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THE TAX IMPLICATIONS OF BITCOIN IN SOUTH AFRICA

Mini dissertation by

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Supervisor: Ms Carika Fritz

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The fruits you reap will be sweet.

"Blessed are the curious,

For they shall have adventures"

SUMMARY

THE TAX IMPLICATIONS OF BITCOIN IN SOUTH AFRICA

By

MELISSA SOPHIA WICHT

STUDY LEADER : MS CARIKA FRITZ

DEPARTMENT : TAX LAW

DEGREE : LEGUM MAGISTER (TAX LAW)

Bitcoin is a virtual crypto-currency that exists solely in electronic form.[1] Bitcoin was first launched in 2009 by Satoshi Nakamoto, which is an alias for a programmer or group of programmers.[2] Bitcoin is defined as "a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity".[3]

Virtual currency is a type of fund used and accepted in a virtual or online community.[4] Generally Bitcoin has been and is visible in South Africa ("SA"). It is more apparent in Cape Town.[5] The first commercial conference on Bitcoin was held in Cape Town on April 2015[6] and BitHub, a virtual currency hub and incubator, was launched by the Cape Innovation and Technology Initiative in June 2015.[7] On 7 September 2015, BitHub had a series of education Bitcoin courses which provided students with basic understanding of Bitcoin.[8]

The use of Bitcoins as a medium of exchange is not yet widespread in SA, however, it has been noted that this industry is growing at a fast rate as several online retailers are now accepting Bitcoins as a means of payment for goods and services, for example

1 Ly (2014) 27 *Harvard Law* p 590.
2 Goodspeed (2014) *SA Financial Markets Journal* p 1.
3 Berger (2016) NW University p xi.
4 Atkins (2014) *Pittsburgh* p 26.
5 Nieman (2015) *PER/PELJ* p 1979.
6 Nieman (2015) *PER/PELJ* p 1979.
7 L Berger (2016) *NW University* p iii.
8 L Berger (2016) *NW University* p iii.

Takealot.com.[9] SA has already installed its first Bitcoin vending machine, situated in Kyalami, north of Johannesburg, to give users the ability to get Bitcoins in exchange for rand.[10]

South African authorities have been silent on how bitcoin transactions should be taxed and even regulated. Research on this matter is relatively limited in South Africa. Studies are thus needed and are relevant to address the South African taxation implications of bitcoin exchange transactions as countries such as Australia and the USA have already issued guidelines to taxpayers in this regard.

The primary research objective of this study was to comparatively explore how Bitcoins should be classified in SA from a tax perspective. A comparative study was therefore performed to understand the current tax position in SA with regards to the classification of Bitcoins either as an asset or currency for Bitcoin transactions that may result in taxable income.

The research has limitations in that it did not look at cross-border tax evasion, collection of taxes, permanent establishment rules and the enforcement of taxes on Bitcoin transactions. Tax legislation is vast in SA and therefore every type of transaction could not be analysed due to the extensive nature of tax.

It was found that the current SA legislation does make provision for the classification of Bitcoin. However, it is suggested that SA authorities amend certain legislative requirements to cater for Bitcoin, as well as issue appropriate guidelines for the treatment of Bitcoin transactions, as was done in the U.S. and Australia.

[9] > http://bit.ly/1Q0Tg1R < (accessed: 14 June 2016).
[10] > http://bit.ly/1Q0Tg1R < (accessed: 14 June 2016).

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

Bitcoin is a virtual crypto-currency that exists solely in electronic form.[1] Bitcoin was first launched in 2009 by Satoshi Nakamoto, which is an alias for a programmer or group of programmers.[2] Bitcoin is defined as "a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity".[3]

Virtual currency is a type of fund used and accepted in a virtual community.[4] The Financial Action Task Force has described virtual currency as "a type of digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account and or store of value, but does not have legal tender status".[5] Crypto-currency refers to a math-based, decentralised convertible virtual currency that is protected by cryptography.[6] Crypto-currency relies on public and private keys to transfer value from one individual or entity to another, and must be cryptographically signed each time it is transferred.[7]

Bitcoin may be held as an investment or exchanged for goods and services. Examples include:[8]

(i) buying physical goods and services using online stores. Examples of such in South Africa ("SA") include outdoor and leisure equipment suppliers, tax consulting and professional accounting service providers, corporate gift suppliers, travel agencies and restaurants;

(ii) Bitcoin gift cards: turning digital currency into "real-world" goods and services;

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1 Ly (2014) 27 *Harvard Law* p 590.
2 Atkins (2014) *Pittsburgh* p 29.
3 Berger (2016) NW University p xi.
4 Atkins (2014) 12 *Pittsburgh* p 26.
5 FATF (2014) p 4.
6 Berger (2016) NW University p xi.
7 FATF (2014) p 5.
8 Berger (2016) NW University p 1.

(iii) companies that offer businesses the ability to accept payment by Bitcoins; and

(iv) online Bitcoin auctions.

BitX, South Africa's first rand-to-Bitcoin exchange platform was founded in February 2014 and headquartered in Singapore with a development team in Cape Town.[9] The first commercial conference on Bitcoin was held in Cape Town on April 2015[10] and BitHub, a virtual currency hub and incubator, was launched by the Cape Innovation and Technology Initiative in June 2015.[11]

Currently, there is no primary or secondary legislation relating to virtual currencies, and consequently Bitcoin, that has been promulgated in SA.[12] There are further no published rulings, tax court decisions, government publications or interpretation notes addressing tax considerations of Bitcoin.

A feature of Bitcoin that encourages criminal activities is that it is anonymous when transferring value from one computer to another.[13] The currency works by assigning a public cryptographic key to arbitrary units of value held by a Bitcoin user.[14] Lack of regulation and the anonymous nature of Bitcoin has encouraged criminal activities, such as fraud, money laundering, tax evasion and drug trafficking.

In order to address the tax and criminal implications of Bitcoin, it needs to be established how Bitcoin should be classified. As is shown in this dissertation, Bitcoin can either be classified as an asset, as legal tender or as foreign currency. In order to establish a direction for the SA government authorities, the United States of America and Australia will be investigated due to the regulations already published by the governmental bodies in these countries.

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9 Berger (2016) *NW University* p 2.
10 Nieman (2015) *PER/PELJ* p 1979.
11 Berger (2016) *NW University* p iii.
12 Nieman (2015) *PER/PELJ* p 1979.
13 Guadamuz (2014) *SSRN* p 10.
14 Guadamuz (2014) *SSRN* p 10.

The United States Revenue Service ("IRS") issued a notice stating that the character of virtual currency (i.e. capital or revenue) will depend on whether such virtual currency is a capital asset in the hands of the taxpayer or held mainly for sale to customers in trade or business.[15] The IRS is of the view that Bitcoins should be treated as a commodity for taxation purposes and is therefore property as opposed to currency.

In August 2013, a U.S. District Court issued a judgment in the case of *Securities and Exchange Commission v Trendon T. Shavers and Bitcoin Savings and Trust*, United States District Court[16] ("Securities Exchange case") recognising Bitcoin as a legitimate form of money.[17]

The Australia Taxation Office ("ATO") holds the view that Bitcoins are neither money nor foreign currency and that Bitcoins are an asset for capital gains tax ("CGT") purposes. Broadly, the ATO reasoned that, whilst Bitcoin purportedly functions as money, it fails to ascribe to definitions of money or currency under the regulatory framework in Australia.[18] It was concluded that Bitcoins cannot be money on the basis that the acceptance of Bitcoins in the community is not widespread and universal, as required by the definition of currency in terms of the Australian regulations.[19] It is therefore not a generally accepted medium of exchange.[20]

1.2 RATIONALE FOR THE STUDY

The Davis Tax Committee ("DTC"), in its first interim report on Base Erosion and Profit Shifting ("BEPS"), state that the use of virtual currencies such as Bitcoins, is growing. It encourages the SA legislator to consider the potential impact of virtual currencies on tax compliance and monitor international developments to determine the most suitable approach for SA.[21]

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15 Berger (2016) *NW University* p 2.
16 No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013). Please note, that there are two Securities Exchange cases. The first one dealing with the jurisdiction of the court dated 6 August 2013 and the other was the summary judgement dated 18 September 2014.
17 No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013) p 2.
18 TD 2014/26 p 1; Emery (2016) *Australian National University* p 8.
19 TD 2014/26 p 8; Emery (2016) *Australian National University* p 8.
20 TD 2014/26 p 8; Emery (2016) *Australian National University* p 8.
21 Davis Tax Committee 2014 p 56.

