

Bitcoins and their VAT treatment

How to deal with virtual money: a decision by the European Court of Justice sets the framework

By Heinz Zimmermann



The currency of the future? Although Bitcoins are a virtual payment tool, there are now possibilities for using them for payments in the real world.

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Background

Bitcoins have so far seldom been the focus of analyses addressing taxes. The European Court of Justice had for the first time the opportunity to review the VAT aspects of Bitcoin trading.

What was the issue?

A Swedish entrepreneur had the intention to set up an Internet trading platform where third parties could buy and sell Bitcoins. Should such Bitcoins need to be sold, they could be purchased in advance on the market. In addition it was specifically planned that the virtual currency could be exchanged into conventional currency and vice versa. The difference between the purchase price and sales price of the Bitcoins would serve as compensation for providing the service to support the exchange activity. This service should be the important part of the entrepreneurial activities of the Swedish plaintiff. The facts and circumstances to be examined will, however, not include payments made with Bitcoins.

What are Bitcoins?

This virtual currency is not considered to be e-money as e-money is expressed in conventional currency units. Bitcoins, on the other hand, are treated as virtual money that is only used with the virtual currency unit Bitcoin. In this regard, the European Court of Justice refers to a report by the European Central Bank that indicates it considered Bitcoins to be a “neutrally tradable” virtual currency that users could purchase and sell on the basis of a certain exchange rate.

The online encyclopedia Wikipedia contains a large contribution under the keyword Bitcoin that describes Bitcoin as a payment system available worldwide. The technical basis of this system is the pooling of independent computers, which also makes available transfers of Bitcoins over the Internet. Because of this decentralized computer architecture, there is no central handling agency for these processes. System participants’ credit balances are stored in virtual wallets that are



only accessible to the respective Bitcoin owner through the use of encryption.

The first mention of Bitcoins was most likely in 2008. Publication of open source Bitcoin software then followed in 2009. This core Bitcoin software forms the basis of the decentralized database that is administered by all system participants and where all transactions are registered. This databank, also called a blockchain, is stored redundantly and decentralized on all Bitcoin Cores where it is also administered and permanently actualized over the Bitcoin network.



Bitcoin's exchange rate has often suffered from remarkable fluctuations.



Payments through the network are made pseudonymous addresses. Although a trade or contract partner cannot be identified, traceable information is created as all transactions are publically registered in the transaction history. Once a payment is made, it cannot be reversed when it is confirmed by the network. The transaction history is stored publically in the blockchain. The possession of Bitcoins is

proven by private keys, however. They are known exclusively to the owner and grant access to that particular wallet – that is, that person's Bitcoin account.

When the Bitcoin network came into existence in 2009, the first 50 Bitcoins were created or mined.

The program protocol of the Bitcoin core program determines that the maximum number of Bitcoins that can be mined will total 21 million.

New Bitcoins can only be created through a process called mining. This process creates new data blocks that are added to the existing blockchains. Since the introduction of the Bitcoin program, it has become more and more difficult to create new Bitcoins as the mining process requires a permanent increase in computer power. Through 2013, 50 Bitcoins were paid out for each newly created block. Since 2014, though, that number has halved to only 25.

The rise and risks of Bitcoins

When the Bitcoin system was introduced, Bitcoins as a payment tool were practically worthless. It can be simply stated that trust was lacking that normal currencies provide due to the payment

promise from the issuing government agency. Meanwhile, however, the system has stabilized. One Bitcoin might actually be worth more or less \$250 to \$300. Examining development over previous years does show, however, that Bitcoin's exchange rate has often suffered from remarkable fluctuations.

Although Bitcoins are a virtual payment tool, there are now possibilities for using Bitcoins for payments in the real world (for instance, for games on the Internet or for tour operators).

The critical response to Bitcoins' creation should not be overlooked. For instance, there is the repeated allegation of Bitcoin's use for illegal purposes (inadequate control of the payment flow) as well as the questioning of the legitimacy of non-central payment creation.

Apparently, however, is there still considerable interest in the market for this payment tool documented, as demonstrated by the European Court of Justice decision presented in this article.

