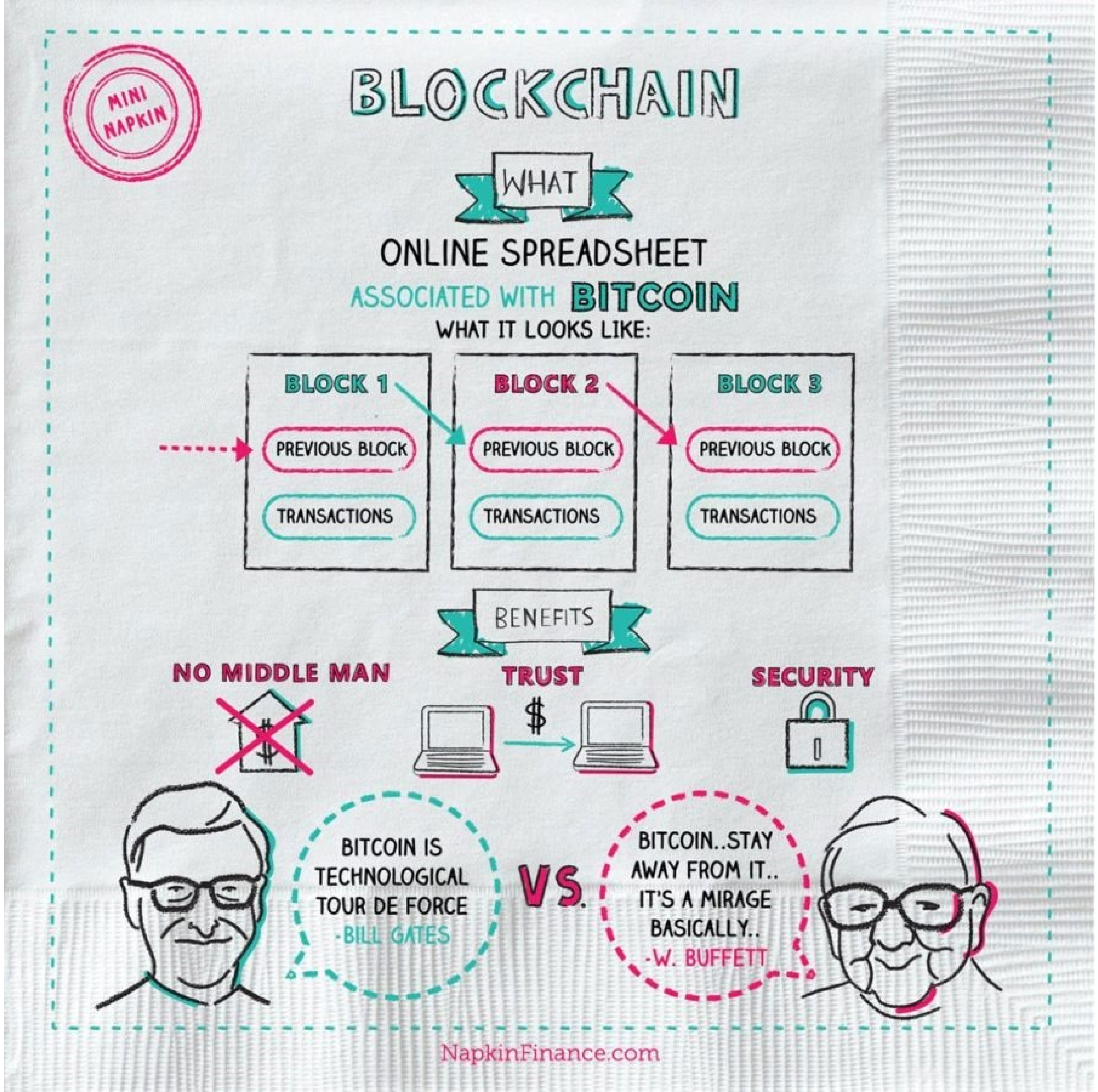
Outline of Cryptocurrencies (cont’d)

- Third, cryptocurrencies are a form of ‘currency’ that is not issued by a sovereign nation; thereby having no connection to a government or state bank.
- Instead each cryptocurrency is contained in its own network. Each time a person interacts with a cryptocurrency, the computer joins that network to record the transaction. More correctly, the transaction is recorded in a public ledger that is constantly ‘talking’ to all the computers in the network. Computers in the network are constantly updating the information and sealing of the recorded parts of the digital ledger by encrypting the record using the above discussed complex mathematical algorithm.
- To incentivise the recording and sealing off of a block in the ledger, computers are rewarded with new currency, known as “native tokens”. In turn, the process of recording and sealing of blocks in the ledger is known as “mining.” The ledger is stored on every computer in the network rather than a central server.

