10-2013

Are Cryptocurrencies 'Super' Tax Havens?

Omri Y. Marian
University of Florida Levin College of Law, marian@law.ufl.edu

Follow this and additional works at: http://scholarship.law.ufl.edu/facultypub

Part of the Banking and Finance Commons, Taxation-Transnational Commons, and the Tax Law Commons

Recommended Citation

This Article is brought to you for free and open access by the Faculty Scholarship at UF Law Scholarship Repository. It has been accepted for inclusion in Faculty Publications by an authorized administrator of UF Law Scholarship Repository. For more information, please contact outlier@law.ufl.edu.
ARE CRYPTOCURRENCIES SUPER TAX HAVENS?

Omri Marian*

Virtual currencies are online payment systems that may function as real currencies but are not issued or backed by central governments. As demonstrated by recent events, virtual currencies present regulators with significant challenges. On May 23, 2013, the U.S. federal government brought an indictment against the operators of Liberty Reserve, a popular virtual currency, charging the operators with money laundering and operating an unlicensed money-transmitting business. The same month, the Government Accountability Office (“GAO”) made public a report exploring the potential tax-compliance risks associated with virtual currencies and economies. Legislators have also taken particular interest in one type of virtual currency—Bitcoin. On August 13, 2013, the U.S. Senate Committee on Homeland Security announced plans to start an inquiry aimed at establishing a regulatory framework for Bitcoin. This short Essay describes the mechanisms by which “cryptocurrencies”—a subcategory of virtual currencies—could replace tax havens as the weapon-of-choice for tax-evaders. I argue that it is reasonable to expect this shift to occur in the foreseeable future due to the contemporary convergence of two unrelated, yet parallel, processes.

The first process is the increasing popularity of cryptocurrencies, of which Bitcoin is the most widely recognized example. Unlike other virtual currencies that are associated with the existence of a virtual economy—usually in computer games—cryptocurrencies “function as a unique curren-

---

* Assistant Professor of Law, University of Florida Levin College of Law. For helpful comments, I thank Yariv Brauner, Marty McMahon, Leandra Lederman, Jason Nance, and participants in the Levin College of Law faculty luncheon and in the SEALS 2013 Annual Meeting Tax Policy Discussion Group.


cy with [their] own free-floating exchange.\textsuperscript{5} Over the past three years, Bitcoin gradually gained the confidence of consumers, retailers, and service providers, and it is now effectively functioning as a currency in the real world. In fact, in August 2013, Bitcoin was officially recognized as a legal form of tender in Germany.\textsuperscript{6} Only two weeks earlier, a federal judge ruled that for purposes of U.S. securities regulation, Bitcoin is indeed “money.”\textsuperscript{7}

At the same time, a second global process has taken shape. Governments around the world have, for the first time, begun to successfully cooperate with their foreign counterparts in their battle against offshore tax evasion. They are doing so by targeting the financial intermediaries through which tax-evaders traditionally operate rather than by targeting the tax-haven jurisdictions that host the financial intermediaries.\textsuperscript{8} Financial intermediaries, like banks, are gradually becoming agents in the service of tax authorities. These financial institutions face increased governmental pressure to deliver information about account holders, to withhold taxes from earnings accumulating in financial accounts, and to remit such taxes to taxing authorities around the world.\textsuperscript{9}

The convergence of these two processes is significant. Cryptocurrencies possess the traditional characteristics of tax havens: earnings are not subject to taxation and taxpayers’ anonymity is maintained. Cryptocurrencies, however, also possess one added value: their operation is not dependent on the existence of financial institutions. Thus, cryptocurrencies could potentially defeat governments’ recent successes in addressing offshore tax evasion. To the extent that cryptocurrencies continue to gain momentum, we could reasonably expect tax-evaders—who traditionally executed their tax-evasion techniques through the use of offshore bank accounts in tax-haven jurisdictions—to opt out of traditional tax havens in favor of cryptocurrencies. I further suggest that while governments have paid some attention to this issue, they have so far failed to identify the acuteness of the potential problem.


\textsuperscript{7} Sec. and Exch. Comm’n v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, at *2 (E.D. Tex. Aug. 6, 2013) (“Bitcoin is a currency or form of money . . . .”).

