

Tax (Re)structuring: the advent of Cryptocurrency

Ombo Malumbe

All Rights Reserved © 2018

Tax (Re)structuring: the advent of Cryptocurrency

by

Ombo Malumbe*

Abstract

The ideology of establishing Bitcoin (read cryptocurrency) has been in place prior to the year 2008 when the first stable cryptocurrency was conceptualised by the mysterious person or group of persons known as Satoshi Nakamoto. However, in this paper, the bone of contention is what impact does cryptocurrency have towards implementation of laws or Regulations in various countries.

As a result of cryptocurrencies, there have been ample questions arising from the Securities/ Capital Markets oriented bodies, Central Banks, and or Government Tax authorities. It is imperative to note that the aspect of Blockchain Technology and Cryptocurrencies pose startling questions towards Governments that have been reluctant to catch up with the Technological and Innovation trends that are taking place day-in-day-out.

Around the world, Governments have taken different stances towards Cryptocurrencies, which include entirely or partially accommodating, banning, classifying, and or taking no action on Cryptocurrencies. Therefore, the imperative issues that emanate are, what are the benefits of Cryptocurrencies, particularly about the application of Tax Laws or Regulations.

Tax Laws or Regulations (Tax Laws) have an element of *nulla poena sine lege*, a Criminal Law based Latin maxim that provides that no one can be convicted for a crime that the laws, at that material time, did/do not define a certain activity as a crime. The application of Tax Laws requires that for a transaction to be taxable, the same ought to be provided expressly through the laws, therefore, in the event that a Country lacks such legal parameters or definitions that would make it possible to Tax Cryptocurrencies, then it makes it a fair model to implement Tax Avoidance Schemes.

The individuals or companies that engage in Cryptocurrencies tend to adopt various names for the Cryptocurrencies, which include Virtual Assets, Utility Tokens, Security Tokens, Equity Tokens, among others, which can merely be challenged based on the Substantive factors over the Descriptive factors that are relatively used by Cryptocurrency enthusiasts. Therefore, to understand the Tax models applied or those

* Attorney of the High Court of Kenya. Specialises in Strategic Legal Services: Corporate Law & Litigation. Partner at Ong'anya Ombo Advocates Nairobi Kenya. e: om@onganyaombo.com m: +254724026355

which can be applied towards Cryptocurrencies, it is essential to focus on classifications provided towards Cryptocurrencies.

The paper gives a simplistic explanation of cryptocurrencies, after that, the article addresses Tax Avoidance in a general manner, which is followed by a minor example on how one can structure their business using cryptocurrencies.

Keywords: Tax Avoidance, Tax Evasion, Tax Laws, Cryptocurrencies, ICO, Tax (Re)structuring, Tax Avoidance Schemes

1. Understanding Cryptocurrencies

Governments or cryptocurrencies enthusiasts have given cryptocurrencies different names; however, herein, the term cryptocurrency will accommodate all forms of altcoins, tokens, or cryptocurrencies.

Owing to the fact that cryptocurrencies, at least most of them, are issued in a similar manner as Shares under Initial Public Offering (IPO) or Follow-up Public Offer (FPO), it will be prudent to relate the two as a means of simplifying it. For instance, cryptocurrencies are programmed to operate on Blockchain Technology – it is possible for companies listed on various stock exchanges adopt Blockchain Technology as a model of engaging investors through IPO/FPO or Private Placement.

The vital difference on how cryptocurrency operate and the tradition IPO/FPO is that when engaging in *Initial Coin Offering*¹ (ICO) the investor does not acquire any rights as that of an *investor*² under the traditional IPO/FPO. In addition, under the conventional setting of IPO/FPO there is a need for companies to comply with various Securities Laws that are regulated by an independent body, hence, it enhances the interests of the investors while in the ICO, that is not the case save for a few countries that are showing interest in regulating such activities. For instance, Philippines, Hong Kong, Singapore, Canada, among others have taken keen interests to formulate regulations concerning initiating and running of ICO.

