HOW TO TAX the BITCOIN?

The financial crash of 2008 left many see their savings, pension funds and investments reduce to very little in a matter of days. In the eyes of many, the institutions who were responsible for regulating and monitoring fiscal conduct, including the banks and government, had lost their credibility in the eyes of many.

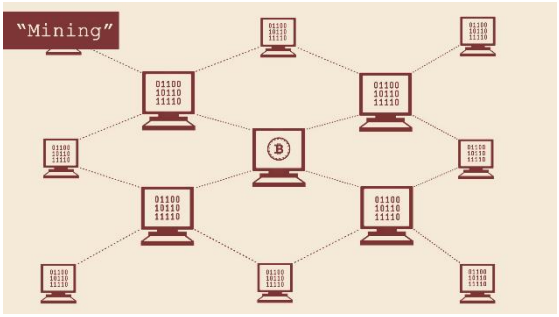
The time was ripe for a new non-governmental, non-centrally controlled currency. One that wasn't monitored or controlled by a centralised banking system. One which's value wasn't affected by a fluctuating interest-rates and inflation. But affected by more pure economics of supply-and-demand.

It was only a matter of time till someone harnessed the virtually limitless connectivity of the internet to bring about a possible alternative. In 2009 the most famous cryptocurrency was born, called Bitcoin. It is the first decentralised currency, with no person, body or institution administering it. It was designed to be an independent form of currency, free from the monetary principles and restraints that govern the standard currencies like the dollar. The ideal was to eliminate the "middle men", whether they be in the form of Banks, commissions, exchange rates and even governments.

However with every financial innovation, the tax authorities are now deeply puzzled on how to tax this new medium of trade. In this article, we delve deeper into Bitcoin, trying to understand the different tax classifications a cryptocurrency can take, and how it may affect the tax-payer.

Bitcoin is a digital currency that lives solely on the internet. It is highly encrypted, created by running long mathematical algorithms; a computer-based process for solving problems. It is virtually impossible to duplicate. Whoever owns a piece of a Bitcoin code, is the owner of the currency.

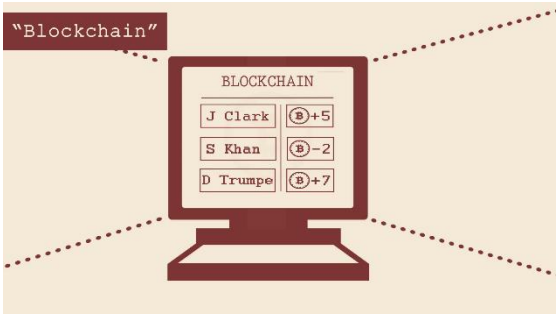
Bitcoin has emerged from two different technologies; "mining", and the "blockchain".



A Bitcoin is created through a complex algorithmic process called "mining".

A large network of programmers, or "miners", run long, time consuming mathematical algorithms on their computers. This is done to bid for a Bitcoin. With a large number of miners running their algorithms, with the hope of labelling their code a "Bitcoin", only a few actually pass the validation process. A computer-based randomiser ensures that the Bitcoin "seal" is awarded to roughly one-in-ten pieces of code, all of which are bidding to become a Bitcoin.

If their algorithm is successful and validated, which is a random process, their code is awarded the Bitcoin status.



The Blockchain

Every Bitcoin transaction, that has ever taken place, is recorded in an online accounting ledger, called the Blockchain.

This Blockchain is a fully transparent, open-source ledger, visible to anyone. Any independent person with access to the network, can easily follow the trail of transactions listed in the Blockchain, and see each transaction the Blockchain is recording.

The Blockchain recognises each Bitcoin transaction as a "block". A transaction block shows the codified identity of the buyer or seller, the amount transacted and the date of the transaction. Each block is encrypted, and impossible to change. The unique encryption code assigned to each bock ensures that it cannot be duplicated either.

As each new Bitcoin transaction occurs, the Blockchain strings together each transaction-block, with each new transaction being added to the existing chain. Hence, forming a chain-like structure, hence the name "Blockchain".

What truly sets the Blockchain apart as a bookkeeping system, is its universal nature and complete transparency. The far-reaching capacity of the internet has allowed such an open-source record-keeping system to be in place. There is no single body or organisation administering it. The same ledger is accessible to everyone, at the same time. It is automatically updated with each new transaction.