On 18 September 2014 a user alert was issued to the South African public by the National Treasury, the South African Reserve Bank ("SARB"), the Financial Services Board, the South African Revenue Service ("SARS") and the Financial Intelligence Centre. Members of the public were warned to be aware of the risks associated with the use of virtual currencies for r transactions and investments.[22] Due to the absence of specific laws or regulations to address the use of virtual currencies in SA, no legal protection or recourse are afforded to users of virtual currencies.[23]

The Organisation for Economic Co-operation and Development ("OECD") published an Action Plan on BEPS in July 2013 as a response to the growing concern regarding virtual currencies. In its working paper dealing with Bitcoins, the OECD expresses the view that there are two policy issues, namely the issue of how to treat capital gains and losses for tax purposes in the crypto-currency world and using anonymity to evade taxes.[24] South Africa is one of the many non-member economies with which the OECD has working relationships in addition to its 34 member countries.[25] South Africa is an associate in seven OECD Bodies and Projects, and a Participant in 13. It has also adhered to 11 OECD instruments, including, most recently, the Declaration on Automatic Exchange of Information in Tax Matters (2014).[26]

Therefore, there is a need to address the classification and tax implications of Bitcoin in a South African context and this consequently forms the basis of the dissertation.

1.3 RESEARCH PROBLEM STATEMENT

There is a need for the current South African legal framework to be evaluated in order to establish the taxation of Bitcoin transactions in SA. The research question that consequently arises is whether Bitcoins should be characterised as an asset, currency or legal tender for taxation purposes of Bitcoin transactions with regards to the South African Income Tax Act 58 of 1962.

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22 SA National Treasury 2010 p 1.
23 SA National Treasury 2010 p 1.
24 OECD BEPS 2015 p 12 cited in Berger (2016) *NW University* p 7.
25 >http://bit.ly/1CnfcYf< (accessed: 4 November 2016)
26 >http://bit.ly/1CnfcYf< (accessed: 4 November 2016)

1.4 RESEARCH OBJECTIVES

In order to address the problem statement posed, the following objectives are formulated to answer the research question:

1.4.1 Primary research objective

The primary research objective (or main purpose of the research) is to comparatively explore how Bitcoins should be classified in SA from a tax perspective.

1.4.2 Secondary research objectives

The main research objective of this study is supported by completing the following secondary research objectives:

- investigation into the origin and background of Bitcoin;
- investigation into how Bitcoin operates and how it is made on a basic level for purposes of identifying tax concerns;
- researching of criminal activities surrounding Bitcoin and the issue of tax evasion;
- discussion on the OECD BEPS project and the influence of such on the regulation of Bitcoin;
- research into the legal status of Bitcoins in the U.S.;
- analysis of case law in the U.S. dealing with the characterisation of Bitcoin;
- investigation into guidance provided to date by the U.S. authorities on Bitcoin;
- an analysis of the taxable income consideration on Bitcoin transactions in the U.S.;

- research into the regulatory framework on Bitcoin in Australia;

- investigation into the ATO rulings on Bitcoin for income tax, Goods and Services Tax ("GST") and CGT considerations;

- how the terms "asset" and "currency" are interpreted in SA in terms of a tax perspective;

- an analysis of the tax legislation in SA and how Bitcoin fits into the already established legal frameworks; and

- make possible recommendations or suggestions on the most suitable approach on how Bitcoin transactions should be taxed in SA.

1.5 RESEARCH DESIGN AND METHODOLOGY

The research that is conducted will be applied comparative research. Applied research is original investigation undertaken in order to acquire new knowledge. It is, however, directed primarily towards a specific practical aim or objective.[27]

Descriptive research information is collected that will demonstrate relationships that exist and will assist in describing the current regulatory framework. The objective of explanatory research is to provide details where small amounts of information exist.[28]

A specific research question has been identified which will be answered through the collection and study of research. A comparative analysis of other countries will be conducted to make a recommendation or provide a solution. Exploratory research will be conducted in support of the descriptive research as there are no published rulings, relevant publication or interpretation notes available in SA with the focus on Bitcoin exchange transactions.

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27 >http://bit.ly/2ekdvqC<. (accessed: 29 October 2016)
28 Berger (2016) *NW University* p 9.

In order to obtain data for research, an evaluation of secondary data us done evaluated. Secondary data is the data that has already been collected by and is readily available from other sources.[29] Data such as academic journals, court cases, theses and reports previously published will be assessed.

In order to address the research objectives, a literature review will be conducted to understand the current tax position in SA with regards to the tax implications of Bitcoins or, more broadly, virtual currencies.

A further review will be conducted on Bitcoin transactions in two countries, namely U.S. and Australia. The countries were selected for the following reasons:

(i) These countries are currently the most vocal with regards to classification and interpretation of Bitcoin;

(ii) These countries have developed views, interpretations and guidance to taxpayers dealing and transacting in Bitcoins;

(iii) For purposes of comparison, the taxation systems are similar to that of SA. For example, both countries are resident base for taxation purposes and the CGT principles are synonymous;

(iv) Both countries are members of the OECD and South Africa is an active participant and collaborating country with the OECD.[30]

1.6 PLANNED STRUCTURE OF THE MINI-DISSERTATION

The main outcomes of the present study will be presented in the format of a mini-dissertation. The planned structure of the mini-dissertation is explained and summarised below.

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[29] Berger (2016) *NW University* p 9.
[30] As indicated in paragraph 1.2.

1.6.1 Chapter 1: Introduction

Chapter 1 provides an introduction and background to the present research and also sets out the rationale for the study, and states the research problem, the research question and the research objectives. The research design and methodology are briefly summarised and the chapter finally provide an overview of the chapter structure of the mini-dissertation.

1.6.2 Chapter 2: The concept of Bitcoin

Chapter 2 provides insight into Bitcoin as a virtual currency and evaluates with the main question as to why regulation is required for Bitcoin. The discussion refers to the origin of Bitcoin, the obtaining of Bitcoin, the criminal activities surrounding Bitcoin and the OECD BEPS Action plan. Following on from Chapter 2, Chapter 3 and Chapter 4 provide insight into countries that already have established rules and regulations on Bitcoin in order to provide guidance when SA is finally analysed.

1.6.3 Chapter 3: United States guidance on virtual currencies

Chapter 3 provides a detailed description of the U.S. regulations on virtual currencies, specifically Bitcoin. The objective of this chapter is to understand how the U.S. has considered tax implications on Bitcoin transactions. By obtaining a better understanding of how the U.S. views the taxability of transacting in Bitcoins, a recommendation or suggested solution can be drawn on how transacting in bitcoins should be treated for tax purposes in SA.

1.6.4 Chapter 4: Australia's current legal regulatory framework

Chapter 4 provides a detailed description of the Australian regulations on virtual currencies, specifically Bitcoin. The objective of this chapter is to understand how Australia has considered tax implications on Bitcoin transactions. By obtaining a better understanding of how the Australia views the taxability of transacting in Bitcoins, a recommendation or suggested solution can be drawn on how transacting in bitcoins should be treated for tax purposes in SA.

1.6.5 Chapter 5: A South African Perspective

Chapter 5 provides an investigation into the tax legislation in SA and how Bitcoin would fit into the current regulatory framework taking into account the classifications provided by the comparative countries. It deals with how amendments can be effected to create a sufficient base for taxation of Bitcoin transactions within SA.

1.6.6 Chapter 6: Conclusion

Chapter 6 brings the study to its conclusion. The chapter summarises the findings and conclusions from the other chapters, explains the contribution and limitations of the present study, and also makes suggestions for future research.