Advocate Juliane Kokott had extensively evaluated and analyzed the facts and circumstances to prepare the subsequent court decision. In her final opinion of July 16, 2015, she first examined the question

if the exchange service planned by the Swedish entrepreneur should be treated as a taxable remunerated service.

Bitcoins and VAT: views expressed by the general advocate

The general advocate confirmed this question by making reference to an earlier decision by the European Court of Justice. In this connection, she also pointed out the transfer of legal payment instruments as such did not meet the requirements of a fact subject to VAT. In a national economy, payment instruments should only have the purpose of facilitating the exchange of goods. The general advocate further concluded that this finding should also be valid for other payment instruments whose function was also exhausted through their respective use. In this connection, she particularly referred to the principle of tax neutrality in its specification as a principle of equality.

The transfer of Bitcoins as such would therefore not fulfill a taxable fact.

Since, as determined previously, the exchange service as planned by the plaintiff does represent a taxable service, however, further examination was made to see if



a tax exemption according to Article 135, Section 1, of the VAT Directive would apply.

In this context, the focus was on the exemptions contained in Article 135, Section 1, lit. d) through f), of the VAT Directive.

After her examination, the general advocate concluded that the exemptions according to Article 135, Section 1, lit. d) and f), would not apply.

This examination therefore primarily refers to the exemption according to e).

This rule exempts from tax revenues that relate to foreign currency, bank notes and coins that are legal payment instruments. In her analysis, the general advocate first points out that a tax exemption cannot apply if instruments are transferred on only one side of the parties participating in a transaction payment when goods or services are transferred on the other side. However, if, like in the present case, a payment instrument is exchanged into another one, it should be clear that the exemption rule should, in principle, apply to the exchange service.

The important question is, however, if both payment instruments need to be legal payment instruments. This seems to be the view of the German version of the

VAT Directive transformed into German law that speaks of “foreign currency ... which are legal payment instruments.”

Looking at other transformed versions of the Directive, however, it appears this conclusion might not be unique. England, Finland and, particularly, Italy translate the exemption rule much more openly. According to the Italian version, it might even be questionable if a legal payment instrument needs to be at hand. Instead, the most important point appears to be the debt relief effect of the payment instrument.

In her decision, the general advocate had stated that the purpose of the exemption rule should be decisive because of the unclear interpretation situation. For her, the purpose was that the convertibility of payment instruments should not be hindered by the levy of VAT. As the tax exemption is not limited to currencies valid within the EU, she further concluded that, in the interest of unobstructed money transferring, exchange of Bitcoin, a pure payment instrument, into a legal payment instrument should be exempt from VAT.

The nonlegal payment instrument Bitcoin could fulfill the same payment function as a legal payment instrument.

Arguments from Germany regarding Bitcoins’ lack of stable value and its susceptibility to fraud did not convince the general advocate of the contrary in this case.

The general advocate also sustained her opinion in favor of a tax exemption for the exchange of Bitcoins into “normal” currency when the European Court of Justice dealt with the case.

Judgment of the court

The court followed the deliberations and conclusions of the general advocate in full.

To begin, the court confirmed the opinion that the exchange service planned by the plaintiff had to be looked at as a taxable service.

In particular, however, the court shared the opinion of the general advocate with regard to the tax exemption of the exchange service.

In this connection, the court argued that a too narrow definition of the term payment instrument would be against the rule of tax neutrality as a basis of the VAT system.

The analysis of the court also came to the conclusion that linguistic differences

in the interpretation of a directive rule should not result in an exemption rule losing its effect in the end.

The court thereby followed the conclusion of the general advocate and confirmed in favor of the plaintiff that the exchange of Bitcoins as a pure payment instrument was to be treated as a tax exempt service.

View of the German finance authority

It is important to mention that the German finance authority – at least so far – does not share the opinion of the European Court of Justice. Taxpayers in the future may, however, invoke the decision of the European Court of Justice in their favor with regard to the treatment of VAT in the exchange of Bitcoins. Regarding the ability to use Bitcoins for purchase transactions: by all means, the court decision sent a positive signal. ←



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