
Kluwer International Tax Blog

Tax Administrations and Cryptocurrency Control Strategy

Alfredo Collosa (CIAT, IMF) · Friday, April 9th, 2021

Introduction

The Covid-19 pandemic has produced an exponential increase in e-commerce, with new business models to market goods and services, and also a profound change in the consumption habits of the population, including forms of electronic payments, such as cryptocurrencies.

On the one hand, there is a huge loss of revenue from this crisis. Still, at the same time, everyone is looking more closely than ever at the performance of the Tax Administrations (TAs), as there is a need to safeguard tax revenue to protect the financing of expenditures needed to address the crisis, including the maintenance and expansion of government social protection programs. Above all, the TAs must be ready to restore levels of compliance as soon as possible.

We are witnessing an increase in the use of cryptocurrencies as means of payment, as well as a form of savings and investment.

In general, those are currencies based on advanced cryptographic technologies that allow their issuance, validation, and registration in a decentralized manner.

Their acquisition, sale, use, or possession have an undeniable tax significance. However, in many countries, their tax treatment has not yet been clearly specified. Still, the TAs of many countries are putting in place different control strategies of cryptocurrencies.

Therefore, this comment's aim is to try to provide some ideas of what actions the TAs should promote as a control strategy for cryptocurrencies exchanges.

Challenges for tax administrations

In the first place, there is no uniform tax treatment in the different countries. As the OECD warns in its report "[Taxing Virtual Currencies](#)", there is a lack of comprehensive guidance or a framework for their tax treatment, which is partly due to the complexity of defining the treatment applicable to these assets in a way that covers all their various facets, as well as their complex and rapidly changing nature.

Regulations are also important to protect consumers. In this regard, Spain recently approved that the National Securities Market Commission regulates the advertising of crypto assets.

Besides, for countries in general and TAs in particular, the following difficulties arise:

- lack of centralized control over crypto assets;
- pseudo-anonymity, with difficulties related to obtaining the information of the operations, mainly in the identification of the corresponding intermediary, the reportable event, the available reportable information, and the valuation of the assets;
- valuation difficulties resulting, mainly, from sometimes high volatility, lack of a uniform database, and often inadequate documentation;
- hybrid features, which refer to difficulties in classifying a financial instrument or an intangible asset; and, last but not least,
- the rapid development of the underlying technology (blockchain).

Likewise, as the [FATF \(Financial Action Task Force\)](#) constantly alerts, crimes such as money laundering and financing of terrorism, drug trafficking, illegal arms smuggling, fraud, tax evasion, cyberattacks, evasion of sanctions, child exploitation, and human trafficking could be committed through the use of cryptocurrencies.

The Agency recognizes that virtual assets are an innovative technology to transfer value globally, especially for sending payments and reducing commissions.

For this reason, the Agency recently published a report aimed at combating money laundering and terrorist financing. The report highlights, among others, the following difficulties in its control:

- technology features that increase anonymity, such as the use of peer-to-peer exchange websites, mixing or flipping services, or anonymity-enhanced cryptocurrencies;
- geographical risks, since criminals can exploit countries with weak or non-existent national measures for virtual assets;
- the structure of crypto-asset transactions, that is, the amounts that are made in small amounts or in amounts below the amounts that institutions must report when they encounter an alert, similar to the case of cash transactions;
- carrying out multiple high-value transactions, or in short succession;
- sender or recipient profiles plus unusual behaviour suggesting criminal activity; and, last but not least,
- source of funds or wealth, which may be related to criminal activities.

The FATF has updated its “Guidance for a risk-based approach to virtual assets and VASPs”. [Previous FATF guidance](#), released in 2015 and updated in 2019, recommended regulating virtual assets in a similar way to traditional finance, in practice mandating customary KYC/AML laws that affect most financial entities.

The present document is only a draft, and the [FATF accepts public comments on it until April 20](#).

As explained above, the challenges faced by the TAs are many and go beyond the strictly fiscal issue.

Tax administrations control strategy

The TAs cannot remain inactive on this issue, while waiting for multilateral solutions where a consensus is reached on how cryptocurrencies should be taxed.

Although on this issue, as on the topic of the digital economy, the multilateral solution is optimal, as long as this does not happen, the TAs should act quickly.

The TAs must work with the regulatory framework of their country and determine in each specific case if there are taxable events that are subject to taxation. Still, I think they can contribute a lot to proposing regulatory changes necessary to give certainty to the issue, consumer protection and, above all, improve their control strategy.

As the OECD affirms in its report, each country must have clear guidance and an applicable legislative framework, where guidance is provided on how virtual currencies fit into the existing tax framework, that is, a guide that is comprehensive and addresses the main taxable facts and forms of income associated with the virtual currencies.

In this sense, the [US IRS](#) has been working actively and warns that, according to its legislation, the sale or other exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or the possession of virtual currencies as an investment, generally has tax consequences that could result in tax liabilities. They have issued IRS Notice 2014-21, IRB 2014-16, as a guide for individuals and businesses on the tax treatment of transactions using virtual currencies.

The IRS also published Frequently Asked Questions (FAQ) on Virtual Currency Transactions for people who own cryptocurrency as a capital asset and are not involved in the cryptocurrency trading or selling business.

HM Revenue & Customs, the United Kingdom's tax authority, just published new guidance on cryptocurrency taxation. The update, published on March 30, consolidates two existing pieces of guidance on crypto tax into a single "crypto manual".

To date, HMRC has published two separate documents offering advice on crypto taxation on its website – one for individuals and the other for businesses. The guidance was last updated in December 2019.