CHAPTER 2: THE CONCEPT OF BITCOIN: A VIRTUAL CURRENCY

2.1. INTRODUCTION

Introduced in 2009, Bitcoin is a virtual currency that exists solely in electronic form.[1] Bitcoin originated in a paper in January 2009 entitled "Bitcoin: A Peer-to-Peer Electronic Cash System". The author(s) or individual(s) credited with the development is a computer programmer named Satoshi Nakamoto ("Nakamoto"), a name many believe to be a pseudonym or alias.[2]

Virtual currency is a type of fund used and accepted in a virtual or online community.[3] The unique characteristic of virtual currency is that it is not issued or guaranteed by a governmental body.[4] Virtual currency is not synonymous with electronic fund transfers or payments. The latter is stored funds transmitted through electronic means, such as interbank wire transfers and have a legal basis in established, government-backed currency.[5] The potential of Bitcoin is not solely limited to serving as a payment alternative – it has also been viewed as a commodity, asset class, or security ripe for speculative investment.[6]

There are three commonly recognised virtual currency schemes, which are "closed-flow", "hybrid- flow" or "open-flow" schemes.[7] Closed-flow schemes refer to systems where the virtual currency can only be spent within the virtual environment and cannot be used to purchase goods or services outside of that environment.[8] The hybrid-flow scheme involves the conversion of a government-based, legal currency into virtual currency, which is used either within the virtual or real environment to purchase goods or services.[9] Finally, the open-flow scheme allows for funds to be converted into virtual currency, used within the virtual or real environments and subsequently reconverted into a government-based legal currency.[10]

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1 Ly (2014) *Harvard Law* p 590.
2 Atkins (2014) *Pittsburgh* p 29.
3 Atkins (2014) *Pittsburgh* p 26.
4 Atkins (2014) *Pittsburgh* p 26.
5 Atkins (2014) *Pittsburgh* p 26.
6 Nieman (2015) *PER/PELJ* p 1987.
7 Atkins (2014) *Pittsburgh* p 27.
8 Atkins (2014) *Pittsburgh* p 27.
9 Atkins (2014) *Pittsburgh* p 27.
10 Atkins (2014) *Pittsburgh* p 27.

Bitcoin is considered an open-flow virtual currency, as it can be converted into a government-based legal currency.[11]

There are currently 13.7 million Bitcoins in circulation. The total number of Bitcoins that can be generated is arbitrarily capped as per the Bitcoin work paper at 21 million coins, which is predicted to be reached in 2140.[12]

This chapter provides a background into Bitcoin by considering (i) the definition and origin of Bitcoin; (ii) the system of Bitcoin; and finally (iii) how Bitcoin is obtained.

2.2. DEFINITION AND ORIGIN OF BITCOIN

Bitcoin is a form of digital currency, created and held electronically.[13] No-one controls it and, as mentioned above, it lacks any form of backing by a legal government.[14] Bitcoins are not printed currency, but are rather produced by people, and increasingly businesses, running computers all around the world, using software that solves mathematical problems.[15] More specifically, Bitcoin is considered a cryptocurrency,[16] as it relies on cryptography. Cryptography is communication that is secure from view of third parties, in order to authenticate transactions and administer the creation of the currency itself.[17]

Bitcoin is a completely decentralised "peer-to-peer" network, which means that there is no central administrator or point of control.[18] The Bitcoin system allows for self-regulating, electronic exchange between individuals in which members of the system determine or verify the veracity of every Bitcoin transaction without relying upon third-party intermediaries, such as banks or payment processors (for example, VISA).[19] All Bitcoins are held by users of the network in their own individual Bitcoin wallets. Bitcoin is a chain of transactions between members of a virtual network that achieves, or is attributed, value through the

11 Atkins (2014) *Pittsburgh* p 27.
12 Craig (2015) *Congressional Research Service* p 3.
13 >http://bit.ly/QkYszs< (accessed: 11 June 2016).
14 Atkins (2014) *Pittsburgh* p 28.
15 >http://bit.ly/QkYszs/< (accessed: 11 June 2016).
16 Atkins (2014) *Pittsburgh* p 28.
17 Craig (2015) *Congressional Research Service* p 1.
18 Atkins (2014) *Pittsburgh* p 29.
19 Atkins (2014) *Pittsburgh* p 29.

verification of the Bitcoin's transaction history.[20] As such, the value of Bitcoin is based upon the level of demand for or the willingness of members of the virtual community to accept the currency in exchange for other items of distinct value.[21] Nakamoto's purpose was to remove third-party intermediaries who raise the cost of transactions.[22] This main purpose is essential to understanding how the Bitcoin system functions and the challenges that arise in regulating and taxing transactions within the system.

2.3. HOW DOES THE BITCOIN SYSTEM WORK?

Bitcoin relies on cryptography, which is communication that is secure from view of third parties, in order to authenticate transactions and administer the creation of the currency itself.[23] Each Bitcoin and each user is encrypted with a unique identity.[24]

"Spending" Bitcoin simply means sending them from one user to another, just as one would do when sending an email via the internet.[25] At certain intervals, all of the transactions during the preceding period are bundled together in a block, and these blocks are then linked to form a chain.[26] This creates a database of all approved transactions and is recorded on a decentralized public ledger.[27] The ledger is visible to all computers on the network; however, it does not reveal any personal information regarding the parties' identities.[28] The database of transactions keeps a record of all transfers and Bitcoin cannot be spent twice and thus the double spending problem is solved.[29]

A user must download the Bitcoin management software in order to obtain and possess Bitcoin.[30] This software connects the computer to the peer-to-peer network of connected computers on the Bitcoin system, referred to as "nodes".[31]

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20 >http://www.coindesk.com/information/what-is-bitcoin/< (accessed: 11 June 2016).
21 Atkins (2014) *Pittsburgh* p 28.
22 Atkins (2014) *Pittsburgh* p 29.
23 Craig (2015) *Congressional Research Service* p 1.
24 Craig (2015) *Congressional Research Service* p 1.
25 Bal (2014) *Leiden* p 56.
26 Bal (2014) *Leiden* p 56.
27 Also referred to as a *distributed ledger* or *block chain*.
28 Craig (2015) *Congressional Research Service* p 1.
29 Craig (2015) *Congressional Research Service* p 1.
30 Atkins (2014) *Pittsburgh* p 30.
31 Atkins (2014) *Pittsburgh* p 30.

The Bitcoin file must be electronically transferred from the possessor to the recipient. The Bitcoin file is then stored either on a possessor's computer or in an online database, which are known as "wallets".[32] Each wallet has a public and private cryptographic keys associated to it.[33] The public key is the address of the wallet when receiving or sending Bitcoin.[34] The public key does not disclose any information regarding the personal identity of the owner and therefore allows for anonymity in a Bitcoin transaction.[35] The private key, on the other hand, is used to authorise the Bitcoin transaction by the sending and receiving party.[36] By authorising the transaction with the private key, the transaction is transmitted to the entire peer-to-peer network and it is included in the transaction history or block chain.

2.4. ATTAINING BITCOIN

Users have three options to gain possession of Bitcoin. Firstly, users can convert their local or conventional currency (e.g. dollars, rands, euros etc.) to Bitcoins via exchange.[37] The price of Bitcoin relative to other currencies is determined by supply and demand.[38] On 19 October 2016 at 07:58 GMT the price of Bitcoin was $634.33.[39] The price is volatile, having been $1 100 in December 2013 and approximately $320 in mid-December 2013. This represents more than 30% fall in value in one month.[40]

Secondly, a user can obtain Bitcoins in exchange for the sale of goods or services. This is when a merchant accepts Bitcoin for the sale of his product, for example.[41]

Thirdly, new Bitcoins may be acquired through "mining". A user serves as a miner by providing his or her computer's processing power to successfully verify Bitcoin transactions in the public ledger.[42] The mining process is where the Bitcoin network enters new coins into circulation. The process simultaneously verifies the history of Bitcoin transactions.[43] Each

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32 Atkins (2014) *Pittsburgh* p 30.
33 Atkins (2014) *Pittsburgh* p 30.
34 Atkins (2014) *Pittsburgh* p 31.
35 Atkins (2014) *Pittsburgh* p 31.
36 Atkins (2014) *Pittsburgh* p 31.
37 Brook (2014) *International L Rev* p 837.
38 Craig (2015) *Congressional Research Service* p 2.
39 >http://bit.ly/28JCMfD< (Accessed: 19 October 2016).
40 Craig (2015) *Congressional Research Service* p 2.
41 Craig (2015) *Congressional Research Service* p 2.
42 Craig (2015) *Congressional Research Service* p 2.
43 Brook (2014) *International L Rev* p 837.

miner's computer is used by the network to solve a complex algorithm, called a "hash".[44] The probability of a user discovering Bitcoin through mining is based on the amount of computer processing power that can be applied.[45]

Figure 1 below provides an illustration of how the Bitcoin system works:

