



UNIVERSITY *of* NICOSIA

Session 9

# Regulatory and Tax Treatment

Introduction to Digital Currencies

# Session objectives

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- Understand that cryptocurrencies and their adjacent firms are already regulated in most developed economies
- Develop a basic understanding of potential regulatory exposure in three significant areas of regulator concern and enforcement action: taxation, money service businesses and securities legislation

# Session outline

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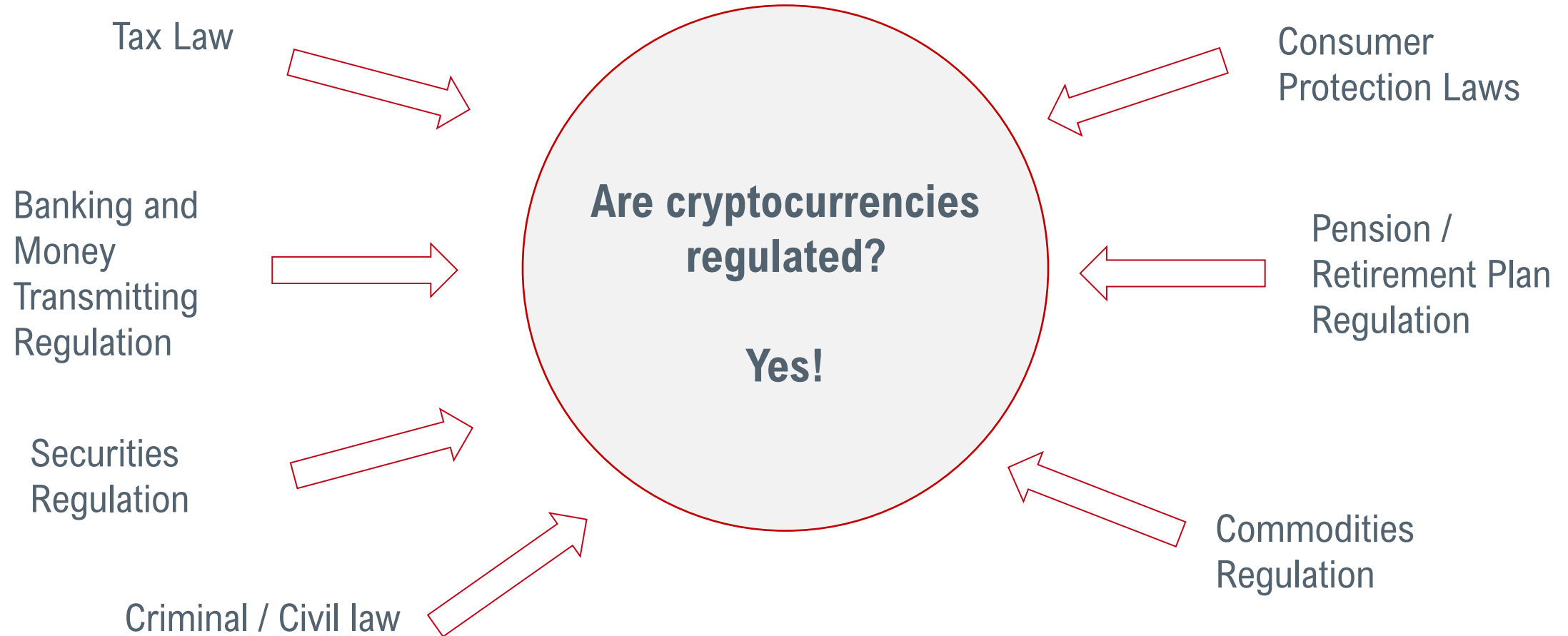
1. Overview
2. Taxation
3. MSBs
4. Securities Regulation
5. Conclusions
6. Further Reading