2. Tax Laws or Regulations

There are various models of Governments across the globe, and each of them assumes the duty to address the collective Socio-economic needs of its Citizens. Therefore, the Governments have established various models of collecting revenue from the subjects and or foreigners for purposes of conducting or realising its duties. One among the different models, it is the collection of Tax through various models of transactions that take place.

However, in certain instances, the law provides room for one to avoid payment of tax either directly or indirectly. As a result, various professionals, particularly Accountants and Attorneys, have analysed statutes and regulations that address tax issues for purposes of cutting down on tax obligation in favour of themselves or their Clients'.

Tax (Re)structuring can lead to two significant eventualities, which are Tax Avoidance and Tax Evasion. There are numerous writings concerning the conflating nature of the two terminologies when it comes to the practicability of applying them, particularly Tax

¹ That includes what other cohorts may refer to as Token Generation Events

². It is vital to appreciate the fact that all these are based on the language adopted for purposes of engaging in a similar project. However, in the event a company intends to IPO/FPO and aligns itself as per the Laws and Regulations of any Securities or Capital Markets body in the respective jurisdiction and provide that the sale of Tokens will lead to acquiring of shares, then that will give some substantial rights to the investors.

Avoidance.³ Therefore, it is prudent that such terms are addressed herein before delving into how Cryptocurrencies can be used to implement Tax Avoidance.

2.1. Principles Guiding Tax Laws

The Government, in order to collect tax effectively, has the obligation to adhere to various tax principles for it to primarily have an equitable tax policy. Implementation of Tax Laws and Regulations, unlike in the past⁴, is not only influenced by the Political or Government Regimes but other countervailing factors come into the picture. For instance, issues concerning Foreign Direct Investment (FDI), whether there exists a Bilateral or Multilateral Tax or Foreign Direct Investment Treaties, the Governments must set laws or regulations that are cordial to all those countervailing factors.⁵ Under Fundamental Principles of Taxation⁶:

Assuming a certain level of revenue that needs to be raised, which depends on the broader economic and fiscal policies of the country concerned, there are some general tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility.⁷

Certainty and simplicity are cited as some of the key factors that ought to come into consideration, leave alone effectiveness, though very imperative. Several Governments like Canada, the United States of America, Mexico, Germany,⁸ *et al*, have accommodated Cryptocurrency but it is easy to note that there is a lot of inconsistency, in some jurisdictions, concerning whether a Cryptocurrency is categorised as **virtual asset** or **virtual currency**.⁹ Depending on the definitive terms given to Cryptocurrency, it will determine the applicable Tax Laws that will apply to it.

Therefore, if Cryptocurrency is accepted as a virtual currency (save that Governments are reluctant to accept it as Legal Tender), it will mean that as a virtual currency, then there is no

³ Christians, Allison, Avoidance, Evasion, and Taxpayer Morality (March 29, 2014). Washington University Journal of Law and Policy, Vol. 44, p. 39 (2014). Available at SSRN: <https://ssrn.com/abstract=2417655>

⁴ Diane Ring, 'International Tax Relations: Theory And Implications' [2007] Tax Law Review 60.

⁵ Evert-jan Quak and Hannah Timmis, *Double Taxation Agreements And Developing Countries*(K4D/Institute of Development Studies 2018) <https://assets.publishing.service.gov.uk/media/5b3b610040f0b645fd592202/Double-Taxation-Treaties_and_Developing_Countries.pdf> accessed 6 November 2018.

⁶ OECD, 'Fundamental Principles of Taxation' [2014] OECD/G20 Base Erosion and Profit Shifting Project.

⁷ Ibid n6

⁸ Prableen Bajpai, 'Countries Where Bitcoin Is Legal & Illegal (DISH, OTSK)' (*Investopedia*, 2018) <<https://www.investopedia.com/articles/forex/041515/countries-where-bitcoin-legal-illegal.asp>> accessed 6 November 2018.