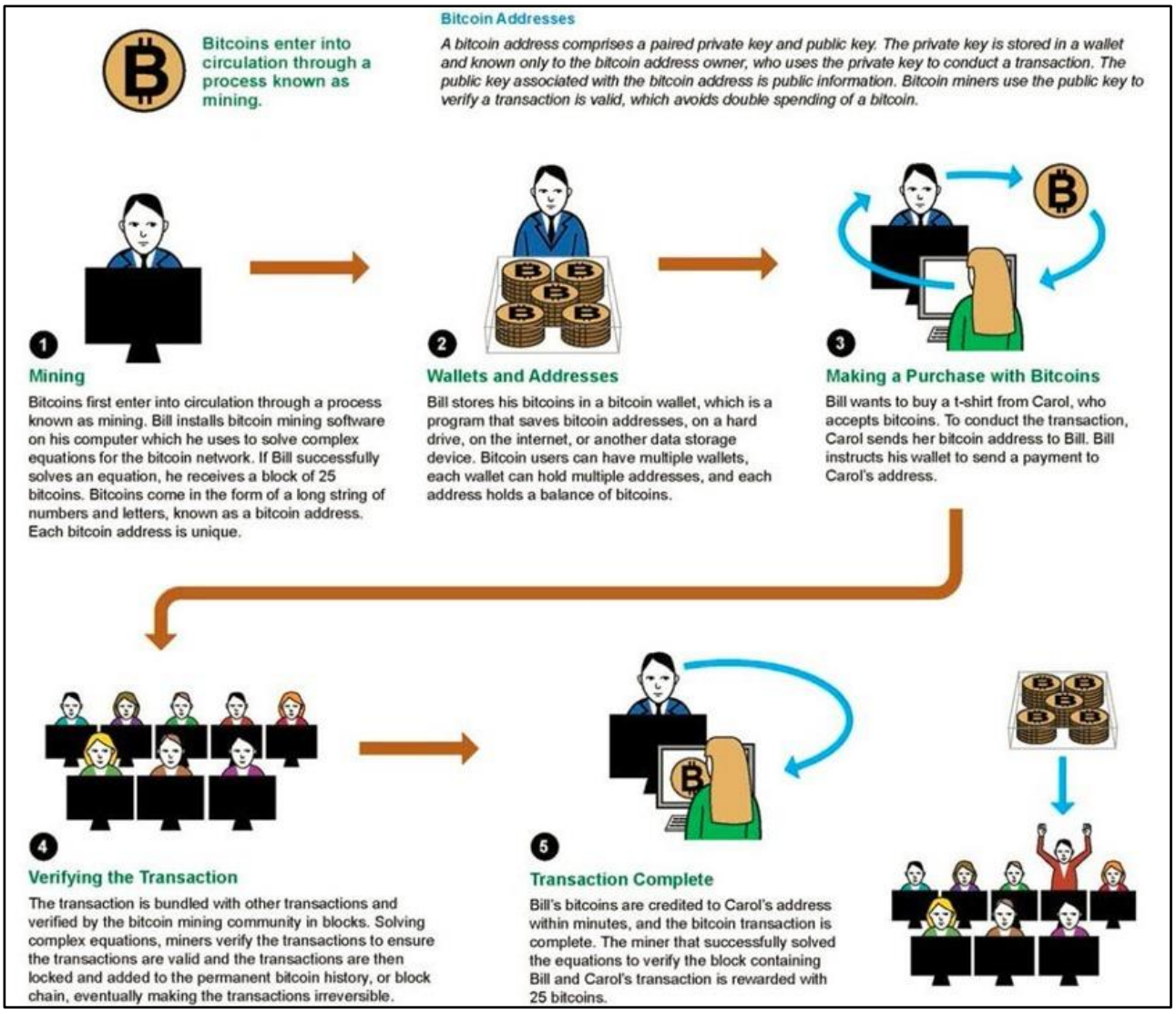

Figure 1: How the Bitcoin System operates. **Source:** OECD 2015 p 43.

[44] Brook (2014) *International L Rev* p 837.
[45] Craig (2015) *Congressional Research Service* p 2.

2.5. TAX EVASION AND CRIMINAL ACTIVITIES ASSOCIATED WITH BITCOIN

A feature of Bitcoin that allows for criminal activities is that it is secure and anonymous when transferring value from one computer to another.[46] It works by assigning a public cryptographic key to arbitrary units of value held in a client.[47] The keys are public and may be inspected by anyone, however, a private key is required to make the transaction.[48] The units of value that are held in wallets may only be transferred by the wallet's owner with the secure keys and the keys themselves make the transaction anonymous.[49]

The problems posed through the feature of anonymity are aggravated by the ease in movement of funds across borders and the speed at which the industry operates.[50] The struggle in detecting suspicious activity and tracking customer activity increases significantly when anonymity shields the customer identity and hinders the identification of sources of funds and the economic purpose of the transaction.[51]

Lack of regulation of Bitcoin has translated into criminal activities by fraudsters and scam artists in terms of, for example, phishing sites passing as exchanges.[52] In January 2015, Bitstamp, a European Bitcoin exchange, suspended services after a security breach involving the loss of 19 000 Bitcoin at approximately $5 million.[53]

The anonymity and the international character of Bitcoin allows criminals to make use of them for purposes such as purchasing drugs, child pornography, money laundering and tax evasion.[54] Therefore, criminals can convert, transfer and withdraw funds without any detection.[55] An example of such criminal activity is the online market place, Silk Road. The Silk Road was an online anonymous marketplace that started its operations in February 2011[56] and it was only accessible on the dark web, which is a part of the internet that entails

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46 Guadamuz (2014) *SSRN* p 10.
47 Guadamuz (2014) *SSRN* p 10.
48 Guadamuz (2014) *SSRN* p 10.
49 Guadamuz (2014) *SSRN* p 10.
50 >http://bit.ly/28Jclpo < (accessed 13 June 2016).
51 >http://bit.ly/28Jclpo < (accessed 13 June 2016).
52 Guadamuz (2014) *SSRN* p 11.
53 Craig (2015) *Congressional Research Service* p 8.
54 Guadamuz (2014) *SSRN* p 28.
55 >http://bit.ly/28Jclpo < (accessed 13 June 2016).
56 Cristin (2012) *Carnegie* p 3.

specialist software to access.[57] The website provided infrastructure for sellers and buyers to conduct transactions in an online environment and ensured anonymity of both sellers and buyers.[58] It only supported Bitcoin as a trading currency.[59] The Silk Road creator, Ross Ulbrich, stated that his marketing involved "starting a thread on Bitcoin [Talk] forum".[60] A study conducted at Carnegie Mellon University revealed that Bitcoin has helped transfer approximately $1.2 million sales per month of illegal narcotics associated with the Silk Road through the use of its virtual currency.[61] Users of the site used Bitcoin to purchase drugs such as heroin, cocaine and LSD. Not only was Silk Road involved in drug-trade, but on August 2011 it announced a new marketplace category: "Forgeries" for fake government-issued documents like drivers' licences, fake IDs and passports.[62] The site was shut down in 2013 when police arrested Ulbrich and in February 2016, Ulbrich was sentenced to two life sentences for operating the site for nearly three years.[63]

With regards to tax evasion, this may occur, for example, where there is underreporting of cash transactions.[64] The core issue is that administrative resources are typically insufficient to enforce tax law, given the relative difficulty of tracing decentralised, quasi-anonymous transactions.[65] Information technology ("IT") regulation faces a similar issue, as it is administratively impractical to regulate each individual internet-user.[66] Bitcoin's software's 'peer-to-peer', decentralised nature and anonymity combines the administrative challenges of IT *and* tax regulation.

In addition to potentially facilitating fraudulent tax evasion, Bitcoin lacks jurisdictional nexus. This ultimately leads to the problems of defining source of profit or place of delivery or consumption of service.[67] This issue is pertinent for regulators and is a key focus of the Organisation for Economic Cooperation and Development ("OECD") Base Erosion and Profit Shifting Project ("BEPS").[68]

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57 >http://bbc.in/1LSCw60< (accessed: 13 June 2016).
58 Cristin (2012) *Carnegie* p 3.
59 Cristin (2012) *Carnegie* p 4.
60 >http://bit.ly/1rTHxD1< (accessed: 13 June 2016).
61 Cristin (2012) *Carnegie* p 1.
62 >http://bit.ly/1rTHxD1< (accessed: 13 June 2016).
63 >http://bit.ly/1rTHxD1< (accessed: 13 June 2016).
64 Emery (2016) *Australian National University* p 24.
65 Emery (2016) *Australian National University* p 24.
66 Emery (2016) *Australian National University* p 24.
67 Which are principles that most tax structures rely on. Marian (2013) 112 *Mich. L Rev* p 40.
68 That is discussed in more detail in paragraph 2.6.