\textsuperscript{8} Itai Grinberg, \textit{The Battle over Taxing Offshore Accounts}, 60 UCLA L. REV. 304, 322 (2012).

\textsuperscript{9} See \textit{id} at 316–17 (describing actions taken by G7 governments against financial institutions as part of recent attempts to tax offshore accounts).
I. A BRIEF BACKGROUND: A NEW ERA IN THE BATTLE AGAINST OFFSHORE TAX EVASION

In the narrowest sense, tax havens allow taxpayers to conceal earnings from tax authorities in the taxpayers’ home jurisdictions by offering “an environment with . . . no or only nominal taxation” in which “[t]he activity is usually not subject to information exchange because, for example, of strict bank secrecy provisions.” It is estimated that the United States loses between $40 billion to $70 billion of tax revenues each year to unreported earnings held in secretive tax-haven bank accounts. The worldwide revenue loss attributed to earnings hidden in offshore accounts has been estimated at as much as $255 billion annually. Given the magnitude of the problem, the United States and other countries have been engaged for years in what is known as the “battle” to tax offshore accounts.

Until recently, the Internal Revenue Service (“IRS”) has had little success in taxing concealed offshore income. After decades of frustration, however, it seems the United States and other countries are finally making significant headway in this battle. As recently described by Professor Grinberg, we are witnessing the crystallization of a new international tax-enforcement regime, which represents “a remarkable shift in international norms.” Under the new regime, financial institutions such as banks are becoming tax-intermediaries in charge of collecting information on account holders and transferring such information to taxing authorities, or in the alternative, serving as tax-withholding agents.

14. J. Richard (Dick) Harvey Jr., Offshore Accounts: Insider's Summary of FATCA and Its Potential Future, 57 VILL. L. REV. 471, 473 (2012) ("Although U.S. taxpayers have been hiding income overseas for years, the IRS historically had little success pursuing such income.").
15. Grinberg, supra note 8, at 382.
16. See id. at 347.
This process gained momentum in the United States in 2010 with the enactment of the Foreign Accounts Tax Compliance Act ("FATCA").\textsuperscript{17} Under FATCA, foreign financial institutions ("FFIs") are required to identify their U.S. account holders to the IRS. If an FFI fails to do so, it faces a 30 percent gross tax on certain payments received from U.S. sources. Once FATCA takes effect,\textsuperscript{18} it will present an impossible choice to any FFI with substantial business in the United States: either breach the bank-secrecy laws in the FFI's home jurisdiction by providing details on its account holders or pay a heavy tax in the United States. However, since FATCA's enactment, the United States has negotiated and signed multiple intergovernmental agreements aimed at dealing with this problem by enabling FFIs to comply with FATCA without breaching the law in the FFIs' home countries. As a result, U.S. taxpayers will not be able to rely on bank-secrecy laws in those jurisdictions as a shield for their hidden taxable earnings.

II. CRYPTOCURRENCIES CAN DEFEAT THE DEVELOPING TAX-ENFORCEMENT REGIME

While the developing success of the tax-enforcement regime described above is indeed remarkable, I suggest that it may only prove to be a lull in the battle against tax evasion and that a new front could quickly emerge. I believe that tax-evaders—under the threat of the new regime—may soon abandon traditional tax-haven jurisdictions in favor of cryptocurrencies.

Cryptocurrencies are web-based, peer-to-peer payment systems that rely on cryptography. They function as "a digital unit of exchange that is not backed by a government-issued legal tender."\textsuperscript{19} They are computer files tendered as a form of payment for real goods and services. The most well-known, and currently the most successful, example of cryptocurrency is the Bitcoin, first introduced in 2008.\textsuperscript{20}

Bitcoins, unlike government-backed currencies and unlike virtual currencies used in computer games, are not really "issued" by anyone. They come into existence when they are "mined" by users. Bitcoin software automatically creates increasingly difficult mathematical problems. Users' computers "mine" Bitcoins by solving these problems. Mined Bitcoins go into circulation. They can be exchanged for goods, services, or even government-backed currencies in online exchanges that facilitate such transactions.


\textsuperscript{18} FATCA's implementation dates have been revised several times. Most withholding and reporting obligations—arguably the most important part of FATCA—are expected to gradually take effect between 2014 and 2017.