BTC Mining in progress

Blockchain technology

- This sealing off process of new transactions in turn relies on the information contained in previously sealed off blocks in the ledger. Thus each block is a link which relies on earlier links. The linking of the blocks in this way provides the reason why the technology used by cryptocurrencies is known as ‘blockchain’.
- In each cryptocurrency’s blockchain system, there are different players. These players are cryptocurrency exchanges, who facilitate the “purchase, sale and trading of cryptocurrencies”, digital wallets that stored cryptocurrencies, payment systems that facilitate payments using cryptocurrencies (where the cryptocurrencies are used to purchase goods and services) and the above discussed miners who secured the public ledger.
- Definitions of what a blockchain is vary, but the general consensus is that it is a database or ledger of transactions which is distributed over a peer to peer network (such as the internet). It uses a variety of cryptographic techniques and validity rules to reach consensus between participants over changes to the shared database without needing to trust the integrity of any of the network participants.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New Zealand

- Trading in cryptocurrencies in a NZ platform is relatively new
- They are not widely accepted, so mainly traded on unregulated, online exchanges
- Bitconia was an Auckland based currency trader
- Bitconia’s cash and bitcoin assets are held in Mt Gox exchange in Japan, at the time the largest bitcoin trading exchange
- It put into liquidation in April 2014
- The liquidation of the company spurred the IRD to clarify the tax treatment of cryptocurrencies

New Zealand

- The Reserve Bank has also issued concerns for “consumer protection, anti-money laundering, and counter-terrorism financing”
- Recent reports of more than 980,00 Bitcoins stolen per month
- FMA has warned that using cryptocurrencies places consumers in a risky position to be targeted by scammers

New Zealand

- April 2018 IRD “Questions & Answers: Cryptocurrencies and Tax”
- Key aspect was to deny it is a currency at all; not fiat currency or legal tender
- not akin to local or foreign currency
- They are a commodity

Tax position in New Zealand

- Akin to gold bullion as unlike shares there is no return (ie dividends) or other benefits (ie membership rights) from holding cryptocurrencies
- Subject to taxation under, inter alia, s CB4 ITA 2007: Personal property acquired for the dominant purpose of profitmaking from resale
- Deductions for purchase price and any other related expenditure (‘mining’ expenditure?)
- As they are a commodity, not an exempt financial product, GST should be payable on transactions
- “Value transfer service”

Tax position in New Zealand

- FMA, October 2017 “Initial Coin Offers”
- Security for the purposes of the FMCA
- ICOs are debt securities, equity securities, managed investment products or derivatives

Tax position in Canada

- A commodity akin to shares
- Subject to taxation under, inter alia, CGT
- As they are a commodity, not an exempt financial product, VAT should be payable on transactions

And then there is Australia

- Australian businesses were more comfortable that New Zealand accepting Bitcoin as legal tender
- However, the limited use was such that ATO refused to consider it currency, in particular not foreign currency as not recognised as “Money”
- 2013 Reserve Bank issued a briefing paper discussing some of the issues stemming from the trading of cryptocurrencies
- Again many concerns about consumer protection, anti-money laundering and counter-terrorism financing

Australia: Tax position

- ATO followed with a series of public rulings
- Australia is schizophrenic (to be explained)
- ATO 18 December 2014 TD 2014/26 “Tax Treatment of Crypto-currencies in Australia – Specifically Bitcoin”
- For income and CGT purposes (it is treated as property within the definition of an assets (s 108-5) and the sale same taxable under CGT Event A1 (s 104-10) disposal of an asset
- In determining its CGT character focus was on the control of the Bitcoin and its value in the digital wallet

Australia: Tax position

- Initially, for GST it is property
- Therefore 10% GST must be charged on transactions
- By contrast exchange of currency would be exempt
- Businesses accepting Bitcoin for purchases were potentially subject to double taxation
- Other jurisdictions extended the exemption to cryptocurrencies

Australia: Tax position

- FinTech industry lobbied for an exemption
- Led to Senate Economics Reference Committee Inquiry into Bitcoin and digital currencies
- 2015 report highlighted the consequent double tax treatment issue and recommended an amendment to the GST ACT to be treated as a financial supply
- Productivity Commission “Business Set Up, Transfer and Closure” Report 2015 agreed that to be competitive the law had to be changed
- The “Backing FinTech Statement” supported the reforms, in particular the needed changes to the GST

