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FACEBOOK'S LIBRA CURRENCY – WILL UNEXPECTED TAX COMPLICATIONS SCARE OFF USERS?

– THOUGHT LEADERSHIP

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The essence of Libra is that Facebook hopes consumers across the world will spend money in a new cryptocurrency. Its value will track a basket of fiat currencies, meaning that the value of a Libra against a particular fiat currency will inevitably fluctuate. That creates a problem for consumers: each time they transact, they'll be making a capital gain or loss. In most countries gains will be taxable, meaning consumers will have to file a detailed tax return showing all their transactions and the exchange rate at the time, and pay any tax due. This seems to us to be a significant barrier to wide adoption.

While many regulators have struggled to define exactly what cryptocurrency is, tax authorities have not generally had that problem. Whatever it is, the taxman doesn't care: gains and losses on cryptocurrency transactions are taxable in almost all countries.

Whether early adopters of Bitcoin et al. have actually paid the tax due is a different question, especially as tax authorities will have little visibility over their transactions. Some cryptocurrency exchanges are now reporting details about account-holders to tax authorities; but many still are not, and even if they were, this would not catch users who are transacting without using an exchange. The decentralised nature of cryptocurrencies makes this a difficult problem for tax authorities to solve, though their relatively limited adoption means it has not been a top priority for most governments.

Libra is very different. On one hand, its intended wide adoption presents a greater threat to tax authorities than any previous cryptocurrency. On the other hand, Libra's different operating model makes it a much easier problem for tax authorities to solve. Instead of the decentralised model of Bitcoin and other cryptocurrencies, the Libra Blockchain will be governed by the "Libra Association", a not-for-profit organisation made up of a range of businesses including Facebook, MasterCard, Visa and PayPal, among others. This means that unlike Bitcoin, for Libra there will be a "central authority" with oversight over users' transactions. We expect that – sooner or later – tax authorities will require the Libra Association to report on its users' transactions, either under existing domestic and international frameworks (e.g. the CRS or FATCA), semi-voluntary schemes (like Airbnb's new agreement with the Danish tax authority) or under new legislation.

For this reason, consumers and businesses will not be able to simply ignore the tax treatment of Libra. What will that treatment look like?

a. For consumers, if Libra rises in value between the time they acquire Libra and the time they spend it, they will have made a gain which most countries will tax; if Libra falls, they will have made a loss (which could ordinarily be set against Libra gains). This will generally be the case regardless of whether the consumer is actually making a gain or loss in economic terms. For example, if a shop sells its goods/services at a fixed price in Libra, then the consumer won't make any economic gain or loss when they spend Libra – but in most countries there will still be a deemed capital gain/loss for tax purposes.

   In principle, a consumer will therefore have to track the point that he or she acquires Libra, the point at which he or she spends it, and the exchange rate each time. If the overall result across a tax year is positive, then tax will have to be paid. For a typical UK consumer this may not be problematic in practice given the UK's generous £12,000 annual allowance for tax-free capital gains – however, around a quarter of a million UK individuals do pay capital gains tax each year, and these individuals face a very complicated compliance burden if they adopt Libra.

   The problem is especially acute for consumers in other countries (such as France, Germany and others), where capital gains exemptions/allowances are far less generous. Those consumers are far more likely to face an actual tax liability and will suffer the difficulties of computing that liability by reference to all of their Libra transactions throughout the year.

b. For businesses, accepting Libra will result in them suffering two taxable events: first, upon receiving Libra from consumers (i.e. "normal" tax on trading profits, which would have happened if they had received fiat currency); and second, upon either converting Libra back to fiat assets or spending the Libra with another Libra-accepting business (profit/loss/gain on the "disposal" of Libra). Again, this will have to be tracked and calculated, which for small businesses in particular will add an unwanted additional layer of tax compliance.

While some of these issues may be mitigated by the fact that Libra is intended to be relatively stable, we would nevertheless expect it to be at least as volatile as a traditional fiat currency. In any event, heavy users of Libra in many jurisdictions are likely to find computing their tax liability a real challenge, with a capital gains computation required to be undertaken for a potentially very large number of transactions occurring throughout the tax year.

One might ask: why don't these issues arise at the moment when people spend money in foreign fiat currency? The answer is that most countries don't charge tax on personal foreign currency transactions conducted abroad. A UK resident spending US dollars in New York faces no UK tax consequences, even if the US dollar appreciates during their stay. On the other hand, if that same UK resident spent US dollars in the UK then there would be taxable events – but this would be an unusual thing to do (currency speculation aside).

This seems to us a big problem for Libra to solve. How many consumers will be willing to deal with a new level of tax compliance, and face potential tax liability, in order to use Libra?

What are the potential answers?

- A political solution: Libra could lobby governments and tax authorities to create a special exemption from tax on Libra gains and losses. Facebook have said that they "look forward to working with policymakers as they clarify the application of existing tax laws to cryptocurrencies, or in some cases to update those laws". However, it seems to us that the chances of reaching such an agreement with tax authorities in all major markets seem slight – why should Libra be treated any differently from a "real" currency, or any other cryptocurrency? And why would tax authorities agree to potentially miss out on taxing users' gains? And if governments did agree to this for Libra, would this breach State aid/ anti-subsidy rules?
- A tech solution: Libra could integrate a user education program and automatic tax calculation and reporting systems to make the process as straight-forward as possible for consumers and tax authorities and taxpayers. Facebook have indicated that they "expect that many wallets and financial services built on the Libra Blockchain will provide people with tools to help manage this". But the prospect of an unexpected tax bill at the end of the year could still be off-putting to many consumers and would simply highlight to users the relative advantage of transacting in local currency instead of Libra.
- A market solution: Libra could simply not operate in countries where the tax treatment for consumers is awkward (or, alternatively, operate, but not expect large scale take-up). It might be thought that tax authorities in the developing world (clearly a significant Libra target) would take a more lenient approach than tax authorities in the EU or the US. That seems to us an unsafe assumption – particularly for countries accustomed to applying capital controls to prevent outflows from their economy.
- A more fundamental solution: Libra could change so that, instead of being a new currency, it is essentially an e-wallet system. A UK consumer spends £50 to buy £50 of Libra and spends £ in UK stores. A French consumer spends EUR50 to buy EUR50 of Libra and spends EUR in Eurozone stores. And so on. When spending in a different currency FX conversions are made instantaneously at the point of transacting. The tax complexities melt away; but so does the uniqueness of the proposition – and this would amount to a significant reversal from what has been announced.

Finding a solution which meets both Libra's apparent aspirations and the needs of its intended users does not appear to be straight forward. If Libra is to launch in 2020 as expected, the Libra Association will need to move quickly to solve these issues in order to ensure that it delivers the seamless experience users have come to expect from Facebook and its other founding members.

C L I F F O R D

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