\textsuperscript{19} GAO REPORT, supra note 3, at 3.

number of Bitcoins to be mined is finite and capped at 21 million. The Bitcoin software gradually reduces the amount of Bitcoin rewarded for successful mining so that all Bitcoins will be mined by 2140. Bitcoins are currently traded at about $139 for the Bitcoin, with a market cap of about $1.6 billion.21

While cryptocurrencies can be used for legitimate purposes, they are also well suited to support illicit transactions. From a tax-evasion point of view, they are particularly attractive. Cryptocurrencies possess the two most important characteristics of a traditional tax haven. First, because there is no jurisdiction in which they operate (they are “held” in cyberspace accounts known as online “wallets”), they are not subject to taxation at source. Second, cryptocurrency accounts are anonymous. Users can start as many online “wallets” as they want to buy or mine Bitcoins and trade them without ever providing any identifying information.

Significantly, Bitcoin (and other cryptocurrencies) offer one additional major advantage to tax-evaders that traditional tax havens do not: the operation of Bitcoin is not dependent on the existence of financial intermediaries such as banks. Bitcoin is exchangeable peer-to-peer by definition. Bitcoin thus seems immune to the developing international anti-evasion regime described in Part I. In cyberspace, financial institutions—the emerging agents of tax collection—are taken out of the picture. Thus, cryptocurrencies have the potential to become super tax havens.22

For example, a service provider could theoretically accept payments for real services in Bitcoin. Given that the service provider is not required to identify herself when establishing her online Bitcoin wallet, it would be very difficult to trace the earnings accumulated in this wallet back to the service provider. Under current U.S. law, such income is clearly taxable to a U.S. service provider.23 It is unlikely, however, that the IRS or any other tax authority will know about the income unless the service provider voluntarily reports it.

More sophisticated approaches to tax evasion through Bitcoin could involve third parties. For example, it is possible to use tax-exempt buying


agents to invest in traded securities and commodities using a Bitcoin-equity swap contract. Under such schemes, a Bitcoin user (the "investor") who is interested in investing in the stock of company X could pay the Bitcoin amount she wishes to invest to a buying agent (the "agent"). The agent would then use the dollar value of the amount paid to buy the stock. The agent would transfer to the investor the Bitcoin value of any dividends paid by company X to the agent. Once the contract was terminated, the agent would either pay to the investor the Bitcoin-value appreciation of the stock, or the user would pay the agent the Bitcoin-value depreciation. At all times the agent would have no tax liability because of its tax-exempt status.

The agent is indifferent as to the performance of the stock because it has no economic exposure. The investor, on the other hand, is fully exposed to the performance of the stock as if she had invested directly in the stock. Tax authorities, however, know nothing about the involvement of the Bitcoin investor, whose income from the investment goes unreported and untaxed.

III. IS BITCOIN-BASED TAX EVASION A REAL PROBLEM?

Given the small volume of the current Bitcoin market, it is hard to imagine that the tax evasion associated with it is of any real significance. Most commentators, however, expect the markets of Bitcoin and other cryptocurrencies to grow over the next few years. Since its inception, Bitcoin gradually gained popularity and earned the confidence of users. It is now an accepted form of payment in many real businesses, and there are several projects aimed at making the use of Bitcoin convenient enough so as to enable point-of-sale payments. Bitcoin has also been recognized as a legal form of tender in Germany and as "currency" for certain regulatory purposes in the United States. This trajectory should cause policymakers to take a serious look at the Bitcoin tax-evasion potential.

This is particularly true given that some evidence suggests that Bitcoin may already be used for tax-evasion purposes. One study found that many owners of Bitcoin wallets use them as "savings accounts." Such wallets are used only to receive but never to send Bitcoins. Earnings in such wallets,
unless voluntarily reported, are beyond the reach of taxing authorities. In addition, researchers have discovered that many Bitcoin users employ “fork and merge” patterns. Large amounts of Bitcoins are split into multiple small accounts, apparently owned by the same user, or large amounts are bought in small batches using multiple wallets. Tax-evaders and money launderers regularly use these tactics to attempt to hide the sources, as well as the destination, of funds. Moreover, some taxpayers have openly acknowledged that they have considered using Bitcoins to avoid tax-reporting requirements.

