International

Bitcoin Transactions: Recent Tax Developments and Regulatory Responses

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The author examines the current treatment of Bitcoin in numerous EU and non-EU countries, and analyses the opinion of the Advocate General in a Bitcoin case that is currently pending before the European Court of Justice.

1. Introduction

Virtual currencies, such as Bitcoin,[1] are an innovative payment method with ever-growing global popularity. Created to free people from government oversight and bank charges, they are slowly acquiring mainstream acceptance and, at the same time, are causing concerns for regulators and tax authorities worldwide. The UK HMRC has observed that “cryptocurrencies have a unique identity and cannot therefore be directly compared to any other form of investment activity or payment mechanism”.[2] The fact that virtual currencies do not fit easily into existing legal categories raises the question as to how Bitcoin should be treated for tax purposes and whether it may trigger any financial reporting obligations.

This article will examine the treatment of bitcoin for VAT and financial reporting purposes, and will describe some recent developments in these areas. Following a brief introduction to the topic, the focus shifts to VAT treatment. The most pivotal questions in this context are whether exchanges of bitcoins constitute taxable supplies under the VAT Directive (2006/112)[3] and, if so, whether a VAT exemption may be applied. Tax authorities seem to have different opinions on this matter. On 16 July 2015, the Advocate General (AG) Juliane Kokott gave her opinion to the Court of Justice of the European Union (ECJ) on the VAT treatment of bitcoin exchange services.[4] In her view, such exchanges are exempt. This article analyses and critically evaluates her opinion.

Next, the author examines whether the possession of bitcoins may trigger reporting obligations under the US Foreign Account Tax Compliance Act (FATCA). Finally, a summary is provided of the statements on Bitcoin made by various regulatory bodies (European Banking Authority, European Central Bank, European Securities and Markets Authority, US Financial Crimes Enforcement Network and Financial Action Task Force).

2. Virtual Currency and Bitcoin

Virtual currency is a digital representation of value that seeks to act as a medium of exchange, store of value and unit of account, but does not have legal tender status.[5] It has no physical existence. It is distinct from both fiat currency (i.e. national money, such as the euro or US dollar) and electronic money (which is a digital representation of fiat currency). Although there are many virtual currency schemes and each has its own unique characteristics, it is possible to divide them into categories based on their use (community-related versus universal) and way of operation (centralized versus decentralized). Community-related currencies are transferable only within a particular community or a virtual world, for example within massively multiplayer online role-playing games (MMORPGs), whereas the use of universal currencies is not limited to a particular environment (they can be used to purchase all kinds of real goods and services on the market).

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1 This article follows the convention established by the official Bitcoin website of capitalizing “Bitcoin” when describing the concept of Bitcoin or the entire network itself, and not capitalizing “bitcoin” when describing the bitcoin as a unit of account (often abbreviated BTC or XBT). *See* http://bitcoin.org/en/vocabulary.

2 UK: HMRC, *Revenue and Customs Brief 9 (2014): Bitcoin and Other Cryptocurrencies* (3 Mar. 2014), available at https://www.gov.uk/government/publications/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies.

3 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347/1 of 11 Dec. 2006 (hereinafter: the VAT Directive (2006/112)), EU Law IBFD.

4 SE: Opinion of Advocate General Kokott, 16 July 2015, Case C-264/14, *Skatteverket v. David Hedqvist*.

5 Financial Action Task Force (FATF), *Virtual Currencies: Key Definitions and Potential AML/CFT Risks* (June 2014), available at http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf.

Decentralized virtual currencies have no central administering authority or oversight, but are distributed via peer-to-peer networks. In contrast, in centralized currency schemes, there is a single institution that controls the system and may issue and redeem currency units.[6]

Bitcoin is by far the most famous example of a universal decentralized virtual currency scheme. It is said that the creation of Bitcoin was a response to the financial crisis, the reactions of governments thereto and to the role of banks and other payment intermediaries in mediating financial transactions. Bitcoin is run by open-source-software, so that anyone with sufficient technical knowledge can contribute to the improvement of its operations. Bitcoins are represented by unique strings of numbers and letters and are divisible into smaller units. Their number is capped at 21 million (projected to be reached by 2140). Bitcoin offers some substantial advantages over traditional paper-based currencies. One of its most appealing characteristics is that it allows all parties to preserve anonymity in transactions. Although all bitcoin transactions are publicly available in a transaction register, they are not linked to individuals. Another advantage of the Bitcoin system is the lack of transaction fees associated with a fund transfer, as transactions take place over a peer-to-peer network. The fact that Bitcoin is subject to enormous value fluctuations has made it attractive for speculative investors.[7]

