

How Luxembourg regulates 21st century tulips...

In recent years, virtual currencies have gained visibility and attracted controversy. With a higher degree of anonymity and lower transaction costs, as well as ease of use online, virtual currencies portray themselves as an alternative to more traditional payment methods. Nevertheless, virtual currencies carry serious risks as well. Often associated with money laundering, drug trafficking, and even the financing of terrorism and crime, virtual currencies are used to perpetrate many offenses via the Internet, including cyber-offenses such as phishing and the sale of malware. Therefore, the legal framing of virtual currencies is essential. But in the meantime, investors should be fully informed about their potential risks.

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What is a virtual currency?

In the world of virtual currencies, Bitcoin often is the first name that comes in mind. But Bitcoin (as well as other virtual currencies such as Ripple, Litecoin, Solidcoin) has no legal value, i.e. it is not legal tender. In 2012 the European Central Bank defined virtual currency as “a digital representation of value, not issued by a central bank, credit institution or e-money institution, which in some circumstances can be used as an alternative to money.”

The purchase and sale of Bitcoins takes place outside regulated markets. To date, Bitcoins are not a store of value and cannot reasonably be used as savings since they are too speculative. Essentially, virtual currency operates in a manner akin to legal tender in that it can be used to purchase digital and physical goods, but it is not endorsed by any Central Bank. This “money” can be transferred, stored, or traded electronically and often can be exchanged for real currency. Some virtual currencies, like Bitcoin, are widely used across the internet, while others are limited to a very specific (online) community.

Virtual currencies vs. digital currencies

While virtual currencies use cryptographic functions in the process of e.g. authorizing or verifying transactions, digital currencies include all currencies that are implemented on computer systems (including, for example, in the form of a simple database). Virtual currencies can therefore be considered as a subset of digital currencies. Characteristic features include the absence of a central counterparty, non-discriminatory public access, and security against fraudulent spending.

Convertible virtual currencies

Many virtual currencies can be exchanged for real currency. These convertible virtual currencies have exchange rates that fluctuate over time, just like real currency exchange markets. Their high volatility is not a secret, as we have seen it in the last two years. While in December 2017 Bitcoin crossed the threshold of USD 18.670, gaining more than USD 8.700 in three weeks, its current price is at its lowest level since September 2017.

Towards regulation of virtual currencies in Luxembourg and internationally

Virtual currencies are still pretty much unregulated.

In its 2014 Newsletter¹, Luxembourg’s Financial Sector regulator, the CSSF, first addressed the “phenomenon” of virtual currencies. While acknowledging that “virtual” currencies are considered as money, since they “are accepted as a means of payment of goods and services by a sufficiently large group of people”, the CSSF points out that virtual currencies “may thus be electronic money [as distinct from banknotes and coins], but not necessarily within the meaning of the European Directive 2009/110 which provides for a definition of electronic money limited to its own scope”. The CSSF further stresses that virtual currencies are not legal tender and entail risks for their holders. Finally, the CSSF recalls that activities

¹ CSSF Newsletter, No. 157, February 2014

² CSSF Warning on Virtual Currencies, and CSSF Warning on Initial Coins Offerings ("ICO's") and Tokens, both issued on March 14, 2018

of the financial sector, such as the "issuance of means of payment in the form of virtual and other currencies", is subject to an authorization of the Luxembourg Minister of Finance. Interestingly, the CSSF appears to assume in this Newsletter that virtual currencies should be qualified as a "means of payment".

Four years later, the CSSF, on March 14, 2018, issued on two warnings about the risks associated with virtual currencies², while at the same time recognizing the growing presence of cryptocurrencies in the global economy. The CSSF stresses that there is currently no uniform definition of virtual currencies, whether at national or EU level.

Recently, several supervisory and oversight bodies have created specialized services ("task forces") to ensure that cryptocurrency practices stay in line with common financial practice as well as with national and international legal and regulatory provisions. It is also at the initiative of one of these bodies (the "Enforcement's Virtual Currency Task Force" of the Commodity Futures Trading Commission of the United States) that on October 15, 2018 a New York Federal Court has ordered a trading firm and its CEO to pay more than USD 2,5 million as damages for a fraudulent Bitcoin Ponzi scheme.

However, in Luxembourg we have not yet reached the point of considering a task force, as we can infer from the Finance Minister's response to parliamentary question no. 3572 related to the virtual currencies:

"The subject of virtual currencies is being studied in various international and European bodies so that the creation of a task force at the national level is not necessary. A concerted action at the level of the G-20 and/or the European Union will indeed bring greater added value than ad hoc national actions. The Franco-German initiative will certainly feed the reflections currently under way, particularly in the G-20 or the Financial Action Task Force (FATF). Luxembourg will adapt its legislation in the light of the results of ongoing work at international and European level."

On December 1, 2018, the G-20 declaration entitled "Building Consensus for Fair and Sustainable Development" was published on the official website of the Council of the European Union and the European Council. The G-20 noted that its members will introduce anti-money laundering and anti-terrorist measures per standards of the FATF, an intergovernmental body formed to fight money laundering and terrorist financing:

"We will regulate crypto-assets for anti-money laundering and countering the financing of terrorism in line with FATF standards and we will consider other responses as needed."

Further, G-20 participants expressed a positive stance on non-banking financial institutions, pointing out the potential advantages of technology in the financial sector, given that the tech innovators are managing associated risks:

"We look forward to continued progress on achieving resilient non-bank financial intermediation. We will step up efforts to ensure that the potential benefits of technology in the financial sector can be realized while risks are mitigated."

The G-20 summit also called for international crypto-taxation and provided an estimate as to when the taxation might start. It is said that after considering various proposals, the final version of the regulation may be expected in 2020.

Taxation of virtual currencies in Luxembourg

On July 26, 2018, the Luxembourg Tax Administration (ACD) published a circular³ to clarify the tax treatment of virtual currencies. The ACD recalled that the virtual currencies cannot be considered as an (official) currency, the value of which is guaranteed by a central bank. By contrast, virtual currencies should be regarded as intangible assets.

³ Circulaire du directeur des contributions 14/5 – 99/3 – 99bis3 of July 26, 2018

Following this, the taxation of virtual currencies, including indirect taxation), takes place within the framework of existing tax laws applicable to assets.

Conclusion

Luxembourg still has a way to go to elaborate a coherent and consistent set of rules governing virtual currencies. At this juncture, it appears that the approach taken by the CSSF ("means of payment") and that taken by the tax administration ("intangible assets") are at odds with each other. The 1993 Law on the Financial Sector needs to be freshened up as well, to create an adequate status for virtual currency issuers and operators of virtual currency systems.