⁹ Due.com 'Understanding Cryptocurrency Tax Obligations' (*Nasdaq*, 2018) <<https://www.nasdaq.com/article/understanding-cryptocurrency-tax-obligations-cm986151>> accessed 6 November 2018.; *See also*, Simon Chandler, 'Money Or Assets? How World Governments Define Cryptocurrencies' (*Cointelegraph*, 2018) <<https://cointelegraph.com/news/money-or-assets-how-world-governments-define-cryptocurrencies>> accessed 6 November 2018.

taxes such Valuable Added Tax (V.A.T.), Capital Gains Tax, etc. save for deductions like commissions collected by licensed Foreign Exchange business entities. However, if Cryptocurrency is defined as a Virtual Asset, then it is imperative that any transactions concerning cryptocurrency will result to various models of taxes being applied, particularly V.A.T., Capital Gains Tax, among others.

If there is uncertainty concerning the applicable laws, then that will result in a decision that favours the citizen or foreigner and not the revenue collector, for instance, in *United States v. Critzer*¹⁰:

While the record amply supports the conclusion that the underreporting was intentional, the record also reflects that, concededly, whether defendant's unreported income was taxable is problematical and the government is in dispute with itself as to whether the omitted income was taxable.

We hold that [the] defendant must be exonerated from the charges lodged against her. As a matter of law, defendant cannot be guilty of willfully evading and defeating income taxes on income, the taxability of which is so uncertain that even co-ordinate branches of the United States Government plausibly reach directly opposing conclusions. As a matter of law, the requisite intent to evade and defeat income taxes is missing. The obligation to pay is so problematical that defendant's actual intent is irrelevant. Even if she had consulted the law and sought to guide herself accordingly, she could have had no certainty as to what the law required.

It is settled that when the law is vague or highly debatable, a defendant -- actually or imputedly -- lacks the requisite intent to violate it.¹¹

In reference to the excerpt above, derived from the cited case, among others, it is vivid that the uncertainty of the laws concerning the classification of cryptocurrency makes it impossible to determine how the law on collection of revenue will apply to cryptocurrency. In addition, it is more interesting when the Government takes a sit back and watch approach.

2.2. Interpretation of Tax Laws

The Courts are likely to address the issue of tax schemes based on various influential factors other than the language of the tax laws that are in place. For instance, where the law is clear, the Court will focus on the language and the purposive interpretation of the law.¹² The impact of adopting the purposive interpretation may result in disregarding the Tax Schemes that would have been implemented for purposes of reducing the tax obligation as indicated in *Commissioners of Inland Revenue v McGuckian* (*Supra*): this more of "Substance over form" which was adopted from Ramsay Principles.¹³

¹⁰ 498 F.2d 1160 (4th Cir. 1974)

¹¹ Ibid n10

¹² *Commissioners of Inland Revenue v McGuckian* HL (Times 20-Jun-97, Gazette 09-Jul-97, House of Lords, Bailii, [1997] UKHL 22,

¹³ *W T Ramsay Ltd v Inland Revenue Commissioners* HL ([1981] 1 All ER 865

In *Griffin v Citibank Investments Ltd*¹⁴ the Court pronounced that the Ramsay Principles are not absolute principles, they are mere general principles that form part of other equally sustentative rules. The Court, in its wisdom, stated that the lack of *composite transaction* discredits the use of Ramsay Principles. In addition, a transaction will fall under the Ramsay Principles if the sole purpose of the transaction was developing artificial steps with *no commercial benefits* other than saving on tax.¹⁵ Irrespective of the Ramsay Principles indicating that *no commercial advantage* being a key factor, the courts have recently pronounced that it is not in all circumstances that the element of *no commercial benefits* will deny a person the tax advantage.¹⁶

Ramsey Rule, not to be confused with Ramsay Principles, is primarily based on the Elastic or Inelastic Demand that may result when the Government effects Tax Laws.¹⁷ Such policies can lead to high demand or deadweight loss. Governments note that due to elastic demand, which will reduce the demand of a product, for instance, when a tax is imposed on a luxurious product or service, which makes people shy from purchasing such products or services, therefore, the purposes of the revenue collection will be ineffective. However, when the Government adopts *inverse-elasticity rule*¹⁸ to imposes proportional tax models, though at a lower percentage, on basic needs like bread, milk, among others, it will not lead to a *deadweight loss* as those are basic needs.