Although the Bitcoin system is used by an increasing number of people, many of its users are not fully aware of the credit, liquidity and operational risks they take due to the fact that the system lacks regulation or public oversight. Bitcoin transactions are irreversible and the system has no built-in mechanisms to protect customers against fraud. Malware and hacker attacks are also a constant concern, and may result in the loss of accumulated bitcoins. In February 2014, the then biggest exchange platform, Mt. Gox, closed its website and filed for bankruptcy protection after 850,000 bitcoins (approximately USD 450 million) belonging to customers and the company were stolen due to hacking into its computer system.[8] In January 2015, Bitstamp, a Slovenia-based bitcoin exchange platform, halted operations and reported that 19,000 currency units had vanished in a hacking attack.[9] Due to its anonymity and nearly untraceable transactions, Bitcoin has appeal for criminal activity. It became associated with the website Silk Road, a “digital black market” accessible only through the anonymized browsing service.

Although Bitcoin has been in operation since 2009, little is known about the characteristics of Bitcoin users. The anonymity of the system prevents an analysis of the Bitcoin community and the motives for the use of this virtual currency. In empirical literature, there have been some attempts to examine the characteristics of Bitcoin users and their motives. Lui (2013) conducted a survey among members of the Bitcoin community and identified three main motives for the use of this currency scheme, namely curiosity, profit and politics.[10] However, his findings cannot be representative of a larger group as, for example, those planning to use Bitcoin for illegal activity were unlikely to participate in the survey. Yelowitz and Wilson (2015)[11] collected Google Trends data (from January 2011 to July 2013 for all US states and Washington DC) to examine the motives for using Bitcoin. They found that computer programming enthusiasts and illegal activity are positively associated with Bitcoin use, whereas no such association can be identified for political or investment motives.

3. VAT Treatment

3.1. Introductory remarks

EU VAT is levied on supplies of goods and services effected for consideration within the territory of the European Union by a taxable person acting as such.[12] In the context of virtual currency, the two most interesting VAT questions are (i) whether exchanges of bitcoins (for fiat currency and other goods and services) constitute taxable supplies under the VAT Directive (2006/112) and, if so, (ii) whether a VAT exemption may be applied.

One of the inherent features of the EU VAT system is that the mere payment of money is not regarded as a supply of goods or services and has no VAT consequences. Although the VAT Directive does not prescribe it explicitly, this fact has

6 For more information on the concept and characteristics of virtual currency, *see* A. Bal, *Taxation of Virtual Currency* ch. 3 (Leiden University 2014).

7 In late 2013, the bitcoin price reached an all-time high of approximately USD 1,242 and exceeded that of gold. In 2014, bitcoin prices dropped from approximately USD 750 (January) to USD 370 (December). Bitcoin price statistics are available at http://bitcoincharts.com.

8 BBC News, *Mt. Gox Bitcoin Exchange Files for Bankruptcy* (28 Feb. 2014), available at http://www.bbc.com/news/technology-25233230.

9 R. Hackett, *Hackers Steal $5 Million from Major Bitcoin Exchange* (5 Jan. 2015), available at http://fortune.com/2015/01/05/bitstamp-bitcoin-freeze-hack.

10 S. Lui, *The Demographics of Bitcoin (Part 1 Updated)* (2013), available at http://simulacrum.cc/2013/03/04/the-demographics-of-bitcoin-part-1-updated.

11 A. Yelowitz & M. Wilson, *Characteristics of Bitcoin Users: An Analysis of Google Search Data*, Applied Economics Letters (Jan. 2015).

12 Art. 2 VAT Directive (2006/112).

been confirmed by ECJ case law.[13] Money used as a means of payment cannot be consumed and VAT is a tax on final consumption of goods and services.

Consequently, if transfers of bitcoins were considered payments of money, a taxable person that makes such transfers in respect of a supply of goods or services would not itself perform a taxable supply. VAT would be levied only on the supply of goods or services, whereas the transfer of bitcoins would constitute consideration. However, if transfers of bitcoins did not constitute payments of money but rather supplies of services, they would be subject to VAT. In such circumstances, exchanges of bitcoins for other goods or services would constitute barter transactions.

If transfers of bitcoins are within the scope of the VAT Directive (2006/112) (i.e. they are not regarded as mere payments of money), it is necessary to examine whether a VAT exemption may apply. Article 135(1) of the VAT Directive provides for VAT exemptions for:

> [...]
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> (d) transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection;
>
> (e) transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest;
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> (f) transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities referred to in Article 15(2).

Should the conditions specified in article 135(1) be met, transfers of bitcoins would be tax free.