Bitcoin's jurisdictional omnipresence threatens to further erode jurisdictional clarity as to a State's sovereign right to tax, by lacking any connection to a State or physical location.[69] Consequently, certain transactions that are the subject of tax contention or tax avoidance may escape the jurisdiction of a country and therefore escape any legal consequences.[70]

The administrative challenges and tracking features of Bitcoin lead it to be a potential tax haven for tax evaders and a legal minefield for tax enforcement.[71] Tax havens allow taxpayers to conceal earnings from tax authorities in the taxpayers' home jurisdictions by offering "an environment with no or only nominal taxation" in which "[t]he activity is usually not subject to information exchange because, for example, of strict bank secrecy provisions".[72]

While Bitcoin can be used for legitimate purposes, it is well suited to support unlawful dealings. Bitcoin possesses the two most important characteristics of a traditional tax haven.[73] First, because there is no jurisdiction in which they operate (they are "held" in cyberspace accounts known as online "wallets"), they are not subject to taxation at source.[74] Second, Bitcoin accounts are anonymous.[75] Users can start as many online "wallets" as they want to buy or mine Bitcoins and trade them without ever providing any identifying information.[76]

Another major advantage to tax-evaders that traditional tax havens do not possess, is that the operation of Bitcoin is not dependent on the existence of financial intermediaries such as banks.[77] Therefore, the reliance on financial intermediaries to assist in combating tax-evasion is not possible when dealing with Bitcoin. For example, a service provider could theoretically accept payments for real services in Bitcoin. Given that the service provider is not required to identify itself when establishing its online Bitcoin wallet, it would be very difficult to trace the earnings accumulated in this wallet back to the service provider.[78]

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69 Marian (2013) 112 *Mich. L Rev* p 40.
70 Marian (2013) 112 *Mich. L Rev* p 40.
71 Marian (2013) 112 *Mich. L Rev* p 40.
72 Marian (2013) 112 *Mich. L Rev* p 40.
73 Marian (2013) 112 *Mich. L Rev* p 42.
74 Marian (2013) 112 *Mich. L Rev* p 42.
75 Marian (2013) 112 *Mich. L Rev* p 42.
76 Marian (2013) 112 *Mich. L Rev* p 42.
77 Marian (2013) 112 *Mich. L Rev* p 42.
78 Marian (2013) 112 *Mich. L Rev* p 42.

2.6. OECD BEPS ACTION PLAN

Political leaders, media outlets, and civil society around the world have expressed growing concern about tax planning by multinational enterprises that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed.[79]

In response to this problem, the OECD published an action plan on BEPS in July 2013.[80] Revenue losses from BEPS are conservatively estimated at $100-240 billion annually, or anywhere from 4-10% of global corporate income tax ("CIT") revenues.[81] Given developing countries' greater reliance on CIT revenues as a percentage of tax revenue, the impact of BEPS on these countries is particularly significant.[82]

The BEPS Action Plan identifies 15 actions to address BEPS in a comprehensive manner, and sets deadlines to implement those actions.[83] Action 1 of BEPS deals with the tax challenges of the digital economy.

The OECD made various findings regarding the digital economy, such as:

(i) The rapid technological progress that has characterised the digital economy has led to a number of emerging trends and potential developments. Although this rapid change makes it difficult to predict future developments with any degree of reliability, these potential developments [such as Bitcoin] should be monitored closely as they may generate additional challenges for tax policy makers in the near future;[84]

(ii) while no unique BEPS issues are presented by the digital economy, many of the key features of the digital economy, particularly those related to mobility, aggravate BEPS concerns;[85]

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79 OECD BEPS 2015 p 12.
80 OECD BEPS 2015 p 12.
81 >http://bit.ly/1LdAOhZ< (accessed: 13 June 2016).
82 OECD BEPS 2015 p 12.
83 OECD BEPS 2015 p 12.
84 OECD BEPS 2015 p 143.
85 OECD BEPS 2015 p 194.

(iii) The place of supply for digital business to consumer services should follow the destination principle, i.e. these should be subject to VAT/GST at the customers' location;[86]

(iv) the concept of "virtual permanent establishment" was a suggestion of an alternative connection that would apply to electronic commerce operations.[87] This could be done in various ways, such as extending the definition to cover so-called "virtual fixed places of business", "virtual agencies" or "on-site business presences." All of them would require a modification of the permanent establishment ("PE") definition (or the addition of a new nexus rule in treaties).[88]

2.7. CONCLUSION

To conclude, Bitcoin is a virtual currency that relies on cryptography and anonymity in terms of its transactions. These features may ultimately assist various criminal activities, such as online drug trade, money laundering or tax evasion. The use of Bitcoin in a modern era, where technology plays a major role, is growing substantially. As the economy becomes globalised, currencies not tied to a specific jurisdiction become more appealing and therefore Bitcoin usage has grown substantially. Ensuring tax compliance of Bitcoin has therefore become an important challenge that countries on a global scale are preparing to tackle.

The OECD has further acknowledged the tax issues surrounding the digital economy, specifically with respect to Bitcoin. There is a multitude of legal concerns for regulators to address, specifically with regards to taxation. Given the explosive growth of Bitcoin usage and the unique characteristics of Bitcoin, regulators must act to ensure that the tax laws sufficiently address the modern economy, including Bitcoin.

86 OECD BEPS 2015 p 94.
87 OECD BEPS 2015 p 156.
88 OECD BEPS 2015 p 156.

CHAPTER 3: UNITED STATES GUIDANCE ON VIRTUAL CURRENCIES

3.1. INTRODUCTION

The Internal Revenue Service ("IRS"), a United States ("U.S.") government agency responsible for the collection and enforcement of taxes,[1] began seriously considering taxation of virtual economies in 2007, culminating in minor steps to effect taxation compliance.[2] A report by the Government Accountability Office ("GAO") was released in May 2013, which consequently resulted in the IRS developing guidance on the taxation of virtual currencies.[3]

This chapter examines (i) the legal status of Bitcoins in the US, including case law that dealt with the classification of Bitcoin; (ii) guidance to date on the regulation of Bitcoin, including the GAO report that delivered a recommendation to the IRS, as well as the IRS Notice 2014-21 providing guidance on the taxation and reporting of Bitcoin; (iii) the U.S. tax treatment of foreign currency; and (iv) the consequences of the IRS notice.

3.2. LEGAL STATUS OF BITCOINS IN THE U.S.

The legality of transacting with or creating Bitcoin as a so-called "currency" or "legal tender" in terms of U.S. law is uncertain.[4] In the U.S. only money itself (for example, the U.S. dollar) is regarded as a legal tender.[5] The Constitution of the United States of America, 1987 ("U.S. Constitution") gives Congress the power "to coin money" to the exclusion of the states.[6] However, it is unclear whether U.S. federal law only permits the federal government, to the exclusion of other entities, to create currencies.[7] Title 31 of the U.S. Code[8] does not seem to make the distinction between legal currency and legal tender, so they appear to be treated

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1 >http://bit.ly/241gPZJ< (accessed: 8 April 2016).
2 As will be highlighted in this chapter.
3 Huang (2015) *Yale J.L. & Tech* p 227.
4 Wiener (2014) *Tax Notes Int'l* p357.
5 Guadamuz (2015*) Peer-Reviewed Journal* p 18.
6 U.S. Constitution Article I s 8.
7 Wiener (2014) *Tax Notes Int'l* p 357.
8 The United States Code is a consolidation and codification by subject matter of the general and permanent laws of the United States. It is prepared by the Office of the Law Revision Counsel of the United States House of Representatives. See: >http://uscode.house.gov/< (accessed: 30 June 2016).

in a similar fashion.[9] This is validated by numerous official documents that indicate clearly that only the U.S. dollar is allowed as the official currency of the U.S. For instance, according to the Federal Bureau of Intelligence ("FBI") "it is a violation of federal law for individuals, ... or organisations, ... to create private coin or currency systems to compete with the official coinage and currency of the United States".[10]