## Session 9: Regulatory and Tax Treatment

# **1. Overview**

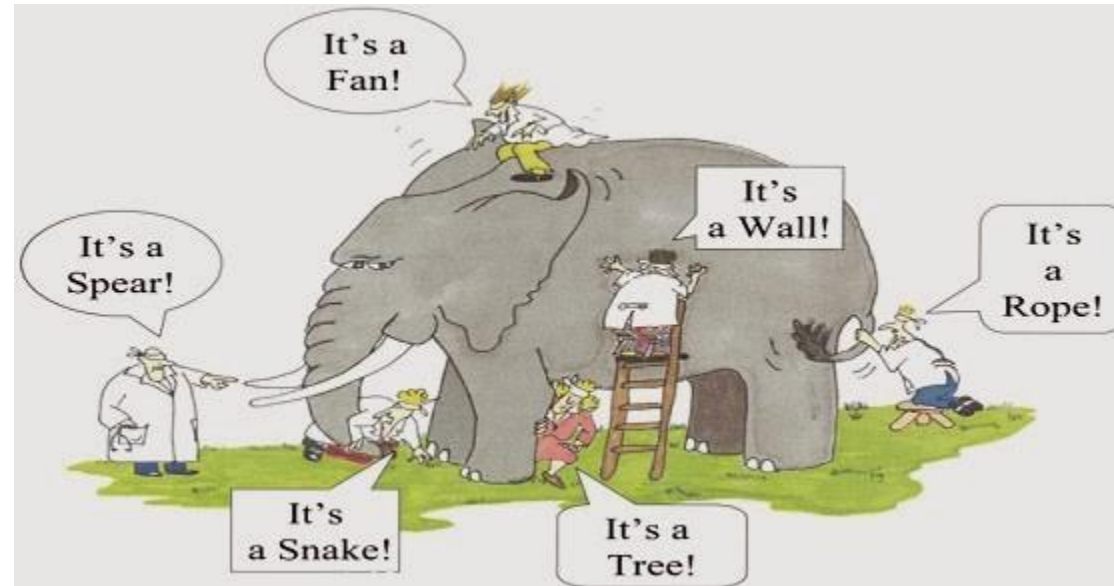
# Overview

Cryptocurrencies are heavily regulated in many jurisdictions



# Overview

Many regulatory agencies assert regulatory authority over cryptocurrency



Because cryptocurrencies do not easily fit into existing regulatory categories, it is easy for each regulatory agency to see them in a different (and sometimes contradictory) light