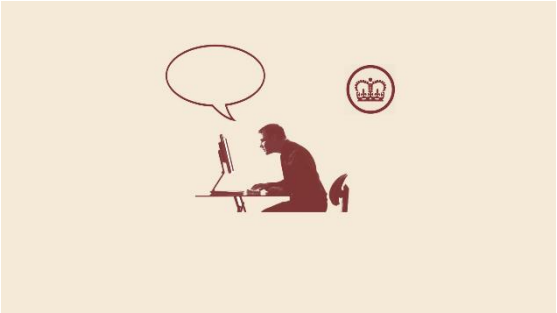
This contrasts with the financial recording systems and databases used for typical currencies like the dollar. Where it is usually controlled and administered through central banks and governments.

Since its launch in January 2009, the complex supply-chain function needed to create a Bitcoin, has resulted in a gradual decrease in the number of Bitcoins being generated and issued each year. For example, from 2009 to 2012, a total 2.6 million Bitcoins were created and issued. From 2013 to 2016, this was halved to 1.3 million in total.

With predictions that the number of Bitcoins released into market will be further halved to 650,000 Bitcoins from 2017 to 2020, the current value of Bitcoin has sky-rocketed in 2017 by 1,600%. For example, a single Bitcoin is currently valued at a staggering £13,039. However this time last year it was valued at £750. Those who saw the trend, invested early. And the current supply-and-demand dynamics of the currency indicate the same investors are inline to make a huge return on their investment.

The limited supply of Bitcoins, and its high demand, particularly amongst those looking to trade in an alternative to mainstream currencies, has also contributed to their high valuation.

Tax authorities everywhere have typically struggled to get to grips with and classify new financial innovations, like Bitcoin. For example, for several years it was widely considered that any gains made from buying and selling items on EBay were tax-free. Only when UK's HM Revenue & Customs set aside a dedicated team of investigators to fully understand how EBay worked, were they able to categorise such gains as taxable-income.



A Currency, or a Commodity?

Currently, the total trade-volume of Bitcoin is at £3.5 billion (£5.0 billion). Meaning, there are £3.5 billion worth of Bitcoin transactions happening every day, across the world. A vast portion of these daily Bitcoin transactions take place in the UK. Several UK tax-payers and investors are still unclear as to how the gains they have made from trading in Bitcoin, will actually be taxed. As UK tax-laws are designed to tax profits from different sources, in different ways.

A currency is defined as a system of money in general use in a particular country, as the dollar in the US, and sterling in the UK. However if the government and institutions that manage the supply and flow of a currency, refuse to recognise an exchange means as a currency, it no longer can meets the definition.

This is what is currently happening with Bitcoin across several countries, where some governments have decided to ban the general use of Bitcoin and similar cryptocurrencies altogether. For example, China and Vietnam have both banned the use of Bitcoin, and if anyone or company found trading in it will be fined and prosecuted.

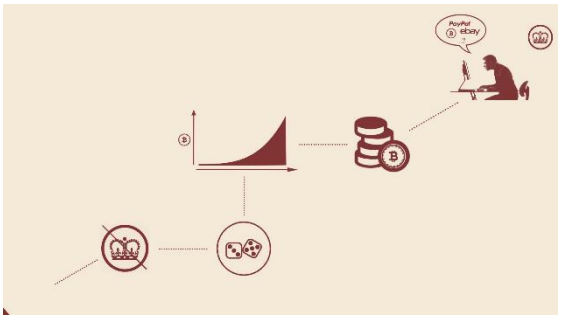
The UK's Treasury declines to recognise Bitcoin as a genuine currency. Citing its highly secretive nature as the main reason. As the identity of the owner of a Bitcoin is encrypted (i.e. turned into code). And the fact that the anonymity Bitcoin users enjoy, has led to various money-laundering and criminal activities through the internet.

However if Bitcoin was to be categorised as a currency, it would have deep tax implications.

Any gains made from buying and selling a currency are typically categorised as gambling, or more precisely, *spread-betting* in UK tax. Spread-betting is where a speculator takes a position on whether the price of a currency will go up or down. He never owns the currency in question, but simply wagers on whether its value will go up or down at a specific point in time in the future. The gain that would be made if the value was to go up, would be tax-free, as spread-betting is classified as a form of gambling for UK tax purposes, and any gains or profits made from gambling have been tax-free for years.