3.2.1. SECURITIES EXCHANGE CASE

In August 2013, a U.S. District Court issued a judgment in the case of *Securities and Exchange Commission v Trendon T. Shavers and Bitcoin Savings and Trust*, United States District Court[11] ("*Securities Exchange* case") recognising Bitcoin as a legitimate form of money.[12] This case deals with a complaint by the Securities Exchange Commission ("Commission") against Trendon T. Shavers ("Shavers") and Bitcoin Savings and Trust ("BTCST") (Shavers and BTCST referred to as the "Defendants"). Shavers founded and operated BTCST. BTCST was an unincorporated online investment scheme in which Shavers solicited and accepted investments, and paid all purported returns, in Bitcoin.[13] Shavers promised BTCST investors up to 1% interest daily to be paid every three days at first, or 7% interest weekly.[14]

The court pointed out that section 10(b) of the Exchange Act of 1934[15] makes it unlawful for any person, in connection with the purchase of security, directly or indirectly to "(a) employ any device, scheme, or artifice to defraud; (b) make an untrue statement of a material fact or a material omission; or (c) engage in any act, practice, or course of business which operates … as a fraud or deceit upon any person".[16]

Shavers argued primarily that the BTCST investments are not securities because Bitcoin is not money, and Bitcoin is not, and cannot be, regulated by the U.S,[17] The Commission

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9 Guadamuz (2015) *Peer-Reviewed Journal* p 18.
10 >http://1.usa.gov/1Lan5ZT< (accessed: 9 April 2016).
11 No. 4:13-CV-416 13 September 2014.
12 4:13-CV-416 p 15.
13 4:13-CV-416 p 1.
14 4:13-CV-416, p 2.
15 15 U.S.C §§ 78J(b).
16 4:13-CV-416 p 14-15.
17 4:13-CV-416 p 2.

argued that the BTCST investments met the definition of a "security" because they were both investment contracts and notes.[18]

The court stated that an investment contract is any contract, transaction or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.[19] In order to determine whether or not BTCST contracts met the definition of investments, the Court delved into the issue as to whether or not Bitcoin is considered money.

The Court relied on the definition of money being, "anything that functions as a medium of exchange, a unit of account, and a store of value".[20] The Defendants urged the Court to rely on the IRS Notice 2014-21 ("IRS Notice"), which, they assert, finds that Bitcoin is property, rather than money.[21] However, as brief background and as noted by the Court, the IRS statement refers to Bitcoin as a "convertible virtual currency," and acknowledges that Bitcoin can operate like "real" currency,[22] but it does not have legal tender status in any jurisdiction".[23]

The Court held with regard to the IRS Notice, the following:

(i) The IRS Notice states that, for federal tax purposes, virtual currency is treated as property. However, when reporting virtual currency to the IRS, "a taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars";[24]

(ii) The IRS Notice did not make any determinations about whether Bitcoins are money or not, only that for federal tax purposes, Bitcoins are to be treated as property;[25]

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18 4:13-CV-416 p 2.
19 4:13-CV-416 p 8.
20 4:13-CV-416 p 12.
21 4:13-CV-416 p 12. The IRS Notice is discussed in detail in this dissertation in the paragraph 3.2.4.
22 i.e. the coin and paper money of the U.S. or of any other country that is designated as legal tender.
23 4:13-CV-416 p 12.
24 4:13-CV-416 p 12.
25 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 12.

(iii) Further, in twenty-three places throughout the IRS Code, money is referred to as property;[26]

(iv) It could find no reason to conclude that Bitcoin is not money and rather found that the IRS definition and guidance directed the Court towards similarities between money and Bitcoin for federal tax purposes.[27]

The Court held that Bitcoin has a measure of value, can be used as a form of payment, and is used as a method of exchange. Therefore it can be considered to be money.[28] It further found that Bitcoin is considered money because it meets the six characteristics of money: durability, portability, acceptability, limited supply, divisibility and uniformity.[29] It noted that the only limitation to Bitcoin is that it is limited to those places that accept it as currency.[30] However, the court stated that Bitcoin can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money.[31]

The Court held that even if it considered that Bitcoin was not money, it may still be considered an investment contract if it is classified as property.[32] The Court therefore ultimately found that the BTCST investments were considered money and investment contracts, and, as such, are securities.[33]

However, conventional currency, has been based on gold or silver. Bitcoin, on the other hand, is backed by mathematics.[34] Since Bitcoin is characterised as money in the *Securities Exchange* case, it has value and therefore the law of supply and demand determines its price.[35] For example, when the demand for Bitcoins increases, the price proportionately

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26 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 13.
27 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 13.
28 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 15.
29 *Durability* means that the bills or coins are easily replaceable should they become damaged. *Portability* means that money can easily be transported from one location to the next. *Acceptability* means that money is commonly accepted as a value exchange mechanism. *Limited supply* ensures that money holds its value. *Divisibility* implies that money can be broken down into smaller values. *Uniformity* establishes a standard for the look of various denominations. Wiener (2014) *Tax Notes Int'l* p357.
30 No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013) p 2.
31 No. 4:13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013) p 2
32 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 14.
33 No. 4:13-CV-416, 2014 WL 4652121 (E.D. Tex. Sept. 18, 2014) p 14.
34 Yu (2015) *University San Diego* p 3.
35 Yu (2015) *University San Diego* p 3.

increases. There is only a limited number of Bitcoins in circulation and new Bitcoins are created at a predictable and decreasing rate, which means that demand must follow this level of inflation to keep the price stable.[36] Since there is no way for anybody to find the private keys that would allow Bitcoins to be spent again, lost[37] Bitcoins cannot be retrieved. As a result, the remaining Bitcoins in circulation are in higher demand and increase in value.[38]

3.2.2. REJECTION OF BITCOIN BY VARIOUS U.S. STATES

U.S. State authorities have taken a closer look at Bitcoin transactions. In March 2013, the U.S. Treasury Department's Financial Crimes Enforcement Network issued interpretive guidance regarding the treatment of decentralised virtual currencies, such as Bitcoin, under the Bank Secrecy Act of 1970 ("BSA"). Under the guidance, "administrators or exchangers" of Bitcoin are required to register and are subject to the regulation as "money service businesses" ("MSB") under the BSA. In May 2013, the U.S. Department of Homeland Security issued a warrant to the largest Bitcoin exchange base, Mt. Gox who failed to file as an MSB under the BSA. Consequently its funds were seized by Homeland Security.[39] In May 2013, California's Department of Financial Institutions issued a warning to the Bitcoin Foundation, demanding that it cease and desist "conducting the business of money transmissions" in California.[40]

In addition, in May 2013, the New York State Department of Financial Services issued a notice of inquiry into the appropriate regulatory guidelines that should put in place for virtual currencies.[41] The New York department subsequently subpoenaed 22 entities and investors nationwide involved in the Bitcoin industry, seeking information on money-laundering controls, consumer protection practices, funding sources and investment strategies for Bitcoin investors.[42]

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36 Yu (2015) *University San Diego* p 2.
37 For example, throwing away a hard drive with Bitcoins stored on the hard drive.
38 Yu (2015) *University San Diego* p 3.
39 Wiener (2014) *Tax Notes Int'l* p 357.
40 Wiener (2014) *Tax Notes Int'l* p 357-358.
41 Wiener (2014) *Tax Notes Int'l* p 358.
42 Wiener (2014) *Tax Notes Int'l* p 358.

It seems from the above that local currencies that may compete with the U.S. dollar are not permitted by U.S. state authorities. However, the question of whether Bitcoin can be considered currency in the U.S. for these purposes still remains unclear. There does not appear to be consensus that Bitcoin would fall foul of regulation designed to protect the U.S. dollar as legal tender. On the contrary, there have been electronic payment systems in existence for over a decade and there have not been attempts to curb them by using counterfeiting legislation in existence in the U.S.[43]

3.3. GUIDANCE TO DATE ON BITCOIN

3.2.3. GAO REPORT: MAY 2013

In May 2013, the U.S Government Accountability Office ("GAO") issued a report to the U.S. Senate Committee on Finance entitled "Virtual Economies and Currencies Additional IRS Guidance Could Reduce Tax Compliance Risks" ("GAO Report"). The GAO report described its findings with regard to virtual economies and currencies, ultimately concluding that the IRS should provide guidance to reduce tax compliance risks.[44]

The GAO report (i) dealt with the tax reporting requirements for virtual economies and currencies, (ii) identified the potential tax compliance risks of virtual economies and currencies, and (iii) assessed how IRS addressed the tax compliance risks of virtual economies and currencies.[45]

The GAO report specifically stated:

> "To mitigate the risk of noncompliance from virtual currencies, the Commissioner of Internal Revenue should find relatively low-cost ways to provide information to taxpayers, such as the web statement IRS developed on virtual economies, on the basic tax reporting requirements for transactions using virtual currencies developed and used outside virtual economies".[46]

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43 Guadamuz (2015) *Peer-Reviewed Journal* p 18.
44 U.S. GAO 2013 Virtual Economies and Currencies p 1. See also: Anand (2014) *Hofstra Law Review* p 267.
45 U.S. GAO 2013 Virtual Economies and Currencies p 1.
46 U.S. GAO 2013 Virtual Economies and Currencies p 17.