# Overview

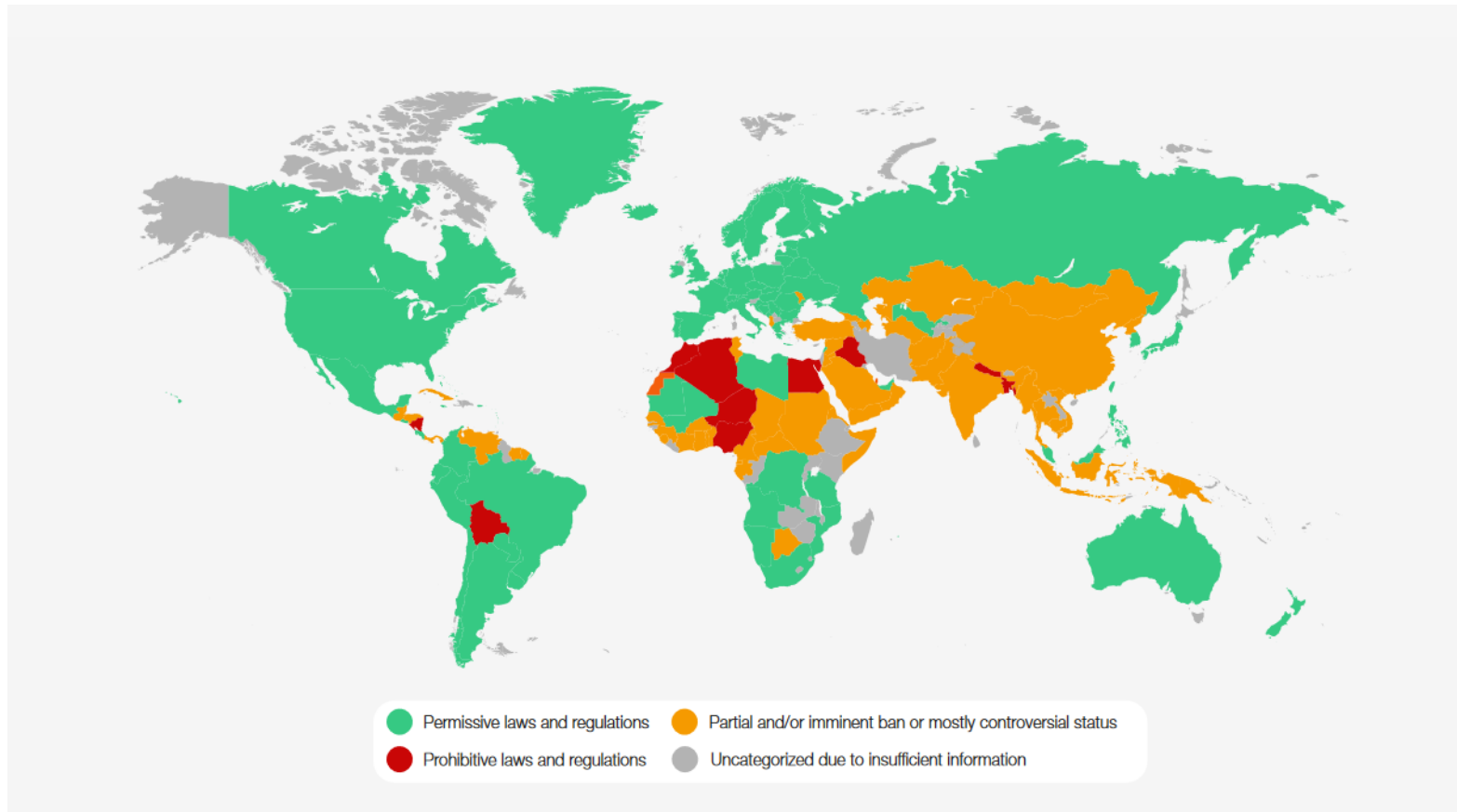
## Regulators have multiple areas of concern



- AML (anti-money laundering)
- Investor protection
- Tax compliance
- Capital / Currency controls (where applicable)
- Market competition and efficiency
- Insider trading
- Consumer protection – fraud and theft
- “Cybercrime” (illegal product sales, ransom, kidnapping, extortion and data ransom)

# Overview

Roughly, the regulatory environment is most favorable in developed economies



Source: Navigating Cryptocurrency Regulations-World Economic Forum – Oct 2021 [https://www3.weforum.org/docs/WEF\\_Navigating\\_Cryptocurrency\\_Regulation\\_2021.pdf](https://www3.weforum.org/docs/WEF_Navigating_Cryptocurrency_Regulation_2021.pdf)



# Overview

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## Cryptocurrency/Cryptoassets are generally treated as property

- This is a general principle that underlies most national approaches – namely that cryptocurrency is treated as property, not ‘currency’
- Why is that?
  - Many nation-states have regulations that explicitly define currency as legal tender of another nation-state, preventing them from recognizing other “currencies” formally as currency.
  - This policy is broadly speaking sensible.
    - Bitcoin might behave as a currency, but should a country extend the same treatment to every other cryptocurrency?
    - If so, should this same treatment apply to other forms of digital currencies, such as in-game credits and frequent flier miles?
  - The exceptions to this approach are countries like Germany that allow for the concept of a “unit of account” (tax & trading purposes) that can be treated as a form of “private money” used in “multilateral clearing circles”

# Overview

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## The session goal is to highlight some key areas of regulatory interest