3.2. Views of tax authorities

Tax authorities have different views on the status of Bitcoin and the application of the VAT exemption to bitcoin transactions.

In many EU Member States, such transactions have been declared exempt. The Belgian tax authorities confirmed that trading in bitcoins and other virtual currencies is similar to the activity of an intermediary negotiating in securities and other negotiable instruments, and, as a consequence, is exempt from VAT under the Belgian provision implementing article 135(1)(d) of the VAT Directive (2006/112).[14] The Finnish Central Tax Board classified transactions involving virtual currency as exempt financial services, disregarding the previous guidance from the Finnish Tax Administration, which denied virtual currency the status of a currency, security or financial asset.[15] According to the UK HMRC, when bitcoins are exchanged for fiat currencies, no VAT is due on the value of the bitcoins themselves. Charges (in whatever form) imposed over and above the value of the bitcoin for arranging or carrying out any transactions in bitcoin are exempt from VAT under article 135(1)(d) of the VAT Directive (2006/112).[16] The Spanish Directorate General of Taxes (*Dirección General de Tributos*) ruled that virtual currencies that operate as a means of payment are to be classified as exempt financial services.[17] In contrast to all these developments, a ruling of the Estonian Tax and Customs Board (*Maksu- ja Tolliamet*) states that bitcoin transactions are subject to the standard VAT rate.[18] In Estonia, such transactions cannot benefit from the exemption for financial services, as such exemption does not apply to the provision of services of alternative means of payment.

Outside the European Union, transactions involving bitcoins do not seem to benefit from an indirect tax exemption. According to the Norwegian Tax Administration (*Skatteetaten*), supplies of bitcoins constitute taxable supplies of

13 *See* e.g. UK: ECJ, 9 Oct. 2001, Case C-409/98, *Commissioners of Customs & Excise v. Mirror Group plc*, para. 26, ECJ Case Law IBFD.
14 *See* http://www.tax-news.com/news/Belgium_Says_Bitcoin_VAT_Exempt_For_Now____65939.html.
15 *See* https://www.cryptocoinsnews.com/finland-rules-bitcoin-services-as-vat-exempt.
16 HMRC, *supra* n. 2.
17 *See* http://lawandbitcoin.com/en/bitcoin-is-vat-exempt-in-spain.
18 EE: Tax and Customs Board (*Maksu- ja Tolliamet*), *Maksustamine Bitcoin'idega kauplemisel* (Mar. 2014), available at http://www.emta.ee/index.php?id=35227&highlight=bitcoin.

electronic services. As Bitcoin does not have legal tender status, the exemption for financial services cannot apply.[19] In the view of the Inland Revenue Authority of Singapore (IRAS), virtual currencies do not constitute money, but rather services, and do not qualify for exemption. Registered businesses selling bitcoins need to charge goods and services tax (GST) on those sales, except for sales to a customer outside Singapore. If virtual currencies are used to pay for goods or services, the transaction is regarded as barter trade.[20] According to a guidance paper issued by the Australian Taxation Office (ATO),[21] bitcoin transactions should be treated as barter transactions. Businesses must charge GST when they supply bitcoins and may be subject to GST when they receive bitcoins in return for goods and services. The supply of bitcoins is not a financial supply for GST purposes. The ATO confirmed its view in another ruling on the GST implications of transactions involving bitcoins.[22]

Switzerland seems to follow the majority view of the EU Member States. In June 2015, the Swiss Federal Tax Administration (*Eidgenössische Steuerverwaltung*, ESTV) decided to treat Bitcoin as a means of payment for VAT purposes.[23] This decision was made in response to a formal request submitted by a group of three Swiss Bitcoin organizations. The Swiss tax authorities confirmed that transfers of bitcoins do not constitute either supplies of goods or supplies of services. The decision is not a general statement on how VAT law should be applied to bitcoin transactions. As it was issued in response to a formal request, it is legally binding only on the parties that wrote the inquiry. It is highly unlikely that another request would be answered differently; however such paradoxes cannot be completely excluded.