Specifically, the GAO report identified five tax compliance risks involving virtual economies and currencies.[47] The risks are listed and discussed below:

(i) Lack of taxpayer knowledge regarding tax consequences:

Income is generally defined as any indisputable accessions to wealth, clearly realized, and over which the taxpayers have complete power.[48] Inexperienced taxpayers may not be able to properly classify income earned through virtual economies or currencies as taxable income.[49] If taxpayers using virtual currencies turn to the Internet for tax help, they may be misinformed in the absence of clear guidance from the IRS.[50]

(ii) Uncertainty about how to characterise income:

Even if taxpayers are aware that they may have a tax liability, they may be unsure of the proper tax treatment of virtual transactions.[51] Characterisation, for example, depends on whether the virtual economy activity or virtual currency unit is to be treated as property, barter, foreign currency, or a financial instrument.[52] Certain virtual currency transactions, for example, could be considered barter transactions, which may not be an obvious characterisation to taxpayers who are not tax professionals.[53] This characterisation could result in noncompliance with requirements for reporting and paying tax on barter income.[54]

(iii) Uncertainty about how to calculate basis for gains:

Income earned from virtual economy or currency transactions may not be taxable if it is occasional income from selling goods for less than their original purchase

47 U.S. GAO 2013 Virtual Economies and Currencies p 12-14.
48 U.S. GAO 2013 Virtual Economies and Currencies p 13.
49 Such as virtual online game assets exchanged for real word currency. U.S. GAO 2013 Virtual Economies and Currencies p 13.
50 U.S. GAO 2013 Virtual Economies and Currencies p 13.
51 U.S. GAO.2013 Virtual Economies and Currencies p 13.
52 U.S. GAO 2013 Virtual Economies and Currencies p 13.
53 U.S. GAO 2013 Virtual Economies and Currencies p 13.
54 U.S. GAO 2013 Virtual Economies and Currencies p 13.

price.[55] It may be difficult for individuals receiving income from virtual economies to determine their basis for calculating gains.[56] For example, some online games require players to pay a monthly fee in exchange for use of the game and a monthly allowance of virtual currency, such as Bitcoin. If a player then sells a virtual tool gained in the game for real money, calculating the basis for any taxable gain may be problematic for a taxpayer.[57]

(iv) Challenges with third-party reporting requirements:

Third-party information reporting requirements do not apply specifically to transactions using virtual economies or currencies.[58] Virtual economy or currency transactions may be subject to third-party information reporting to the extent that these transactions involve the use of a third-party payment network to reconcile the transaction and where the taxpayer meets reporting threshold requirements.[59] Due to the fact that virtual economy and currency transactions are inherently difficult to track, including identifying the true identities of the parties to the transaction, third-party information reporting may be difficult or burdensome for some virtual economy and currency issuers to manage.[60]

(v) The potential for using virtual economies and currencies as vehicles for tax evasion:

Some taxpayers may use virtual economies and currencies as a way to evade taxes. Transactions can be difficult to trace and many virtual economies and currencies offer some level of anonymity and therefore taxpayers may use them to hide their taxable income.[61]

Various US practitioners corroborated the GAO's analysis, but criticised its failure to address specific tax-related questions, such as when to recognise gains or losses, and how to

55 U.S. GAO 2013 Virtual Economies and Currencies p 13.
56 U.S. GAO 2013 Virtual Economies and Currencies p 13.
57 U.S. GAO 2013 Virtual Economies and Currencies p 13.
58 U.S. GAO 2013 Virtual Economies and Currencies. p 14.
59 U.S. GAO 2013 Virtual Economies and Currencies p 14.
60 U.S. GAO 2013 Virtual Economies and Currencies p 14.
61 U.S. GAO 2013 Virtual Economies and Currencies p 14.

determine cost basis.[62]

U.S. taxpayers, as well as taxpayers around the world, require clear guidelines and examples to follow when it comes to transactions involving virtual currencies. For years individuals and practitioners have been seeking direct, straightforward answers to questions regarding the calculation of their tax consequences for virtual-world transactions.[63] The IRS responded to the concerns and issued Notice 2014-21 in March 2014, providing guidance and information on the application of existing U.S. federal tax principles to transactions using virtual currency, including Bitcoin.[64]

3.2.4. IRS NOTICE: GUIDANCE ON TAX TREATMENT OF BITCOIN

The IRS defines virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value".[65] While virtual currency is recognised as a digital representation of value and operates like "real" currency (such as traditional coin and paper money, which can be used as a medium of exchange) it does not have legal tender status in any jurisdiction.[66] A virtual currency is a substitute for real currency or has an equivalent value in real currency. Since Bitcoin is used in real-world economic transactions, the IRS has stated that transactions involving convertible virtual currencies have U.S. federal tax consequences that may result in tax liabilities.[67]

For U.S. federal tax purposes, the IRS held that virtual currency is treated as property and "general tax principles applicable to property transactions apply to transactions using virtual currency".[68] The U.S. tax principles applied to property transactions can be complex. Before investigating the effect of the IRS decision to treat Bitcoin as property, it is important to understand the tax treatment of property. Investment property is property that produces investment income, for example stocks and bonds.[69] The essence of the tax liability created by selling investment property is captured by calculating and reporting gains and losses.[70]

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62 Anand (2014) *Hofstra Law Review* p 269.
63 Anand (2014) *Hofstra Law Review* p 269 – 267.
64 Yu (2015) *University San Diego* p 11.
65 IRS. Notice 2014-21. p 1.
66 Yu (2015) *University San Diego* p 11.
67 IRS. Notice 2014-21. p 2; Yu (2015) *University San Diego* p 12.
68 IRS. Notice 2014-21. p 4.
69 IRS. Publication 550. P 1.
70 IRS publication 550 p 3. See also: Yu (2015) *University San Diego* p 12 where this topic is discussed.

To calculate gains or losses on the sale of property, it is important to follow the three steps to reporting gains and losses. These steps are as follows:

(i) Step 1: calculate the realised gain or loss

Gain or loss on the sale of investment property is calculated by comparing the "adjusted basis" of the property with the "amount realised" from sale of the property.[71]

The basis of the property is usually equal to the cost – i.e. the amount an individual pays in cash, debt obligations, or other property or services to purchase the property.[72] If the property is acquired by gift, inheritance or in some other way than by purchasing it, the basis would be the fair market value.[73] Fair market value is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts and neither is being forced to buy or sell.[74] Adjustments (such as costs or fees associated with purchase) are usually made after the basis of the property is determined, resulting in an "adjusted basis".[75]

"Amount realised" is the amount received from a sale or exchange.[76] The amount is also reduced by any sales expenses, including redemption fees and sales commissions.[77]

Gains occur when the "amount realised" from a sale is greater than the "adjusted basis" of the property. When the "adjusted basis" is greater than the "amount realised", the difference is a loss.[78]

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71 IRS publication 544 p 3.
72 IRS publication 544 p 3.
73 IRS publication 544 p 3.
74 IRS publication 544 p 3; Treasury Regulation §1.170A-1(c)(2).
75 Yu (2015) *University San Diego* p 13.
76 "Exchange" amount is the total money a taxpayer receives plus the fair market value of all property or services received. IRS publication 544 p 3.
77 IRS publication 544 p 4.
78 IRS publication 544 p 3.