2.3. Tax Avoidance

In the English Dictionary, the term Avoidance and Evasion can somewhat be used interchangeably, however, in the legal arena, the law provides definitions concerning various terms, hence, creating a distinction. The general meaning, and according to the Organisation of Economic Co-operation and Development (OECD) under its Glossary, defines these terms as follows:

Tax Avoidance is [a] term that is difficult to define but which is generally used to describe the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal it is usually in contradiction with the intent of the law it purports to follow.¹⁹

Tax Evasion is [a] term that is difficult to define but which is generally used to mean illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays

¹⁴ ChD 14 Nov 2000

¹⁵ Ibid n14

¹⁶ *Revenue and Customs v PA Holdings Ltd* [2010] UKUT 251 (TCC)

¹⁷ OUP, 'Ramsey Rule - Oxford Reference' (*Oxfordreference.com*)

<<http://www.oxfordreference.com/view/10.1093/oi/authority.20110803100403456>> accessed 6 November 2018.

¹⁸ OUP, 'Inverse Elasticity Rule - Oxford Reference' (*Oxfordreference.com*)

<<http://www.oxfordreference.com/view/10.1093/oi/authority.20110803100009622>> accessed 6 November 2018.

¹⁹ OECD, 'Glossary of Tax Terms - OECD' (*Oecd.org*)

<<http://www.oecd.org/ctp/glossaryoftaxterms.htm>> accessed 6 November 2018.

less tax than he is legally obligated to pay by hiding income or information from the tax authorities.²⁰

It is evident that the element of conflating of the two terms emanates in various platforms that are *pro* collection of revenue by Governments. According to the definition hereinabove, Tax Avoidance results after the analysis of the existing laws and regulations and, thereafter, coming up with models of how to pay less tax or no tax at all but within the confines of the law while Tax Evasion is when a person disregards the laws and regulations concerning taxes by failing, neglecting or refusing to pay the tax. Simply, one model is done by taking advantage of the loopholes in various provisions of the law, while the other does not take place within the confines of the law.

The legitimacy of Tax Avoidance has resulted in Activists who are against it; therefore, the activists raise objections towards such practices, flagging it as an “immoral” practice. However, the development of society creates what is regarded as the hierarchy of laws. Depending on where one comes from, the hierarchy of laws emerges from the customary law or statutory laws, and one supersedes the other. For instance, in the Republic of Kenya, the Judicature Act²¹ provides that the Constitution is supreme, followed by statutes and last in the line is Cultural Laws. In the United States of America (the US), the hierarchy of laws initiates from the US Constitution, Laws (statutes) enacted by Congress, Rules promulgated by federal agencies, State constitution, Laws enacted by the state legislature, Rules promulgated by state agencies, City/county charters (the “constitution” for the city or county), Local laws and ordinances, and Rules promulgated by local agencies²².

What can be deduced herein above is that laws will take precedence over other social assumptions that persons with different opinion will hold. For instance, the “immoral act” that is being addressed by the Activist is more of what can be regarded as “Social Morals” and not “Legal Morals”. Social Morals and Legal Morals are best expressed through Same-Sex Marriage. If a Country makes laws to decriminalize Same-Sex Marriage, it will mean that persons of the Same-Sex can get married due to the Legal Morality established by that provision of the law, while those who dissent to such Same-Sex Marriage law, are merely relying on Social Morals to transgress the Legal Morality.