3.3. *Skatteverket v. David Hedqvist*: Case C-264/14

3.3.1. Facts and issues

A Swedish national, David Hedqvist, intended to open a bitcoin trading platform where bitcoins would be exchanged for Swedish kroner. The price of bitcoins would be based on an exchange rate shown on an exchange rate portal, adjusted by a percentage charged by him as a transaction fee. He asked the Swedish Board for Advanced Tax Rulings (*Skatterättsnämnd*) whether the proposed service would attract VAT. According to the ruling issued by the Board, the buying and selling of bitcoins is a service performed for consideration, but not subject to VAT, as bitcoins are used as a legal means of payment. The Swedish tax authorities (*Skatteverket*) appealed the ruling and on 2 June 2014 the Swedish Supreme Administrative Court (*Högsta förvaltningsdomstol*) referred the following questions to the ECJ:

> 1. Is article 2(1) of the VAT Directive to be interpreted as meaning that transactions in the form of what has been designated as the exchange of virtual currency for national currency and vice versa, which is effected for consideration added by the supplier when the exchange rates are determined, constitute the supply of a service effected for consideration?
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> 2. If the answer to the first question is in the affirmative, is article 135(1) to be interpreted as meaning that the abovementioned exchange transactions are tax exempt?

3.3.2. AG Opinion

On the first question, the AG observed that bitcoins are useful only as a means of payment (medium of exchange). As they serve the same purpose as national currencies, the principle of fiscal neutrality requires that they be treated in the same way.[24]

The AG further noted that, in line with previous ECJ case law, the mere transfer of legal tender or other means of payment should not attract VAT. The function of legal tender is to facilitate transactions rather than to be consumed as goods or services. However, the activities envisaged by David Hedqvist go further than transferring a means of payment.

19 NO: Norwegian Tax Administration (*Skatteetaten*), *Bruk av bitcoins – skatte- og avgiftsmessige konsekvenser* (11 Nov. 2013), available at http://www.skatteetaten.no/no/Radgiver/Rettskilder/Uttalelser/Prinsipputtalelser/Bruk-av-bitcoins--skatte--og-avgiftsmessige-konsekvenser.

20 IRAS, *e-Commerce Transactions*, available at https://www.iras.gov.sg/irashome/GST/GST-registered-businesses/Specific-business-sectors/e-Commerce/#title5.

21 AU: Australian Taxation Office (ATO), *Tax Treatment of Crypto-currencies in Australia – Specifically Bitcoin* (20 Aug. 2014), available at https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin.

22 ATO, *Goods and Services Tax: The GST Implications of Transactions Involving Bitcoin*, GSTR 201/3 (17 Dec. 2014), available at http://law.ato.gov.au/atolaw/view.htm?DocID=GST/GSTR20143/NAT/ATO/00001.

23 *See* http://bitcoinassociation.ch/blog/no-vat-on-bitcoin-in-switzerland.

24 *Hedqvist* (C-264/14), para. 15 and 17.

They constitute currency exchange services, which fall within the scope of article 2(1)(c) of the VAT Directive, as was already clarified by the ECJ in *First National Bank of Chicago* (Case C-172/96).[25]

With regard to the second question, the AG examined the requirements of article 135(1)(d), (e) and (f) of the VAT Directive (2006/112).

Article 135(1)(f) applies to transactions in "shares, interests in companies or associations, debentures and other securities", i.e. to items that represent property rights in corporations, debt instruments and rights related thereto. As neither bitcoins nor Swedish kroner could be regarded as such, the AG concluded that article 135(1)(f) cannot be applied.

In considering article 135(1)(e), which exempts transactions "concerning banknotes and coins used as legal tender", the AG first observed that the exemption cannot be applied if one party transfers a means of payment, whereas the other transfers goods or services. In such a case, the transfer of the means of payment represents consideration for the goods or services.[26] In contrast, the exemption is applicable if one means of payment is exchanged for another one. However, as the present case concerns exchanges between Swedish kroner (which are legal tender in Sweden) and bitcoins (which are not legal tender in any country, but can be used as a means of payment), it has to be clarified whether only one or both of the means of payment must constitute legal tender. The AG noted that the wording of the VAT Directive is unclear on this matter. According to the German version, both sides of the transaction must constitute legal tender; however under the English translation, only one must constitute legal tender. The Finnish and Italian versions do not contain a requirement that either side of the transaction include legal tender. Given this ambiguity, the question needs to be answered by taking into account the purpose of the VAT exemption. The AG observed that the purpose of the VAT exemption is to allow for the free exchange of means of payment, which would benefit the internal market insofar as cross-border services require currency conversions. Although Bitcoin is not legal tender, it serves the same purpose as national currencies, i.e. it functions as a medium of exchange. Therefore, the purpose of article 135(1)(e) justifies the application of VAT exemption to exchanges of bitcoins for national currencies.

Finally, the AG examined whether bitcoins could be regarded as "negotiable instruments" under article 135(1)(d) of the VAT Directive. She answered this question in the negative, as "negotiable instruments" derive their value from other currencies but do not constitute currencies themselves. Moreover, article135(1)(e) is *lex specialis* as far as currency exchange services are concerned.

