



INTERNATIONAL TAX REVIEW

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Cryptocurrencies: Unanswered questions from a Mexican tax perspective

06 September 2018

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Mexico's tax system lacks clarity on the status of cryptocurrencies. Treating them as either property or currency each have their own specific implications, writes Omar Zuñiga, partner, and Eduardo Brandt, senior associate, at Creel García-Cuéllar Aiza y Enríquez.

The Financial Technology Institutions Law (FinTech Law) was published on March 9 2018. This law recognises the existence of cryptocurrencies and allows financial technology institutions to operate in cryptocurrencies that are recognised by Mexico's central bank. The legal recognition of cryptocurrencies as a new asset class brings with it the need to determine their tax treatment.

Cryptocurrencies' tax treatment depends greatly on their characterisation for tax purposes. The Mexican tax system lacks guidance on characterising cryptocurrencies, leaving taxpayers to reach their own conclusions. Mexico is not alone here; whether a cryptocurrency is property or a currency has been debated in several jurisdictions, with the US favouring the former definition and Switzerland the latter.

Cryptocurrencies as property

If cryptocurrencies are treated as property for tax purposes, taxpayers should generally take the same approach as with any other property transaction. For Mexican income tax purposes, taxpayers are not required to include value fluctuations in taxable income, and are only taxed upon a realisation event (e.g. a sale or exchange). Upon such an event, taxpayers should calculate the gain derived in the transaction as taxable income by comparing the fair market value at the time of disposal with the cryptocurrency's tax basis. This means that, unlike traditional currencies, payment for goods and services using cryptocurrencies should be treated as a barter transaction. As such, taxpayers are considered to have disposed of the cryptocurrency and sold the goods simultaneously, creating a taxable gain. Likewise, conversions from one cryptocurrency into another should be treated as a taxable event in the absence of any rules allowing tax-free like-kind exchanges.

Several practical issues remain unresolved under the 'property' construct. For example, there is uncertainty as to the methodology for taxpayers to compute their tax basis in the cryptocurrency in the event of multiple acquisitions (i.e. first-in, first-out, last-in, last-out, specified identification or weighted average), which may result in tax planning opportunities considering the volatility of cryptocurrencies. From a valuation perspective, it is also uncertain which value should be considered when computing gains on a disposition, as cryptocurrencies' market prices may fluctuate intraday and market prices may differ between exchanges.

From a VAT perspective, the 'property' construct entails that any transaction in Mexico is subject to 16% VAT. In the absence of any specific rules, it may be hard to establish whether a cryptocurrency transaction takes place in a Mexican territory. Since cryptocurrencies are more akin to an intangible asset for VAT purposes, any cryptocurrency transaction should be treated as materialising in Mexico if it takes place between Mexican residents. Therefore, taxpayers may be faced with the draconian (perhaps impossible) task of determining whether a transaction triggers VAT, as it is generally hard to establish the residency of a counterparty to a transaction conducted on a cryptocurrency exchange.

Cryptocurrencies as currencies

Conversely, treating cryptocurrencies as currencies would result in different tax consequences. As a starting point, cryptocurrency holders would need to mark-to-market their investment and consider foreign currency gains or losses on any value fluctuations between the MXN and the specific cryptocurrency. This would be challenging for taxpayers, as they would be required to recognise value fluctuations on a highly volatile asset. However, cryptocurrency transactions would not trigger taxable gains for the cryptocurrency holder. From a VAT perspective, treating cryptocurrencies as currencies would be favourable, as cryptocurrency transactions would benefit from exemption under VAT law. While the currency construct has surprising income tax consequences, the VAT regime would be preferable for taxpayers using cryptocurrencies as a payment method for everyday transactions.

In our view, the 'currency' construct is hard to sustain from a legal perspective, as cryptocurrencies generally lack legal tender status in most jurisdictions, rendering them more akin to property for tax purposes. While there are stronger legal grounds to classify cryptocurrencies as property, this classification defeats the purpose of cryptocurrencies as decentralised currencies, as the income tax and VAT consequences of everyday transactions may curtail the use of cryptocurrencies as a payment method. A solution could be to grant a statutory exemption from income tax and VAT on transactions falling within a specified threshold – this has been proposed in the US for transactions under \$600. This would both promote the use of cryptocurrencies as a payment method and avoid costly compliance expenses for taxpayers. It would also be a better use of the tax administration's time and resources given the complexities of auditing cryptocurrency transactions.

Hard forks

Another major unresolved tax issue for cryptocurrencies involves hard forks, defined by David Farmer in the July 27 edition of The Coinbase Blog as a "change to the software of the digital currency that creates two separate versions of the blockchain with a shared history". A hard fork entails the original holder retaining their interest in the original cryptocurrency while having the right to use the forked cryptocurrency, with each being traded separately and having its own value. Perhaps the best-publicised hard fork was that involving bitcoin (BTC) and bitcoin cash (BCH), which took place on August 1 2017.

A hard fork raises several unique tax issues because it is unclear, according to the American Bar Association, whether a cryptocurrency holder who becomes entitled to use a forked cryptocurrency must recognise the fork in taxable income. One could argue that despite a cryptocurrency and a forked cryptocurrency sharing a pre-fork transaction history, they have different intrinsic qualities that account for their different market values. If they have material differences and their own market values, it is hard to maintain that the fork is not an accession to wealth for the holder, who can now use the forked cryptocurrency as a payment method.

Assuming the fork is taxable, several complexities arise as to the timing and amount of the inclusion. For example, after a hard fork takes place, the forked cryptocurrency faces a process of market price discovery, during which the market will determine its value. In the absence of any rules, taxpayers may be left with the difficult task of determining the amount of income inclusion. This is because the fair market value of the forked cryptocurrency will be determined gradually, and it is uncertain when the holder takes constructive receipt of the forked cryptocurrency.

Another aspect to consider is that the fork does not give rise to taxable income, as the market value of the original cryptocurrency already prices in the possibility of a fork. To sustain this position, one would have to argue that the fair market value of the original cryptocurrency was decreased by the value of the forked cryptocurrency. This may be hard to probe given market volatility and the fact that the forked currency will undergo market price discovery of its own. Under this construct, and assuming cryptocurrencies are property

for tax purposes, a practical issue may arise as to how to divide the tax basis between both cryptocurrencies because this will be relevant when computing taxable gains on subsequent dispositions.

The complexities and intricacies described above highlight how tax legislation has been surpassed by cryptocurrency development. The need for tax regulation is evident, but in the absence of any specific guidance regarding cryptocurrencies, taxpayers should be aware that cryptocurrency transactions may create taxable events.



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