Governments have identified the regulatory challenges of virtual currencies, including the potential of Bitcoin to facilitate tax evasion. However, governments have yet to fully consider cryptocurrencies in the context of the emerging regime in which financial institutions are tax-enforcement agents. For example, in 2007, the IRS looked into potential tax compliance risks associated with web-based payment systems and eventually opted not to act. One of the reasons cited for inaction was the lack of “strong evidence of the potential for tax noncompliance related to virtual economies . . .” In 2007, however, none of the developments described above, namely the enactment of FATCA and the increasing popularity of Bitcoin, had even started to take shape. The 2007 IRS action did not consider the development of major peer-to-peer, open-flow payment systems such as Bitcoin, which operate in real economies and are not limited by the volume of virtual in-game economies. The IRS recently indicated that “the increasing use and misuse of cyber-based currency and payment systems to anonymously transfer illicit funds as well as hide unreported income from the IRS is a threat [the IRS is]
vigorously responding to.”\textsuperscript{35} It is not clear, however, what such a response includes.\textsuperscript{36}

The 2013 GAO Report’s main recommendation is that the IRS develop “low-cost ways to provide information to taxpayers... on the basic tax reporting requirements for transactions using virtual currencies developed and used outside virtual economies.”\textsuperscript{37} The IRS has agreed to implement this recommendation.\textsuperscript{38} This recommendation, however, falls very short of addressing the real difficulty that cryptocurrencies pose to tax collection. There is little question that earnings in cryptocurrencies such as Bitcoin are taxable.\textsuperscript{39} Educating taxpayers about that fact, while somewhat useful, has little relevance to the tax-evasion problem. Tax-evaders who use offshore bank accounts to evade taxes, and who may opt to use Bitcoins to facilitate tax evasion, are taxpayers who are well aware of their obligation to report earnings and pay taxes. Nonetheless, such taxpayers purposely choose not to report their income or to pay taxes. Education achieves little in such cases.

The real challenge is to develop enforcement mechanisms that allow tax authorities to discover funds hidden in cryptocurrency accounts. It seems that authorities have not taken this course of action because of the relatively small size of the economic exchange facilitated by cryptocurrencies; or, in the alternative, because the problem is wrongly associated with the insignificant volume of “virtual economies.” As noted, the cryptocurrencies market is expected to grow, and it is by no means limited by the size of any virtual game’s economy. Cryptocurrencies are used as real money to purchase real goods and services in the real world.

IV. What Can Be Done?

It is clear that traditional anti-tax-evasion mechanisms cannot successfully address Bitcoin-based tax evasion. For example, exchange-of-information agreements are irrelevant, since Bitcoin’s operation is not dependent on the existence of a sovereign jurisdiction. There is no jurisdiction to exchange information with. As with traditional cases of offshore tax evasion, governments may employ complex statistical analysis to try to


\textsuperscript{36} Emails sent to the acting director of Technology Operations Investigative Services, IRS Criminal Investigation, on June 11, 2013, and to the director of Communications and Education, IRS Criminal Investigation, on June 12, 2013, with inquiries related to IRS efforts did not produce a substantive response.

\textsuperscript{37} GAO REPORT, supra note 3, at 17.


\textsuperscript{39} Freeman, supra note 22, at 2.
identify the owners of Bitcoin accounts.\textsuperscript{40} Such an approach, however, can only be used in particular cases and cannot be used systematically to address the problem. The innovation associated with Bitcoin as an instrument of tax evasion will necessitate innovative policymaking. A full inquiry into all possible tax-policy solutions is beyond the scope of this Essay. I do suggest, however, several conceivable lines of inquiry to guide policymaking.