- The objective of this session is not to cover any of the regulatory areas in detail nor all the regulatory areas at a high-level. This is impossible to do, even in a whole course.
- In this session, we will also focus on taxation, MSBs (Money Service Businesses) and securities legislation because these are the areas that have caused the most 'dramatic' problems to-date
- Even in this context, the objective is not to cover the topics comprehensively – they are complex matters and vary by jurisdiction.
- The objective is to give you an initial sense of the types of issues that emerge in this area in the hope that you will realize when you need to seek legal or tax advice



Session 9: Regulatory and Tax Treatment

## **2. Taxation**

# Taxation

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Your coins will be taxed

*“In this world nothing can be said to be certain, except death and taxes”*

*- Benjamin Franklin, 1789*



# Taxation

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We will use the IRS (USA) framework for taxation

- We will use the USA (Internal Revenue Service) taxation framework as a case study.
- The framework is both relatively well-developed and has high overlaps with the approach with most industrialized nations.
- We will generally ignore low-tax jurisdictions because they tend to have very low or no taxes on a wide range of activities and are extending similar treatments to cryptocurrencies.



# Taxation

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## The core IRS decision is to treat cryptocurrency as property

- The IRS treats cryptocurrency as property, which means it is taxed in a manner similar to stocks, bonds, real estate, art and so on.
- Due to this treatment, cryptocurrency qualifies for capital gains tax treatment. Capital gains tax rates are lower than ordinary income (salary) tax rates.
- Tax is paid at the time of sale in the event that there was a profit on the sale (if the price has risen since purchase).
- Tax is due whether the sale is for fiat or other cryptocurrency
- From an investment perspective, this is a sensible treatment.
- It does, however, create a serious practical problem in using cryptocurrencies for day-to-day transactions because it means that every time a purchase (e.g. coffee) is made with a cryptocurrency it is, technically, a sale of cryptocurrency (in this case for coffee). That means strictly speaking, every time someone buys a coffee with Bitcoin, they should calculate the purchase price of that fraction of a Bitcoin they used and the current price of Bitcoin and report a capital gain or loss. This is obviously a huge hinderance to day-to-day transactions for law-abiding consumers.

# Taxation

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With one exception, the taxation approaches for other matters are as expected

- Income received in cryptocurrency is treated as ordinary income
- Salaries paid in cryptocurrency are subject to the typical payroll social charges
- Mining companies are taxed as operating business with revenue and expenses
- The most controversial aspect of the current IRS tax treatment is the treatment of hard forks
- In the event of a hard fork, if a user has been given access to the token of the new chain, it is taxable \*at that time\*, at the price of that time, at ordinary income rates.
- This could cause significant hardship since the coins are often not transactable at the price quoted the day of the fork as exchanges might have not listed them.
- Historically, as hard forks have become more liquid, their price has dropped, often dramatically (but the tax will be due on the earlier, higher price).

# Taxation

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## Most countries are taking a similar direction to the United States

- Most countries have taken, broadly a similar approach to the United States in that they are treating cryptocurrency as taxable and as property
- The European Union has stated that VAT does not apply to the purchase of cryptocurrency with fiat which is a sensible decision
- A few countries have given small personal exemptions from taxation for gains and losses in cryptocurrency to exempt small retail transactions which is also a sensible approach
- On the whole, however, tax policy towards cryptocurrency appears to be settling down and one's expectation should be that gains will be taxable
- Of course, in all cases, local tax law is what matters so the jurisdiction of any transaction is what will guide the final approach



## Session 9: Regulatory and Tax Treatment

### **3. MSBs**

# MSBs

Money Service Businesses are a group of non-bank financial institutions

What types of businesses are MSBs?

(1) Currency dealers/exchangers, (2) Check cashers, (3) Issuers of traveler's checks / money orders or stored value cards, (4) Sellers/redeemers of traveler's checks, money orders or stored value cards, (5) Money transmitters, and (6) The US Postal Service.

Once a firm is classified as an MSB, it triggers a wide range of regulatory requirements in the United States such as:

- Having to **register** with the Department of the Treasury
- Developing a **customer identification** (Know Your Customer) and AML (Anti-Money Laundering) program with policies, procedures, internal controls, compliance officers and independent review
- **Reporting cash or suspicious transactions** under the Bank Secrecy Act
- **State-level registrations:** Almost all states require registration or licensing for MSBs that operate in their state, and in some cases, that transact with citizens of their state, even if they don't have operations in-state.