Therefore, the AG recommended that the ECJ answer the questions referred by the Swedish Court as follows:

- exchanges of means of payment without legal tender status, such as Bitcoin, into a national currency, at an exchange rate that takes into account the commission by the service provider, constitute a supply of services for consideration under article 2(1)(c) of the VAT Directive (2006/112); and
- such exchanges are exempt from VAT under article 135(1)(e) of the VAT Directive (2006/112).

It is not clear yet how the ECJ will respond to this opinion. As in most cases the opinion and reasoning of the AG is followed by the ECJ, it is likely that exchanges of bitcoins for national currencies will be VAT exempt in the European Union.

3.3.3. Comments

The AG opinion is based on the assumption that Bitcoin serves the same purpose as national currencies, as its only function is to act as a means of payment/medium of exchange. As the principle of neutrality requires that similar situations be treated in a similar way, the VAT exemption applicable to trade in national currencies should also apply to bitcoin/fiat currency exchanges.

This reasoning suffers from several flaws. First, the AG simply assumes that bitcoins constitute "money", "means of payment" and "currency". As none of these terms is defined under EU VAT law, a proper examination of the Bitcoin classification should begin by providing appropriate definitions and explanations as to how they apply to Bitcoin.

Second, the AG observes that bitcoins are similar to national currencies, yet fails to provide reasons to support this statement. It is obvious that Bitcoin shares some of the characteristics of national currencies: it acts as a medium of exchange by allowing individuals to transact directly with one another, and can also serve as a unit of account to measure the value of goods and services on the market, as it is numerical and divisible. However, although Bitcoin was designed

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25 UK: ECJ, 14 July 1998, Case C-172/96, *Commissioners of Customs & Excise v. First National Bank of Chicago*, ECJ Case Law IBFD.
26 *Hedqvist* (C-264/14), para. 27.

to act as a fiat currency and perform the same functions, there are significant differences between the two. Bitcoin lacks central management, governmental supervision, legal tender status and a physical manifestation (coins, banknotes). It is generated by private persons through a process called “mining”. If the private key needed to spend bitcoins is lost, those bitcoins cannot be used any longer, resulting in a shrinkage of the money base. National currencies are intrinsically and intuitively valuable, whereas the same cannot be said about Bitcoin. To determine how much this virtual currency is worth, users must translate its value into value expressed in a familiar unit of account (e.g. US dollar or euro). It is impossible to determine the value of particular goods in Bitcoin without knowing the bitcoin exchange rate at a particular time. By looking at the string of data, it is not possible to identify its value. Thus, bitcoins and national currencies have different properties that could justify their different treatment for VAT purposes.

The AG statement that Bitcoin is useful only as a means of payment is also doubtful. A group of researchers from Frankfurt University conducted an empirical study on whether users’ interest regarding Bitcoin is driven by its appeal as a speculative asset or as a currency (i.e. a means of payment). They found that users buying bitcoins for the first time are likely to keep them for speculative purposes[27] and do not have the intention to use them to pay for goods and services. The interpretation that bitcoins are used as assets is also supported by the fact that Bitcoin returns react to news events related to this digital currency. The European Securities and Markets Agency also confirmed that users primarily treat bitcoins as speculative assets, stating that “ESMA is aware that many investors seem to consider virtual currencies less as a payment instrument and more as a financial asset”.[28]

Furthermore, the AG failed to explain why transfers of bitcoins cannot be treated as supplies of electronic services. A discussion to that effect would be necessary, given that some countries with similar VAT systems (Norway, Singapore and Australia) regard transfers of bitcoins as supplies of electronic services. An electronically supplied service cannot be subject to VAT exemption and is always standard rated. Treating payments with bitcoins as electronic services would have the unfortunate effect that exchanges of goods and services for bitcoins would be treated as barter transactions and final consumers who regularly pay their suppliers with bitcoins would have to be treated as taxable persons for VAT purposes.

The AG conclusion is welcomed by the whole Bitcoin community, as it means a lower compliance burden for bitcoin traders, namely because they are not required to charge VAT and comply with VAT obligations. It also means that supplies of goods and services for bitcoins will not be treated as barter transactions. While a taxpayer-friendly solution is clearly a good thing, it should nevertheless be supported by convincing and sound theoretical arguments.

Once the ECJ has decided the matter, there will be uniform treatment of bitcoin/fiat currency exchanges in the European Union. Clear rules will increase legal certainty and make people less hesitant to start using Bitcoin. The popularity of this currency scheme is also likely to increase. However, as the ECJ decision will be valid only in the European Union, differing tax treatment in other jurisdictions where bitcoin is used and traded could still cause problems in the future.