Australia: Tax position

- Outcome: new definition of digital currency in s 9-10(4) GST Act, , retrospective effective from 1 July 2017
- Effect: supplies and acquisitions using digital currencies are exempt from GST
- GST will only apply for transactions using digital currencies to buy or sell other digital currencies

- For Courts have held that for ASIC regulation it is not a financial product (Senate Economics Reference Committee Inquiry)
- ASIC is moving forward on how to regulate initial coin offerings but to date can only say that it “might be” a financial product

Taxation position in UK

- UK also classifies cryptocurrencies in different way depending on the taxation regime
- Profits and losses are included in the normal rules imposed by the corporations tax
- Gains from exchange movements are also included in the corporations tax

- It is treated as a commodity for CGT purposes

- But is treated as currency (akin to a negotiable instrument) for VAT purposes
- Exempt from VAT under Article 135(1)(d) of the EU VAT

Conclusion

- The above discussion highlights the very different stances that governments may take towards cryptocurrencies.
- At one extreme the government may prohibit the creation of ICOs, declare that they are not a form of legal tender and prohibit trading in cryptocurrencies. As in China, such transactions may be illegalConcerns as to cryptocurrencies use in money laundering and illegal activities clearly underpin this approach in China and Korea.
- Japan, by contrast, has taken the polaristic view that cryptocurrencies are “currency” and sought to support and foster trading in same. Clearly this is spurred by this Nation’s embrace of e-commerce and the benefits that flow from same.

Conclusion

- If trading is allowed how are they to be taxed? Regulated?
- The above discussion highlights the very different stances that governments may take towards cryptocurrencies.
- If it is to obtain the status of "currency", whether that be foreign currency or equivalent to local currency, will be determined by the government of the relevant jurisdictions. To this end in the case of the UK VAT and Australia's GST, cryptocurrencies are treated as a legal form of tender, "currency".
- By contrast, in the case of New Zealand, Canada and Australia's CGT, it may be determined that transactions involving cryptocurrencies merely involve the sale of property, akin to the sale of shares, futures, or in some cases the parallel that is drawn is gold bullion or oil.
- As to which way a government might turn is anyone's guess: A toss of a (bit)coin!

Conclusion (cont’d)

- This in turn raises many difficult tax issues. Due to the rapid growth of the digital economy, the taxation of cryptocurrencies presents a great challenge to the existing tax system. In particular, the nature of cryptocurrencies often poses problems in determining the source of tax. Both domestic tax laws and double tax agreements (‘DTA’) are based on the core notions of “source” and “residence”, at times domicile.
- One challenge to the application of an income tax system to trades in cryptocurrencies is the difficultly in determining the source of the income. In turn, should the tax be imposed by the source country of the enterprise/exchange or to the tax resident trader? In an era of digital economy, electronic transactions are often characterised by a lack of physical nature. In particular, it is difficult to apply the traditional concept of tax residency in the context of cryptocurrency trading. This impacts not only on issues of source and residence, but also complicates the tax collection process.

Conclusion (cont’d)

- Characterising the cryptocurrency is going to be the key to the assessability of any gains made through trades. If they are treated as a commodity, then existing business income, personal income and capital gains tax provision can apply and assess these gains.
- A further issue relates to the valuation of the sales and cost base from the exchange of cryptocurrency. As the price of cryptocurrency is fluctuating, there is a lack of objective valuation method and trading platforms to determine the value of the cryptocurrency.
- A related issue is to decide the types of expenditure eligible for tax deduction. For example, should the electricity expense related to the mining of the cryptocurrency be deductible? Also, many taxpayers are holding their cryptocurrency in “paper wallets” or other physical devices. Should cost/loss be tax deductible when the taxpayers lost access to their crypto wallets or when their cryptocurrency being embezzled by hackers such as Coinbase in Japan.

Conclusion (cont’d)

- Whether it is consider a financial product akin to a share, also entails further tax and non-tax issues. Financial products and regulated under securities legislation, normally administered by a State authority. If cryptocurrencies are not considered financial products they will not be under the umbrella of such regulations. From a tax perspective, if they are considered financial products, trading in cryptocurrencies will again be subject to existing business income, personal income and capital gains tax provisions. However, financial products are normally exempt from GST/VAT.
- There are further issues in the context of GST/VAT. If a cryptocurrency is deemed to be a commodity in as in China, the trade between a legal and a digital currency for a consideration would constitute a supply for VAT purposes. By contrast if it is treated as currency, as in Australia and the European Union, the exchange of cryptocurrency and a digital currency is VAT exempt.


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