In reference to the above example and the subtopic at hand, the act of engaging in Tax Avoidance is conducted as per the provisions of the law, without flaunting the said laws, therefore, the act of Tax Avoidance reflects Legal Morality. In *IRC v. Duke of Westminster*²³ it was stated that:

²⁰ OECD, 'Glossary of Tax Terms - OECD' (*Oecd.org*)

<<http://www.oecd.org/ctp/glossaryoftaxterms.htm>> accessed 6 November 2018.

²¹ CAP 8 of the Laws of Kenya.

²² Mark Davies, *An Introduction to The Structure And Sources Of American Law* (NYC Gov)

<http://www.nyc.gov/html/conflicts/downloads/pdf2/municipal_ethics_laws_ny_state/introduction_to_american_law.pdf> accessed 6 November 2018.

²³ [1936] A.C. 1: However, as highlighted under the interpretation part of the paper, there are other countervailing principles such as the Ramsay Principles and the Griffin Case.

Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.²⁴

The words of Tomlin, J. makes it clear that Social Morals are not substantial to negate any act or omission that has been conducted as per the applicable laws.

It is imperative to note that the Westminster Principles were somewhat indirectly reviewed by the decision under in *W T Ramsay Ltd v Inland Revenue Commissioners (Supra)*– also referred to as Ramsay Principles. However, the Griffin Case portrays that there can be a distinction of facts to disallow the application of the Ramsay Principles, not to mention that in *Collector of Stamp Revenue v Arrowtown Assets Ltd*,²⁵ the Courts have adopted a different approach that makes it clear that the Ramsay Principles are not absolute principles when addressing issues of Tax Avoidance Schemes as addressed by Justice Chan PJ.

In addition, not all Governments take Tax Avoidance Schemes (Tax [Re]structures) lightly, for instance, some Governments, through their respective General Anti-Avoidance Rules, provide guiding principles that a party (re)structuring its tax obligation ought to consider. Therefore, regardless of the contents herein, it is imperative that one reviews the Jurisdictional laws or regulations concerning tax (re)structuring and the permissible extent.

3. Tax (Re)structuring through Cryptocurrency

(Re)structuring of Business Entities or Individual Taxes by adopting Cryptocurrency will heavily rely on the stance a Government takes concerning Cryptocurrency. The model of Tax (Re)structuring, in this case, concerns Countries that have not declared a clear position on what Cryptocurrency is, and Governments that are taking a **sit back and watch approach**.

3.1. Theoretical Factors

Test 1 (for the readers' personal analysis)

A business, for instance, a Limited Liability Partnership or Limited Liability Company by Shares/ Guarantee that is registered in a country known as **Smileto** whereby the State has taken a sit back and watch approach on issues concerning Cryptocurrencies. In addition, the **Smileto** has issued a notice to all financial institutions in the country not to accept Cryptocurrency based transactions, not to mention, its Central Bank informs the Citizens of the **Smileto** that anyone taking part in such transactions and suffers a loss, the person will not have any recourse under the Central Bank monetary based laws and regulations.

Test 2 (for the readers' personal analysis)

A business, for instance, a Limited Liability Partnership or Limited Liability Company by Shares/ Guarantee that is registered in a Country known as **Sadto** whereby the country has

²⁴ [1936] A.C. 1

²⁵ [2003] HKCFA 52

conflicting approach on Cryptocurrency, therefore, resulting to a confusion on whether Cryptocurrencies are taxable as Virtual Assets or payment for commissions or application of licenses from Governmental bodies for purposes of conducting Money Transfer Services since it is a Virtual Currency.