4. Bitcoin and FATCA

No US tax law has ever had a more global reach than FATCA (the Foreign Account Tax Compliance Act). FATCA’s aim is to prevent tax evasion by US citizens with foreign bank accounts by imposing compliance obligations on financial institutions. Not only banks, but also many entities outside the traditional financial services sector are affected by FATCA’s operation.

FATCA requires that a foreign financial institution report financial accounts held by US citizens; otherwise withholding taxes will apply. In a FATCA context, the definitions of both “financial account” and “foreign financial institution” are very broad. A foreign financial institution includes entities that accept deposits in the ordinary course of a banking or similar business; hold financial assets for the account of others; or engage in the business of trading securities or commodities. The term “financial account” includes any depository or custodial account.

No guidance on the treatment of Bitcoin under FATCA has been provided so far. The IRS guidelines on the tax treatment of virtual currencies do not address the FATCA issue. However, due to the broad definitions of both foreign financial

27 Baek and Elbeck (2015) provided more insight into the use of Bitcoin as an investment vehicle. Based on data from www.bitcoincharts.com, they found that the Bitcoin market is 26 times as volatile as the stock market and presents more chances for extreme values to occur. Thus, the Bitcoin market appears to be highly risky and speculative compared to the stock market. However, all external economic factors do not seem to have any significant impact on the Bitcoin market returns, which are internally driven by buyers and sellers. *See* C. Baek & M. Elbeck, *Bitcoins as an Investment or Speculative Vehicle? A First Look*, 22 Applied Economics Letters, at 30-34 (2015).

28 ESMA, *Call for Evidence*, at 7 (22 Apr. 2015), available at http://www.esma.europa.eu/system/files/2015-532_call_for_evidence_on_virtual_currency_investment.pdf.

institution and financial account, there is a strong possibility that foreign bitcoin exchanges and payment services may be considered foreign financial institutions subject to FATCA reporting obligations. Many of these businesses operate in a similar way to banks, in that they offer a customer the possibility to transfer the customer's bitcoins to an account and record the customer's balance on their books.

US citizens who own certain foreign financial accounts with a total value of at least USD 50,000 at the end of the tax year are also subject to FATCA reporting obligations (Form 8938 must be submitted to the IRS). The penalty for failure to file is generally USD 10,000 and may increase to up to USD 60,000 for continuing failures to file.

The FATCA reporting requirement is separate from the reporting requirement for purposes of foreign bank account reporting (FBAR).[29] Under FBAR, US persons with over USD 10,000 in foreign financial assets must report a financial interest in, or signature authority over, a foreign financial account to the Financial Crimes Enforcement Network (FinCEN). The FBAR reporting obligation may exist even if there is no associated taxable income. The filing is treated quite seriously by the financial authorities, with no filing deadline extensions and penalties for failure to report ranging from USD 10,000 to USD 100,000 per violation.

There is still no clear statement as to whether bitcoin accounts are subject to the FBAR reporting. However, under the FinCEN guidance of 2013,[30] virtual currency exchange businesses should be regarded as financial institutions for FBAR purposes. Also, the 2014 decision of the US District Court for the Northern District of California in *United States v. Hom* (2014) could have significant implications for Bitcoin accounts.[31] The Court ruled that online poker sites operated as financial institutions and the gaming accounts represented foreign financial accounts subject to FBAR reporting. Based on that decision, a US individual storing bitcoins with any of the exchange businesses could be subject to the FBAR reporting requirements if the value of his or her bitcoin holdings exceeded USD 10,000 at any time during the year.

5. Bitcoin and Financial Regulatory Bodies

5.1. European Central Bank

In October 2012, European Central Bank (ECB) published a study on the relevance of virtual currency schemes for central banks.[32] The assessment covers the impact of virtual money on stability of prices; financial and payment systems; as well as reputational risk concerns and regulatory issues. The report concludes that virtual currency schemes fall within the responsibility of central banks as a result of their characteristics shared with other payment systems. They do not pose a risk to price stability, provided that virtual money creation continues to stay at a low level. The fact that virtual currencies are not regulated exposes users to credit, liquidity, operational and legal risks. As virtual money can be used by criminals, fraudsters and money launderers to perform their illegal activities, a close monitoring of virtual currency systems by public authorities is necessary.

