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Cryptocurrencies: Decrypting the past, regulating the future

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Interest in cryptocurrencies has grown significantly since the inception of bitcoin in 2009. Widely regarded as the next evolution in financial services technology, cryptocurrencies offer the promise of increased speed and accuracy in payment processing; greater access for the unbanked; and a detachment from centralised monetary policy. While trading in cryptocurrency has historically been dominated by speculators, which contributed to notorious price volatility, institutional investors are starting to take note as this asset class matures and gains mainstream acceptance.

The increasing trading and applications of cryptocurrencies have given rise to a number of legal and tax issues, with many yet to be satisfactorily resolved. As regulators around the globe struggle to keep pace with the challenges posed by these rapid advancements in technology, change will come, and it is therefore important for investors and coin issuers alike to be properly versed on the implications moving forward.

First there was bitcoin…

Bitcoin was the first decentralised cryptocurrency to have been developed. The bitcoin blockchain comprises a series of blocks which record transactions between different addresses. The entire blockchain can be downloaded from the Internet and any interested party may study it as they wish. Unlike other fiat currencies, which can be devalued by monetary policy, there will only be 21 million bitcoins in this universe. What this means is that this digital token cannot be devalued by simply generating more coins. The decentralised nature of bitcoin transactions are designed to keep it further out of reach of any single regulatory or government authority.

The dominance of bitcoin, however, has been gradually slipping as different cryptocurrencies have been introduced. Currently, the second most valuable cryptocurrency, by total market capitalisation, is ether, the form of payment on the ethereum blockchain.

Then there was Initial Coin Offerings (ICOs)

The rising popularity of cryptocurrencies is evidenced by the rapid increase in ICOs. This is a funding structure whereby a new blockchain venture issues its own token to investors as opposed to traditional shares or debt. ICOs are often structured as an exchange of ether or bitcoin for a pre-determined amount of the new token, but new and novel pricing mechanisms are starting to emerge.

It is worth noting that the economic motivation behind participating in an ICO is slightly different from the purchase of debt or equity in a new venture. Investors will only realise an economic return if there is demand for the token itself, which can come in the form of fevered speculation or a real world business case. A factor that led to a rise in the price of ether in recent times was the rising demand from purchasers who invested in ICOs. It is perhaps not surprising then that the price of ether has since retreated as these new ventures progressively cash out of their holdings to fund their projects with fiat currency.

A murky history…

Along with its merits, the anonymity of cryptocurrencies has also made this the payment method of choice for criminals and dark web users. This anonymity can be further enhanced by *'tumblers'*, which causes a mixing of cryptographic funds to further obfuscate the original source and the addresses involved in a transaction. As seen in the recent WannaCry ransomware attack, victims were instructed to make payment in bitcoin in exchange for unlocking their computers.

There have been also some high profile cases of cryptocurrency exchanges being hacked, resulting in significant losses. The Tokyo-based Mt Gox exchange was the world's largest bitcoin exchange at the time it was hacked in 2014, leading to the exchange declaring bankruptcy. The Hong Kong-based exchange Bitfinex was also hacked in 2016, losing over US$70 million of digital currency. As such, regulators are looking to prevent further exploitation of cryptocurrencies.

Regulatory and tax considerations

While regulatory status of cryptocurrencies varies from country to country, the regulatory response tends towards a middling position – cryptocurrencies are generally not considered to be legal tender, though it is also not illegal to use them in transactions.

However, the growing awareness and vendor acceptance of cryptocurrencies have led to increased analysis by central banks and regulators. There are early signs that the pendulum seems to be swinging towards cryptocurrencies being brought within the regulatory mainstream, though these are not without their challenges.

Regulatory Issues

Currently, the issue of a new token is generally regarded as not amounting to a *'security'* for securities law purposes, and therefore falls outside of existing regulatory regimes. Similarly, ICOs are being conducted with comparatively light informational disclosures and none of the investor protection mechanisms, which are common for a standard IPO or debt issue.

A key risk area is the manner which the individuals sponsoring an ICO are incentivised. It is common for sponsors to pre-mine a significant amount of the tokens which are issued and retain these as part of their incentive. The lack of regulation also means that there is little stopping a sponsor embarking on a pump-and-dump once the token is listed on a public cryptocurrency exchange (which can happen within days of an ICO). There is also the potential for price manipulation and trading on asymmetric information in a manner which would be insider trading if the tokens were securities. Regulators are certainly aware of the challenges presented by cryptocurrenices and are proceeding with caution.

Income tax

There are a significant number of tax issues associated with the trading of cryptocurrencies. The position of traders, who are not subject to a worldwide basis of taxation, requires close analysis. For example, a Singapore-based trader may be able to take a position that their frequent trades are not subject to local taxation as capital gains, given the current administrative position of the IRAS in relation to share trading gains made by individuals.

However, if they choose to trade cryptocurrency on a Hong Kong based-exchange, a comprehensive double tax agreement is not in place between both countries. As such, the trader will be unable to assert that they are not permanently established in Hong Kong and, hence, exempt from tax on that basis.

Value added tax

The application of value added tax regimes to cryptocurrencies is another area of complexity. In Singapore, the IRAS regards the supply of cryptocurrency as a supply of services. If cryptocurrency is used as a mode of payment to a foreign supplier, the supply of the cryptocurrency is zero-rated. As the annual registration requirement in Singapore is S$1 million, the risk of double taxation should only be of concern to frequent or high-value traders. In similar jurisdictions where these issues arise, it is necessary to consider core propositions, such as whether a trader is carrying on a business of trading in cryptocurrency, and whether they have a sufficient jurisdictional nexus for indirect taxes to apply. The outcome is typically highly fact dependent.

Common reporting standard (CRS)

Modelled on the US Government's Foreign Account Tax Compliance Act, the CRS is an international initiative for the automatic exchange of financial account information. This information flow is intended to ease the detection of offshore financial accounts by tax authorities and thus encourage higher levels of disclosure of offshore funds by taxpayers. An immediate question is whether the CRS reporting will apply to cryptocurrency exchanges. This ultimately depends upon whether a participating country regards these exchanges as financial institutions.

Perhaps the most troubling gap is that there is no way for CRS to apply to the reporting of a cryptocurrency which is held outside of the financial system. The bulk of bitcoin remains undetectable until they are converted into fiat currency on an exchange, or by way of an over-the-counter trade where funds are settled into a bank account. With this in mind, it is then little wonder that exchanges are now coming under increased scrutiny from an anti-money laundering and know your customer perspective.

Moving forward

To invest into cryptocurrencies, it is important to remain up to date on the regulatory and tax developments as they unfold. One of the key decisions which needs to be made is which exchange cryptocurrency is to be bought and sold. The jurisdiction in which that exchange operates may represent a touch point sufficient to create a taxable nexus. This could lead to a range of potential disclosure, withholding and other tax-related implications. Investors must be savvy enough to reap the most out of their cryptocurrency investment.

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