# MSBs

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Why do we care about MSBs?

So that our cryptocurrency business is not classified as an MBS without us realizing it because then we could end up in jail by accident



# MSBs

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## FinCEN has clarified which firms are MSBs

- FINCEN (Financial Crimes Enforcement Network) is the bureau of the US Department of Treasury tasked with fighting financial crime. It has made two public rulings regarding “virtual currency” clarifying which parties in the digital currency ecosystem are MSBs (**Money Service Businesses**) and are therefore subject to regulation:
- Consumers are NOT MSBs: “A user who obtains convertible virtual currency and uses it to purchase real or virtual goods or services is not an MSB under FinCEN's regulations”
- Miners are NOT MSBs so long as they are mining for their own account. If they are mining in order to transmit money for others to third parties, they would be MSBs
- Exchanges ARE MSBs if they allow transmission of value to third parties. In the Bitcoin ecosystem, that would mean that firms like Coinbase would be MSB.

# MSBs

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## It was not obvious at first to crypto-firms that they might be MSBs

- Legal penalties for violating MSB regulations (even unknowingly) are very severe and can include heavy fines and jail time.
- Prior centralized digital currency firms such as e-Gold and Liberty Reserve were indicted and closed for failing to register as money transmitters (among other charges).
- Several early Bitcoin exchanges such as Mt.Gox (May 2013) and BitInstant (Jan 2014) ran afoul of MSB regulations, along with individuals exchanging crypto with others on an individual basis.
- **MSB compliance is expensive and time-consuming.**
- **This means that startups using digital currencies in MSB contexts will need to be well-funded and have strong compliance expertise.**
- These regulations certainly apply to exchanges, remittance firms, gift card firms and other related businesses where value (money) will be transmitted.

# MSBs

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## New York's BitLicense has a similar scope at the state level

- The BitLicense is a business license issued by the New York State Department of Financial Services to those conducting business in the state of New York in certain segments of “virtual currency”.
- It is considered the most onerous state license of its kind in the United States
- **Licensure is required if a company's business activity involves:**
  - **Receiving virtual currency (VC) for Transmission or Transmitting VC, unless for non-financial purposes**
  - **Storing, holding, or maintaining custody or control of VC on behalf of others;**
  - **Buying and selling VC as a customer business**
  - **Performing Exchange Services as a customer business**
  - **Controlling, administering, or issuing a VC**

# MSBs

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FATF issued guidance in summer 2019 at the nation-state level for virtual currency

- FATF (Financial Action Task Force) is an inter-governmental organization with 39 member states focused on money laundering and terrorist financing.
- Most developed nations are members of FATF.
- FATF is the forum used by these states for harmonization of AML (anti-money laundering) approaches.
- Though the details are beyond the scope of this course, last summer FATF issued guidance for its member states on AML harmonization for virtual assets.
- The guidance was at least as strict as what already existed in most member states and, in some areas, stricter.
- It is expected that there will be continued regulatory interest and enforcement in this area as it remains an area of concern.

# MSBs

## FATF issued updated guidance in October 2021

On October 28, 2021, FATF updated in 2019 Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers (VASPs) covering six key areas:

- Clarifications of the definitions of virtual assets and VASPs
- Guidance on how the FATF standards apply to stablecoins
- Additional guidance on the risks and the tools available to countries to address the money laundering and terrorist financing risks for peer-to-peer transactions
- Updated guidance on the licensing and registration of VASPs
- Additional guidance for the public and private sectors on the implementation of the “Travel Rule”. *The “Travel Rule” require VASPs to obtain, hold, and transmit originator and beneficiary information in order to identify and report suspicious transactions and prohibit transactions with designated persons and entities*
- Principles of information-sharing and co-operation amongst VASP supervisors