FATCA-like solutions, namely, targeting intermediaries that facilitate Bitcoin trading and exchange, may be appropriate, but it is not clear to what extent. As mentioned, there are no traditional financial intermediaries involved in Bitcoin trading. There are no “banks” holding information on account holders. That said, it seems that with the increasing popularity of Bitcoin, some internet intermediaries emerge naturally in the market. Websites that facilitate the exchange of Bitcoin to real currencies must hold some information on their account holders (such as a bank account number, credit card number, or PayPal account) in order to enable the exchange. It might be possible for tax authorities to regulate such intermediaries in the same manner in which they regulate financial intermediaries under the FATCA regime.\textsuperscript{41} Such FATCA-like regulation, however, is only useful at the point of exchanges of Bitcoin to government-issued currencies. Any transaction made solely in Bitcoins, meaning with no exchange to real currencies, avoids such regulation. Theoretically, if Bitcoin becomes widely accepted so as to enable taxpayers to “live on it,” taxpayers could live their lives using only Bitcoins, without ever reporting income.\textsuperscript{42}

The German government has recently suggested taxing Bitcoins as capital assets.\textsuperscript{43} Namely, taxpayers would have to report income when they dispose of Bitcoins in the same way they report income on the disposition of stock, bonds, and other financial assets held for investment. Again, such a strategy is only relevant for point-of-exchange transactions, in which Bitcoin

\begin{itemize}
  \item[40.] See Fergal Reid & Martin Harrigan, An Analysis of Anonymity in the Bitcoin System, in SECURITY AND PRIVACY IN SOCIAL NETWORKS 197, 198 (Yaniv Altshuler et al. eds., 2013).
  \item[41.] In fact, Bitcoin exchange services must be registered as “money transmitters” with the U.S. Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”) under the regulations relating to money-services businesses. See Fin. Crimes Enforcement Network, Dept. of Treasury, Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FinCEN (Mar. 18, 2013), http://fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf. The same regulatory approach could be used to combat tax evasion.
\end{itemize}
owners voluntarily reveal their earnings from under their veil of cyber¬
secrecy. The German approach provides no remedy for Bitcoin-based tax
evasion in which earnings in Bitcoin remain unreported and potentially
never exchanged to government-backed currencies.

A more radical possibility is to operate against Bitcoin users. This form
of action is interventionist and carries with it substantial political and norma¬
tive implications. Under such an approach, for example, legislators could
take action to chill the enthusiasm about Bitcoin by disallowing payments in
Bitcoin. While not addressing the issue of tax evasion directly, it could harm
Bitcoin liquidity and value, and as such make it ineffective for tax-evasion
purposes. Such an overreaching approach would probably result in the loss
of the social benefits associated with Bitcoins.44

Also, given that the number of Bitcoins is finite and that current market
capitalization is low, governments could theoretically eliminate Bitcoin by
owning it all. For example, central banks could purchase Bitcoins, and
governments could employ sizable computing powers to mine Bitcoins and,
by doing so, take Bitcoin out of circulation. This, again, will make Bitcoin
irrelevant for tax-evasion purposes. Even assuming we are able to clear
the legal and normative hurdles associated with such an approach, however,
there is no assurance that other virtual currencies will not take Bitcoin’s
place.

Granted, each of the suggested approaches has its practical and, more
importantly, normative implications. There may be good reasons to allow
cryptocurrencies to circulate due to their many apparent benefits, notwith¬
standing that they are also used to facilitate illicit transactions (like any other
currency). I do not advocate any of the approaches suggested above. I simply
present them as a starting point for policy deliberation.

**Conclusion**

Over the past three years, cryptocurrencies have been gaining confi¬
dence and popularity among users, and their market volume is expected to
increase. Cryptocurrencies offer, at least theoretically, a near-perfect alterna¬
tive to tax-evaders who can no longer find a safe haven in tax-haven jurisdic¬
tions. It is thus reasonable to expect that as the market volume of crypto¬
currencies increases, so will the tax avoidance associated with it.

To date, most tax policymakers seem to be operating under the faulty as¬
sumption that cryptocurrency-based economies are limited by the size of
virtual economies. The only virtual aspect of cryptocurrencies, however, is
their form. Their operation happens within real economies, and as such their

44. For a summary of the benefits, see, for example, Nicholas A. Plassaras, Regulating
Digital Currencies: Bringing Bitcoin Within the Reach of the IMF, 14 CHI. J. INT’L L. 377, 387–91
(2013).
growth potential is, at least theoretically, infinite. Such potential, together with recent developments in cryptocurrencies markets, should alert policymakers to the urgency of the emerging problem.