3.2. Diagram (*Dummy*)

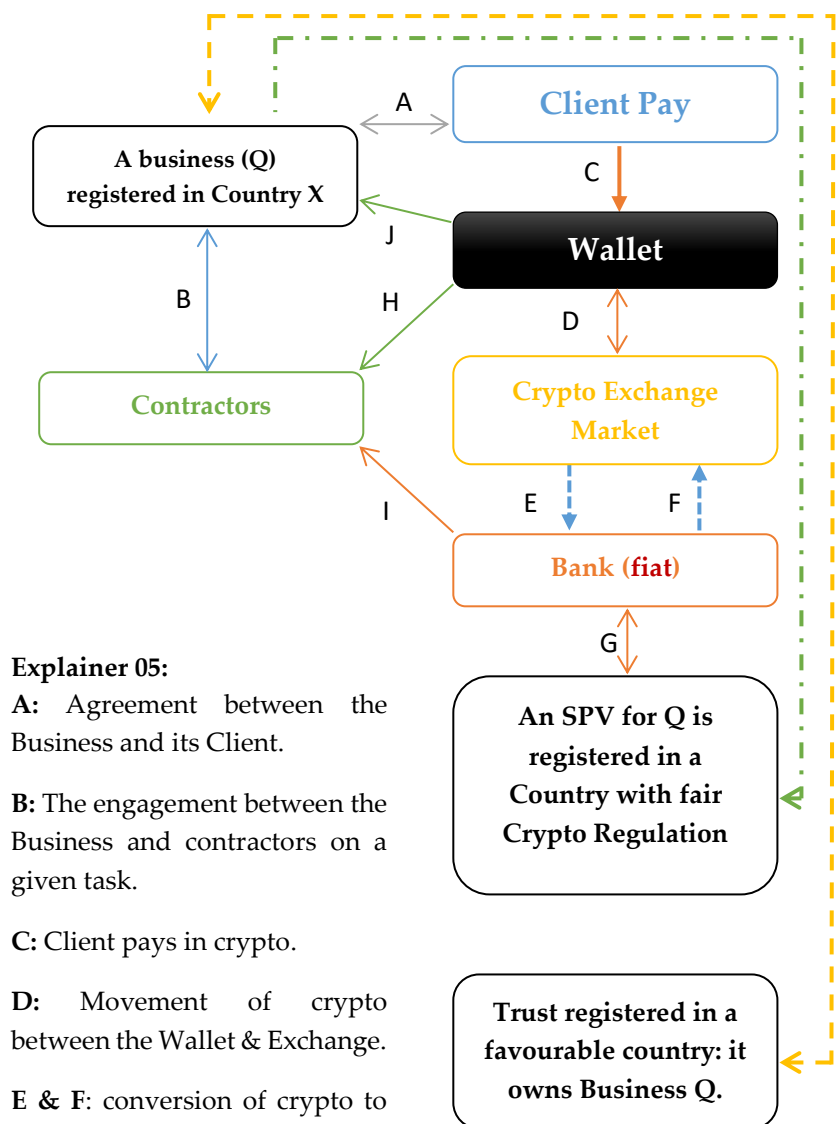
Explainer 01: Initiates a Consultancy Service and indicates that it only accepts certain stable cryptocurrencies as models of payment of the services rendered.

Explainer 02: It hires Contractors, in this case, experts in different areas of that niche that the business is interested in. Also, the Contractors are paid in cryptocurrencies.

That enables the company to avoid Statutory obligations such as making contributions to Health Funds, among others.

Explainer 03: Irrespective of establishing business in such areas, it is imperative that the payments in cryptocurrency are stored/exchanged in a company that is registered in stable – in terms of cryptocurrency regulations – country. That will help in avoiding selling the cryptocurrency at lower rates when the regulatory framework changes where the business is registered.

Explainer 04: One can consider checking imperative laws, rules, or treaties. In reference to treaties, in most cases are multi/bilateral Double Taxation Agreements between two or more countries or blocks to ease tax burden upon their respective citizens.



Explainer 05:

A: Agreement between the Business and its Client.

B: The engagement between the Business and contractors on a given task.

C: Client pays in crypto.

D: Movement of crypto between the Wallet & Exchange.

E & F: conversion of crypto to other fiat currencies or *vice versa*.