Source: <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html>



# MSBs

## SEC statement on DeFi Risks, Regulations and Opportunities in Nov 2021

On Nov 9, 2021 Securities and Exchange Commissioner Caroline A. Crenshaw issued a statement covering the following key areas:

- Decentralized Finance (DeFi) presents a panoply of opportunities.
- However, it also poses important risks and challenges for regulators, investors, and the financial markets.
- Fundamentally, DeFi is about investing, which includes speculative risks taken in pursuit of passive profits from hoped-for token price appreciation, or investments seeking a return in exchange for placing capital at risk or locking it up for another's benefit.
- Crenshaw questioned the very nature of DeFi, calling its lack of transparency and pseudonymity “structural hurdles” that are bound to hold the market's development back until appropriate investor safeguards are put into place.
- Crenshaw argues: “Without a common set of conduct expectations, and a functional system to enforce those principles, markets tend toward corruption, marked by fraud, self-dealing, cartel-like activity, and information asymmetries.”

Source: <https://www.sec.gov/news/statement/crenshaw-defi-20211109>



# MSBs

## UK Statement on CBDCs and next steps

- Her Majesty's Treasury (HMT) and the Bank of England (BoE) announced the creation of a joint CBDC Taskforce in April 2021 to coordinate the exploration of a potential UK CBDC.
- A CBDC would be a new form of digital money issued by the Bank of England and for the use by households and businesses, to be used alongside cash and bank deposits.
- The Government and the BoE have not yet made a decision on whether to introduce a CBDC in the UK.
- On November 9th, 2021, HMT the BoE announced the next steps in the exploration of a Central Bank Digital Currency (CBDC).
- In 2022, both agencies will launch a public consultation to assess the merits and implications of a CBDC as well as starting high level design planning.
- If regulators chose to develop a CBDC following their 2022 consultation, the announcement suggests that it would launch the second half of the decade at the earliest.

Source: <https://www.bankofengland.co.uk/news/2021/april/bank-of-england-statement-on-central-bank-digital-currency> launch during the second half of the decade at the earliest.

Source: <https://www.bankofengland.co.uk/news/2021/november/statement-on-central-bank-digital-currency-next-steps>

# MSBs

## Singapore's approach to Cryptoassets, Defi and CBDCs

- On November 9th 2021, Ravi Menon, the managing director of the Monetary Authority of Singapore (MAS) made a statement on, cryptoassets, DeFi and CBDCs.
- MAS does not view cryptoassets as money, while Virtual Asset Service Providers are subject to licensing and supervision.
- Menon also recognized the potential benefit that blockchain technology could bring to an economy and he highlighted a particular interest for cryptoassets which are backed by reserves.
- Regarding CBDCs, MAS sees benefits in issuing a wholesale digital currency targeted at banks to improve reserve management and transform cross-border payments, however turning to a retail digital Singapore Dollar CBDC is not considered as urgent.
- Menon however, announced the launch of Project Orchid to work on the technical requirements needed to issue a CBDC if MAS decides to launch a CBDC.

Source: <https://www.mas.gov.sg/news/speeches/2021/the-future-of-money-finance-and-the-internet>



# MSBs

## Sweden considers banning PoW mining due to environmental concerns

- The Swedish Financial Supervisory Authority (SFSA) and the Swedish Environmental Protection Agency (SEPA) have stated that they consider Proof-of-Work based cryptoassets a threat to the climate transition.
- Due to the rise in the price of cryptoassets in recent weeks, bitcoin transaction difficulty increased, requiring more computing power. Therefore, electricity demand between April and August 2021 has surged because of Bitcoin mining by several hundred per cent and now amounts to 1 TWh annually, equal to the electricity of 200,000 Swedish households.
- The SFSA and SEPA suggest that legislators (including the European Commission) consider a tax on energy-intensive production of Bitcoin, a ban on PoW mining and disclosure requirements for businesses who trade or invest in cryptoassets using this protocol.
- Regarding tax treatment Swedish tax authorities are planning on sending letters out in Nov 2021, to remind investors in cryptocurrencies to pay the correct income and capital gain taxes on their crypto asset holdings.