5.2. European Banking Authority

The European Banking Authority (EBA) is a regulatory agency of the European Union. It provides advice to EU institutions in the areas of banking, payments and e-money regulation, as well as on issues related to corporate governance, auditing and financial reporting. Its overall objectives are to maintain financial stability in the European Union and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

The EBA started evaluating virtual currencies in 2013. On 13 December 2013, it issued a public warning to make consumers aware of a series of risks deriving from buying, holding or trading in virtual currencies.[33] It identified the following risks:

- no specific regulations exist in the European Union that would protect consumers from financial losses if a platform that exchanges or holds virtual currencies fails or goes out of business;

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29 For a comparison of both reporting requirements, *see* http://www.irs.gov/Businesses/Comparison-of-Form-8938-and-FBAR-Requirements.
30 FinCEN, *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (18 Mar. 2013), available at http://fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf.
31 US: DC (ND Cal.), 4 June 2014, *US v. Hom*, Case 3:13-cv-03721-WHA.
32 ECB, *Virtual Currency Schemes* (Oct. 2012).
33 EBA, *EBA Warns Consumers on Virtual Currencies* (13 Dec. 2013), available at https://www.eba.europa.eu/-/eba-warns-consumers-on-virtual-currencies.

- when using virtual currency for commercial transactions, consumers are not protected by any refund rights under EU law;
- misuse could lead law enforcement agencies to close exchange platforms at short notice and prevent consumers from accessing or retrieving any funds that the platforms may be holding for them; and
- digital wallets that contain consumers' virtual currency stored on computers, laptops or smart phones are not impervious to hackers.

On 4 July 2014, the EBA published an opinion addressed to the EU and national supervisory institutions in which it advises that financial institutions be discouraged from buying, holding or selling virtual currencies while no regulatory regime is in place.[34] The EBA has concluded that, while there are some potential benefits from using virtual currencies (such as faster and cheaper transactions), the risks associated with their use outweigh the benefits. To address and mitigate those risks, a substantial regulatory regime is necessary. Such a regime would need to cover governance requirements for several market participants, the segregation of client accounts, capital requirements and, most importantly, the creation of "scheme governing authorities" accountable for the integrity of a particular virtual currency scheme and its key components, including its protocol and transaction ledger. As long as no such regime is in place, some of the more pressing risks may be mitigated in other ways, for example by discouraging credit institutions, payment institutions and e-money institutions from buying, holding or selling virtual currencies.

5.3. European Securities and Markets Authority

The European Securities and Markets Authority (ESMA) has been monitoring and analysing virtual currency investments to understand their impact on market integrity and financial stability; developments in the market; and potential benefits and risks for investors. On 22 April 2015, ESMA launched a call for evidence on investments using virtual currency.[35] The call invited market participants and other stakeholders to submit feedback and any additional information on the following topics:

- virtual currency investment products, i.e. collective investment schemes or derivatives that have virtual currencies as an underlying asset or invest in virtual currency related businesses and infrastructure;
- virtual currency based-assets/securities and asset transfers, i.e. financial assets – such as shares and funds – that are exclusively traded using virtual currency-distributed ledgers; and
- the application of the distributed ledger technology to securities/investments, whether inside or outside a virtual currency environment.

The consultation was open until 21 July 2015.

5.4. US Financial Crimes Enforcement Network

Decentralized and untraceable virtual currencies are said to be a channel for money laundering, illicit financing and tax evasion.[36] There are concerns that virtual currency is used by terrorists to shift money across borders and by those who wish to conduct illegal activities online anonymously. Bitcoin became a favourite means of payment on Silk Road, a digital marketplace for illegitimate trade that operated exclusively on a Tor network. Among illicit goods and services that were advertised for sale on Silk Road were drugs, fraudulent identification documents and computer-hacking tools.

Given these obvious attractions of virtual currency to criminals and terrorists, regulatory agencies in charge of preventing money laundering and terrorist financing became interested in the phenomenon of virtual money in order to ensure that criminals do not benefit from the innovative payment systems.

34 EBA, *EBA Proposes Potential Regulatory Regime for Virtual Currencies, but also Advises that Financial Institutions Should Not Buy, Hold or Sell Them Whilst No Such Regime Is in Place* (4 July 2014), available at https://www.eba.europa.eu/-/eba-proposes-potential-regulatory-regime-for-virtual-currencies-but-also-advises-that-financial-institutions-should-not-buy-hold-or-sell-them-whilst-n.

35 ESMA, *supra* n. 28.

36 For examples of cases in which virtual currency was abused for money laundering purposes, *see* FATF, *supra* n. 5.

In March 2013, the US Financial Crimes Enforcement Network (FinCEN)[37] published guidance titled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies".[38] According to this guidance, a person that transfers or exchanges virtual currencies for national currencies is considered a money transmitter for registration and reporting purposes under the Bank Secrecy Act.[39] The definition of a money transmitter does not differentiate between national currencies and convertible virtual currencies. Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter, regardless of the amount of money transmission activity.[40] By contrast, a person that creates units of convertible decentralized virtual currency and uses it to purchase real or virtual goods and services is a user of the convertible virtual currency and not subject to regulation as a money transmitter.