HMRC's 2019 guidance also stated that individuals would be liable to pay income tax and national insurance contributions on crypto received from an employer as a form of payment or through mining, transaction confirmation, or airdrops. The crypto sector has changed significantly since then.

The main difficulty is the lack of information, which is why the TAs, more than ever, should promote cooperation with other organizations and institutions, both internally and internationally.

The issue is very complex, since, as stated by Ms Begoña Pérez Bernabéu[1], although the TAs have access to the information stored in the blockchain, they would still need to be able to link the public key with the real identity of a taxpayer to ensure compliance with the tax obligations on the part of the latter.

For this purpose, in the US, the IRS formed a special working group whose mission is to reduce tax evasion with cryptocurrencies. The unit is made up of agents trained in tracking cryptocurrencies and the services of blockchain analysis companies.

The creation of 'Operation Hidden Treasure' will establish a team of specialists having the goal to reverse-engineer blockchain transactions, find undeclared Bitcoin purchases, and trace them back

to the taxpayers that own them.

The key element is that these companies analyze blockchain using modern techniques and allow cryptocurrency transactions to be deanonymized, and thus attributed to US taxpayers.

As an example, the blockchain and [cryptocurrency](#) analysis company, CipherTrace, released its new tool called “CipherTrace Traveler” that complies with anti-money laundering requirements and some suggestions that the FATF would have proposed years.

The Australian Taxation Office (ATO), for its part, has in recent years been pushing hard to ensure that cryptocurrency investors [declare their holdings](#) appropriately – and, in 2019, it [launched](#) a data-matching program that [uses third-party data](#) to expose the assets of the estimated nearly 1m Australians that have invested in cryptocurrencies.

That [program](#), which partnered the ATO with agencies including the Australian Transaction Reports and Analysis Centre (AUSTRAC) and Australian Securities and Investment Commission (ASIC), leverages on J5 assets that include “cryptocurrency and cyber experts” from Australia, the UK, Canada, and the Netherlands as well as the IRS Criminal Investigations unit – the same one supporting the Operation Hidden Treasure taskforce.

In South Korea, the [National Tax Service \(NTS\)](#) has issued a warning to the crypto traders that they have to report their earnings even from tokens held in foreign exchanges. The agency alerted that South Koreans who are using overseas exchanges are also responsible for reporting all their profits gained. By doing so, crypto holders should pay correspondent taxes on them from 2022.

For its part, the European Commission is on the verge of preparing a reform to improve cooperation between national tax authorities so that they have a greater capacity to identify taxpayers, who are actively using new means of payment and investment, such as crypto assets and electronic currencies, and thus be able to reduce fraud and evasion.

The work of this initiative is still in a preliminary phase, but it has recently published a public consultation on an extension of the current directive on administrative cooperation (DAC 8) so that it also covers crypto assets and digital money.

The OECD plans to begin in 2021 to collect and exchange information on these assets at the national level, taking advantage of the experience of the automatic exchange of financial accounts, according to the “Common Reporting Standard” (CRS), which has been operating since 2017, increasing, year after year, participating countries, accounts reached, and amounts covered.

Another very important issue is that the TAs include the issue in their tax control plans.

In this regard, the AEAT of Spain in its 2021 Annual Tax and Customs Control Plan in relation to cryptocurrencies proposes the following actions:

- obtaining information from various sources on operations carried out with cryptocurrencies;
- systematization and analysis of the information obtained to facilitate the actions of control of the correct taxation of the operations carried out and the origin of the funds used in the acquisition of cryptocurrencies; and
- develop international cooperation and participation in international forums to obtain information on operations with cryptocurrencies and other virtual assets.

Other control strategies relate to preventive control actions, such as sending letters or informing the taxpayers about the information collected by the TAs.

In this regard, the IRS periodically sends letters to taxpayers with transactions in virtual currency, which potentially do not report income or pay the tax resulting from transactions in virtual currency or do not report their transactions correctly.

I also consider it vital that the TAs permanently train their staff to carry out a better cryptocurrency control strategy.

The training refers not only to in-depth knowledge of the subject but to new skills to use modern data analysis and research techniques. The use of the latest technologies by the research units of the Tax Administrations for the collection and analysis of information in all types of networks is very important.

I believe that TAs should work together with other public and private organizations to promote the transparency of these type of operations and, where appropriate, collect the corresponding taxes.

Obviously, in many cases, cryptocurrencies' control strategies require regulatory changes, excellent information management, intelligent control plans, and human resources training with new digital skills.

In short, today more than ever, it is vital that TAs obtain information about the actors and their economic activities, as well as the regulatory capacity, to determine their obligations, plus the management capacity to implement legislation efficiently.

[1] The Tax Administration against the anonymity of cryptocurrencies: the pseudonymity of Bitcoin BEGOÑA PÉREZ BERNABEU. VI Meeting of Financial and Tax Law IEF Spain 2018.

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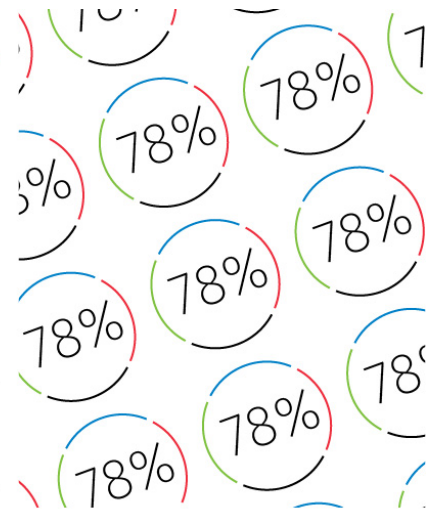
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