Source: <https://www.fi.se/en/published/presentations/2021/crypto-assets-are-a-threat-to-the-climate-transition--energy-intensive-mining-should-be-banned/>

SourceL <https://www.ftadviser.com/investments/2021/10/22/hmrc-to-send-nudge-letters-to-crypto-asset-investors/#:~:text=HMRC%20is%20preparing%20to%20send,from%20their%20crypto%20asset%20holdings>



# MSBs

## OFAC sanctions crypto addresses holding NTFs with \$532K

- On November 8th 2021, the US Department of the Treasury announced new sanctions against Chatex, a Latvian cryptoasset exchange used to launder the proceeds of ransomware attacks. The Treasury estimated that ransomware payments reached \$590 million during the first half of 2021.
- A large proportion of the cryptoassets received by Chatex can be traced to ransomware payments or sales from the Russian darknet market *Hydra*. Among the \$324.3 million in cryptoassets held by the 30 Chatex addresses listed by OFAC are 42 non-fungible tokens (NTFs), worth approximately \$531,600 in total.

Source: <https://www.elliptic.co/blog/crypto-addresses-holding-nfts-worth-532k-are-among-latest-sanctioned-by-ofac>



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## **4. Securities Regulation**

# Securities Regulation

Securities regulation applies to ICOs/STOs/IEOs in all formats

**ICOs**

Initial Coin Offerings

**STOs**

Security Token Offerings

**IEOs**

Initial Exchange Offerings



The regulatory analysis is the same, regardless of the format or the name of the offering

# Securities Regulation

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## The United States uses the “Howey Test” to classify investment contracts

- We will use the United States as the primary case study for this topic. Long standing law in the United States is that the “securities” include “investment contracts” and whether a transaction is an investment contract or not is determined by the “Howey Test”.
- The form of the investment contract (how it is “labeled”) is irrelevant to the Howey Test. What matters are the substantive tests below.
- The Howey Test classifies a transaction as an investment contract if:
  - There is an investment of money
  - In a common enterprise
  - With a reasonable expectation of profits from the efforts of others
- The SEC has given guidance regarding digital assets and the Howey Test here: <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>
- In the next slides we will walk through this framework and think about how it applies to typical ICOs.





# Securities Regulation

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## Prong 1: Is there an investment of money?

*“The first prong of the Howey test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.”*



Almost every ICO meets this test as ICOs were typically fundraising tools for the team working on a certain project

Source: Framework for “Investment Contract” Analysis of Digital Assets, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>



# Securities Regulation

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## Prong 2: Is there a common enterprise?

*“Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts.”*



This has been a bit more controversial but given that most ICOs have been, launched by a centralized and identifiable promoter, the SEC has taken the position that this prong holds

Source: Framework for “Investment Contract” Analysis of Digital Assets, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>



# Securities Regulation

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## Prong 3a: Is there a reasonable expectation of profits

*“An evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. Profits can be, among other things, capital appreciation resulting from the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchasers' funds. Price appreciation resulting solely from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered "profit" under the Howey test.”*



Almost all ICOs sold their tokens explicitly or implicitly with the expectation that the buyer would receive capital appreciation

Source: Framework for “Investment Contract” Analysis of Digital Assets, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>

# Securities Regulation

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## Prong 3b: From the efforts of others

*“An Affiliated Party is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.”*



The guidance is quite extensive on this point but it is fair to characterize it as follows: **If a team is issuing a coin in order for that team to build out a crypto-asset network and they are substantively “in charge” of that development, it is likely to meet this test**

Source: Framework for “Investment Contract” Analysis of Digital Assets, <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets>

# Securities Regulation

The emerging typical European three-part classification frameworks are conceptually similar and can be matched back to the Howey Test

## Payment Tokens



Fails the common enterprise or efforts of “affiliated parties” test due to a fully decentralized network. Bitcoin and, slightly controversially, Ethereum are in this category