In May 2015, FinCEN assessed a USD 700,000 penalty against Ripple Labs, a company headquartered in San Francisco that provides virtual currency exchange services, for violating the Bank Secrecy Act by not registering with FinCEN and by failing to implement an adequate anti-money laundering programme designed to protect its products from use by money launderers or terrorist financiers.[41] Following the assessed penalty, Ripple Labs agreed to take steps to ensure compliance with the anti-money laundering rules (e.g. by monitoring all future transactions and reporting any suspicious ones, and having regular independent compliance reviews).

The US practice is likely to set an industry standard and be followed by other countries. Thus, providers of virtual currency exchange services should keep an eye on compliance with anti-money laundering regulations.

5.5. Financial Action Task Force

The Financial Action Task Force (FATF) is an independent intergovernmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing. Established in 1989, it has currently 36 members representing most of the world's major economies. The FATF recommendations are recognized as the global anti-money laundering (AML) and counter-terrorist financing (CFT) standard.

The FATF began the examination of virtual currencies in 2013. In its report "Guidance for a Risk-Based Approach – Prepaid Cards, Mobile Payments and Internet-Based Payment Services", which provides guidance on how these payment products work and how to regulate and supervise them, virtual currency is mentioned as one of the Internet-based payment service models.[42] The FATF also recognized the innovative use of emerging technologies, such as decentralized virtual currencies, in the digital money sector. A more detailed report, "Virtual Currencies: Key Definitions and Potential AML/CFT", was published in June 2014.[43] This report defined virtual currency, distinguished its various types, outlined risks associated with its use and described some recent investigations and enforcement efforts involving virtual currency.

In June 2015, the FATF published "Guidance for a Risk-Based Approach – Virtual Currencies".[44] The 48-page document aims to explain the application of the risk-based approach to anti-money laundering/counter-terrorist financing measures in the virtual currency context; clarify the application of the relevant FATF recommendations to convertible virtual currency exchangers; and help national authorities develop regulatory responses to address the money-laundering and terrorist-financing risks associated with the use of virtual currency. The report recommends adopting regulations and guidelines similar to those applicable to traditional financial institutions and money transfer businesses. Institutions providing exchange services should be registered and keep adequate records of senders and beneficiaries.

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37 FinCEN is one of the US Treasury's primary agencies to oversee and implement policies to prevent and detect money laundering. This is accomplished in two ways. First, FinCEN uses counter-money laundering laws (such as the Bank Secrecy Act) to require reporting and record keeping by banks and other financial institutions. Second, FinCEN provides intelligence and analytical support to law enforcement. *See* http://www.fincen.gov/about_fincen/wwd/faqs.html.

38 FinCEN, *supra* n. 30.

39 Each money services business (MSB) is a financial institution. For the regulatory definition of "financial institution", *see* 31 CFR 1010.100(t).

40 *See* http://www.fincen.gov/financial_institutions/msb/definitions/msb.html.

41 *See* http://www.fincen.gov/news_room/nr/pdf/20150505.pdf.

42 FATF, *Guidance for a Risk-Based Approach – Prepaid Cards, Mobile Payments and Internet-Based Payment Services* (June 2013), available at http://www.fatf-gafi.org/media/fatf/documents/recommendations/Guidance-RBA-NPPS.pdf.

43 FATF, *supra* n. 5.

44 FATF, *Guidance for a Risk-Based Approach – Virtual Currencies* (June 2015), available at http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-RBA-Virtual-Currencies.pdf.

6. Conclusion

Virtual currencies, such as Bitcoin, are an innovative payment method with ever-growing global acceptance. They provide several economic benefits over national currency schemes, but also carry significant risks.

Tax authorities of different countries have diverging views on whether bitcoin transactions are subject to VAT. In her recent opinion, AG Juliane Kokott suggested treating bitcoins in the same way as national currency and applying the VAT exemption for financial services. At the time of writing this article, it was still unclear whether the ECJ would follow the AG opinion.

Although virtual currency is denied legal tender status, it does not seem to escape financial reporting obligations for either individuals or businesses. Bitcoin accounts are likely to fall within the scope of both FATCA and FBAR reporting. Given the anonymity of bitcoin transactions that appeals to criminal and terrorist elements, regulatory agencies in charge of preventing money laundering and terrorist financing are closely monitoring the virtual money industry and issue recommendations to prevent the illicit use of this innovative payment system.