If Bitcoin was to be categorised as a currency, the gains Bitcoin traders would make would also be considered spread-betting gains, and hence, be outside of any income tax. With the current high valuation of Bitcoin, those who invested early, could potentially see the gain they have made through Bitcoin untouched by the tax-authorities.

This obviously would then see the tax-authorities lose millions in lost revenue, as they won't be able to tax the gains made on Bitcoin trades, if they were considered a currency and as a result, a spread-betting gain.



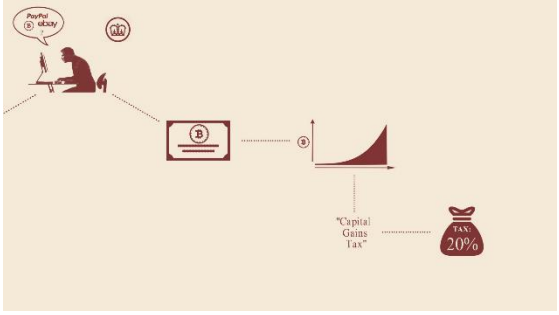
However some are arguing that Bitcoin carries the hallmarks of a commodity, or asset, similar to stocks and shares.

Assets are investments purchased to make a gain on the increase in their value. Once the asset is sold at the higher value, the net gain made would be subject to an asset-based tax, called capital-gains tax. All categories of assets, whether paper-based (like stocks and

bonds), brick-and-mortar based (property, all real-estate), are subject to capital-gains tax when they are further sold. Capital gains tax is currently set at 20% in the UK.

The opinion gaining traction in the UK seems to be that since Bitcoin and other cryptocurrencies are not legally recognised currencies, they should be seen as assets, by default. An exchange medium like Bitcoin that is not centrally administered or controlled, doesn't fit the criteria to be labelled a currency in their opinion. Or even socio-economic reasons. Bitcoin users range from normal speculators, traders, investors, consumers, but also those use it for various criminal activities, due to its highly encrypted nature.

If Bitcoin was to be classified as an asset, the gains the Bitcoin investors have made would be classified as capital gains. The profits made from trading Bitcoins would be then subject to capital gains tax at 20%, and reported in their tax returns as such.



The tax treatment of the profit made from trading Bitcoins would depend on the classification Bitcoin eventually adopts, i.e. an asset, a currency, or even a both.

Taxing the mining of Bitcoin;

When raw materials, be they physical (i.e. wood, metal, ingredients, etc,) or intangible (i.e. energy, labour, time, etc,), or a mixture of both, are combined to create something new, value is created. When this value is then further transferred or sold, it then becomes subject to value-added-tax or consumption-tax.

Many of our every-day-use things are subject to consumption-tax, from the fuel in our car, to the most of the groceries in our fridge. Over 160 countries around the world implement one form of consumption-tax.

However the production, or mining of a bitcoin, has been classified as a non-value creating activity by the UK's HM Revenue & Customs. The algorithmic process used to generate a Bitcoin, which involves programmers, computer processing power, and other overheads (as described above), is a process currently to unclear for the tax authorities. For them, the mining process needs to be further investigated, for it to be classified as a value-creation activity for tax purposes, and the debate continues.

Since its mining is not classified as a value-creation activity by HMRC, the Bitcoin production process is currently outside the scope of VAT, or any other forms of consumption tax, for that matter. This then keeps the Bitcoin mining process currently free of any tax regulations. And at the moment, left for the network of miners and programmers to self-regulate.

Japan for example, as of last July, has taken steps to fully recognise cryptocurrency as a genuine currency, and payment method, nationwide. To promote Bitcoins national acceptance, Japanese tax laws have labelled Bitcoin as exempt from consumption tax.

The virtual nature of Bitcoin and cryptocurrency has been a difficult issue for tax authorities to understand, and find a unilateral means of taxing it. As was the case with other financial intermediaries and exchanges like PayPal and EBay, the tax authorities would need keep a close eye on how Bitcoin flows throw the economy, and what does it resemble more, a trading tool, a currency or an asset, or even a mixture of all three.