## Utility Tokens



No expectation of profit. These are tokens for a product or service, more similar to a gift certificate than a security

## Security Tokens



Tokens similar to those that would meet the Howey Test

# Securities Regulation

## Conclusion - Almost all token offerings of the last cycle were probably securities

*“...a token that represents a participation interest in a book-of-the-month club may not implicate our securities laws, and may well be an efficient way for the club’s operators to fund the future acquisition of books and facilitate the distribution of those books to token holders. In contrast, many token offerings appear to have gone beyond this construct and are more analogous to interests in a yet-to-be-built publishing house with the authors, books and distribution networks all to come. It is especially troubling when the promoters of these offerings emphasize the secondary market trading potential of these tokens. Prospective purchasers are being sold on the potential for tokens to increase in value – with the ability to lock in those increases by reselling the tokens on a secondary market – or to otherwise profit from the tokens based on the efforts of others. These are key hallmarks of a security and a securities offering...the structures of initial coin offerings that I have seen promoted involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws. Generally speaking, these laws provide that investors deserve to know what they are investing in and the relevant risks involved”*

- Jay Clayton, SEC Chairman, 2017

Source: Statement on Cryptocurrencies and Initial Coin Offerings; <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>



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## **5. Conclusions**

# Conclusions

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## Handling regulatory issues well will be critical for crypto-asset businesses

- The financial services industry is a very highly regulated industry. It is normal to expect that corporate entities in the digital currency/crypto-asset space will be equally heavily regulated.
- Decentralized digital currencies share characteristics of currency, property, commodities and money transmission networks. This creates challenges in neatly matching them to pre-existing regulatory categories. In some countries, this has meant that every regulatory asserts authority over the space
- Taxation policy appears to be coalescing around treating crypto-assets as property
- There is a heavy regulatory focus on AML, so businesses have to take extra attention if there is a potential for them to be classified as an MSB
- Most token offerings would be classified as securities offerings under existing laws, so any token offerings have to be carefully evaluated with securities lawyers
- This is a rapidly developing (and exciting) space. Call your lawyer if you are unsure if your activity is regulated!





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## **6. Further Reading**

# Further Reading

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- IRS: *“Frequently Asked Questions on Virtual Currency Transactions”*  
<https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions>
- HMRC: *“Tax on cryptoassets”*  
<https://www.gov.uk/government/publications/tax-on-cryptoassets>
- HMRC: *“Cryptoassets: tax for individuals”*  
<https://www.gov.uk/government/publications/tax-on-cryptoassets/cryptoassets-for-individuals>
- SEC: *“Digital Assets Transactions: When Howey Met Gary (Plastic)”*  
<https://www.sec.gov/news/speech/speech-hinman-061418>
- Paris Europlace: *“France’s New Framework for ICOs and Tokens”*  
[https://www.paris-europlace.com/sites/default/files/public/pariseuroplace\\_brochure\\_francesnewframeworkforicosandtokens\\_april\\_2019-comprese.pdf](https://www.paris-europlace.com/sites/default/files/public/pariseuroplace_brochure_francesnewframeworkforicosandtokens_april_2019-comprese.pdf)

Tip: Clicking while pressing Ctrl key opens a new tab in Chrome browser on non-Apple devices



## Further Reading (cont.)

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- ESMA: “Crypto-Assets Need Common EU-Wide Approach To Ensure Investor Protection”  
<https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection>
- EC: “Consultation Document – On an EU Framework for markets in crypto-assets”  
[https://ec.europa.eu/info/sites/info/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/2019-crypto-assets-consultation-document\\_en.pdf](https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-crypto-assets-consultation-document_en.pdf)
- FATF: “Public Statement On Virtual Assets And Related Transactions”  
<http://www.fatf-gafi.org/publications/fatfrecommendations/documents/public-statement-virtual-assets.html>
- FATF: “Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers”  
<http://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets.html>

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## Questions?

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