G: One will need to manage bank accounts, which is best done through an SPV that does not have control. This reduces chances of a company being Taxed at a given jurisdiction.

H & I: Contractors Payment Models.

Business Q operates as Company Limited by Guarantee.

J: Funds to Business Q in Crypto

Conclusion

Tax (re)structuring is a complex area of law that demands top-notch legal and accountancy analysis. In addition, Governments tend to apply broad terms for purposes of addressing the loopholes that may exist and easily exploited for purposes of Tax Avoidance. For instance, as highlighted herein above, the adoption of GAAR and application of Ramsay Principles, Griffin Case, *Collector of Stamp Revenue v Arrowsmith Assets Ltd (Supra)*, among others, give the revenue collection authority to enhance its scope but to certain limits within confines of the law.

It is evident that most Governments are grappling on how to handle the use of Blockchain Technology to develop Token Economies, which are continuously mushrooming all over the globe. It is the reluctance of the same that leads to the trickle-down effect of these Token Economies towards other laws like Tax Laws, hence, providing a cordial environment for persons to take advantage of the loopholes to develop strategic Tax Schemes.

Reference

Case Law

Collector of Stamp Revenue v Arrowtown Assets Ltd [2003] HKCFA 52

Commissioners of Inland Revenue v McGuckian HL (Times 20-Jun-97, Gazette 09-Jul-97, House of Lords, Bailii, [1997] UKHL 22,

Griffin v Citibank Investments Ltd ChD 14 Nov 2000

IRC v. Duke of Westminster [1936] A.C. 1

United States v. Critzer 498 F.2d 1160 (4th Cir. 1974)

W T Ramsay Ltd v Inland Revenue Commissioners HL ([1981] 1 All ER 865

Books, Journals, and Articles

Bajpai P, 'Countries Where Bitcoin Is Legal & Illegal (DISH, OTSK)' (*Investopedia*, 2018) <<https://www.investopedia.com/articles/forex/041515/countries-where-bitcoin-legal-illegal.asp>> accessed 6 November 2018

Chandler S, 'Money or Assets? How World Governments Define Cryptocurrencies' (*Cointelegraph*, 2018) <<https://cointelegraph.com/news/money-or-assets-how-world-governments-define-cryptocurrencies>> accessed 6 November 2018

Davies M, *An Introduction to The Structure And Sources Of American Law* (NYC Gov) <http://www.nyc.gov/html/conflicts/downloads/pdf2/municipal_ethics_laws_ny_state/introduction_to_american_law.pdf> accessed 6 November 2018

Due.com 'Understanding Cryptocurrency Tax Obligations' (*Nasdaq*, 2018) <<https://www.nasdaq.com/article/understanding-cryptocurrency-tax-obligations-cm986151>> accessed 6 November 2018

OECD, 'Fundamental Principles of Taxation' [2014] OECD/G20 Base Erosion and Profit Shifting Project

OECD, 'Glossary of Tax Terms - OECD' (*Oecd.org*) <<http://www.oecd.org/ctp/glossaryoftaxterms.htm>> accessed 6 November 2018

OUP, 'Inverse Elasticity Rule - Oxford Reference' (*Oxfordreference.com*) <<http://www.oxfordreference.com/view/10.1093/oi/authority.20110803100009622>> accessed 6 November 2018

OUP, 'Ramsey Rule - Oxford Reference' (*Oxfordreference.com*)
<<http://www.oxfordreference.com/view/10.1093/oi/authority.20110803100403456>>
accessed 6 November 2018

Quak EH Timmis, *Double Taxation Agreements And Developing Countries*(K4D/Institute of Development Studies 2018)
<https://assets.publishing.service.gov.uk/media/5b3b610040f0b645fd592202/Double-Taxation-Treaties_and_Developing_Countries.pdf> accessed 6 November 2018

Ring D, 'International Tax Relations: Theory And Implications' [2007] *Tax Law Review* 60