(ii) Step 2: determine the recognised portion of the gain or loss

After the gain or loss is realised, it must be determined if any portion of the realised gain or loss is recognised.[79] Generally, gains or losses realised from sales are recognised for tax purposes. However, certain exchanges are not required to be recognised or are non-taxable.[80] An example of this exception is a "like-kind exchange", which is an exchange of property for the same kind of property.[81]

(iii) Step 3: characterise the recognised gain or loss as ordinary, capital, or Internal Revenue Code ("IRC") section 1231 property

Finally, the third step to reporting gains and losses is to characterise the recognised gain or loss. The character of the gain or loss is important because it affects the taxpayer's tax liability.[82] For individuals, a net capital gain is taxed at a different rate than ordinary income.[83] The tax rate on most net capital gain is no higher than 15% for most taxpayers.[84] Some or all net capital gain may be taxed at 0% if you are in the 10% or 15% ordinary income tax brackets.[85] However, a 20% tax rate on net capital gain applies to the extent that a taxpayer's taxable income exceeds the thresholds set for the 39.6% ordinary tax rate ($413,200 for single; $464,850 for married filing jointly or qualifying widow(er); $439,000 for head of household, and $232,425 for married filing separately).[86]

Recognised gains and losses must be classified as "ordinary", "capital", or "section 1231 gains or losses".[87] The treatment of a gain or loss may be classified as strictly capital or ordinary, or a combination of capital and ordinary, depending on the situation.[88] The character of the gain or loss recognised depends on the character of the assets sold, the length of time the asset was used and the holding

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79 Yu (2015) *University San Diego* p 14.
80 Yu (2015) *University San Diego* p 13.
81 Yu (2015*) University San Diego* p 13.
82 Yu (2015) *University San Diego* p 14.
83 IRS publication 544 p 3.
84 >http://bit.ly/2eGeZOx< (accessed: 29 October 2016)
85 >http://bit.ly/2eGeZOx< (accessed: 29 October 2016)
86 >http://bit.ly/2eGeZOx< (accessed: 29 October 2016)
87 Yu (2015) *University San Diego* p 14.
88 Yu (2015) *University San Diego* p 14.

period (long-term capital gain versus short-term capital gain).[89] Generally, a sale or trade of non-capital assets (for example inventory), or any assets created and used in a taxpayer's trade or business, results in ordinary gains or losses.[90]

Capital gains or losses result from sales of capital assets, which are assets held for investment and personal-use purposes.[91] Examples of capital assets are stocks, bonds, cars, houses.[92] Net capital losses are limited to a $3,000 deduction per year.[93]

Gains or losses are subject to Internal Revenue Code ("IRC") section 1231 treatment when the transaction involves a sale or exchange of property that was held for more than one year and "either used in a trade or business or held for the production of rents or royalties".[94] Section 1231 transactions include sales or exchanges of real property or depreciable personal property, leaseholds, cattle, horses and other livestock and unharvested crops.[95] Section 1231 gains or losses are ultimately characterised as ordinary or capital depending on whether a taxpayer has a net gain or a net loss from all of his section 1231 transactions.[96] If the taxpayer has a net section 1231 loss, it is classified as ordinary loss. If the taxpayer has a net section 1231 gain, it is ordinary income up to the amount of the "non-recaptured section 1231 losses" (i.e. section 1231 losses for the previous 5 years that have not been applied against a net section 1231 gain) from the previous year, the rest is a capital gain.[97]

The term "net capital gain" is the amount by which the long-term capital gain for the year is more than the net short-term capital loss. For 2015, the maximum tax rates for individuals were 0%, 15%, 20%, 25%, and 28%. Capital losses are allowed in full against capital gains plus up to $3,000 of ordinary income.[98]

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89 Yu (2015) *University San Diego* p 14.
90 Yu (2015) *University San Diego* p 14.
91 IRS publication 544 p 22.
92 Yu (2015) *University San Diego* p 14.
93 IRS publication 544 p 69.
94 Yu (2015) *University San Diego* p 14.
95 IRS publication 544 p 23.
96 Yu (2015) *University San Diego* p 14.
97 IRS publication 544 p 23.
98 IRS publication 544 p 36.

3.4. FOREIGN CURRENCY TAX TREATMENT IN THE U.S.

If Bitcoin is not classified as the official legal tender or currency of U.S., another aspect that should be considered is the aspect of foreign currency. Foreign currency transactions are taxed under two different regimes. The first is for taxpayers who typically keep their books and transact business in U.S. dollars but who occasionally use foreign currencies to purchase goods or services.[99] The second is for taxpayers who keep their books and transact most of their business in a foreign currency.[100] The U.S. Internal Revenue Code Title 26 § 988 ("I.R.C. § 988"), which deals with the treatment of certain foreign currency transactions, uses the concept of "functional currency" to distinguish the two approaches.[101]

3.2.5. U.S. DOLLAR AS THE "FUNCTIONAL CURRENCY"

Under international financial reporting standards,[102] a functional currency is the currency used in the primary economic environment where an entity operates. This is the environment in which an entity primarily generates and expends cash.[103] As per the U.S. Treasury, it is considered to be the dollar and individuals and U.S. companies must use the U.S. dollar as their functional currency.[104]

When such taxpayers buy or sell foreign currency or use foreign currency to acquire goods or services, they typically incur gains and losses on that currency, which they must report.[105] For example, a US taxpayer purchases 100 Euros for $110 ($1.1: €1). Shortly thereafter, the exchange rate changes from $1.1: €1 to $1.2: €1, and the taxpayer purchases an asset for €100. Sometime later, the taxpayer sells the asset for €120. The taxpayer has had a €20 gain on the sale of the asset, but in addition had a $10 currency gain when the asset was purchased. Under the U.S. foreign currency regulations, the tax liability is determined as follows. First, the initial purchase of 100 Euros for $110 establishes a $110 basis in those Euros. Second, when the taxpayer purchases the asset with those Euros, it is as if the 100

99 Chodorow (2016) *Florida Tax Review* p 105.
100 Chodorow (2016) *Florida Tax Review* p 105.
101 Chodorow (2016) *Florida Tax Review* p 105.
102 International Accounting Standard 21, The Effects of Changes in Foreign Exchange Rates, as issued on 1 January 2012.
103 IFRS, IAS 21, p 1.
104 Treas. Reg. 1.985-1(b)(1).
105 I.R.C. § 988.

Euros was exchanged for $120 and then an asset was purchased for that amount.[106] This has two consequences, namely:

(i) Firstly, there is a $10 gain on the hypothetical exchange of Euros for dollars. Exchange gains and losses are deemed ordinary, except under limited circumstances;[107]

(ii) Secondly, the basis for the asset purchased is set at $120.[108] When the asset is sold for €120, that amount is converted into dollars at the spot market rate to determine the amount realized on the sale.

In terms of the above facts, the amount realised is $144. Subtracting the $120 basis yields a $24 gain on the sale of the asset.[109] The character of the gain on the sale of the asset depends on character of the asset. As can be seen so far, the tax treatment of foreign currency is no different from that afforded to other property.

However, Congress and the IRS have provided two important rules that may make classification as a foreign currency preferential to treatment as normal property. First, Congress has provided a personal use exemption for currency gains, as long as the gain is under $200.[110]

Secondly, the IRS established special basis accounting rules for different foreign currencies merged in a single account.[111] The default rule is that each batch of currency has its own basis established by its purchase price.[112] Whenever a taxpayer spends money, it must be identified which batch is used so that the amount of any currency gain or loss may be determined. Where different batches of foreign currency with different bases are deposited in the same account, the taxpayer may elect any method for designating which funds are

106 Chodorow (2016) *Florida Tax Review* p 106.
107 The other circumstances include*, inter alia*, sale of a business, disposition of intangible assets. Treas. Reg. § 1.988-3(a).
108 Treas. Reg. § 1.988-2(a)(2)(ii)(C)(Ex. G).
109 Chodorow (2016) *Florida Tax Review* p 106.
110 I.R.C. § 988(e).
111 Chodorow (2016) *Florida Tax Review* p 107.
112 Chodorow (2016) *Florida Tax Review* p 107.

withdrawn and used, so long as it is reasonable and consistently applied from year to year.[113] The result is that each unit of currency has the same, average basis.[114] However, a method that ensures that the highest basis currency is used first, that is, one that ensures the lowest possible currency gains, will not be considered reasonable.[115] Nevertheless, taxpayers can simply achieve this prohibited outcome by depositing different batches of currency into separate accounts and then spending money from the account with the highest basis.[116]

3.2.6. FOREIGN CURRENCY AS THE "FUNCTION CURRENCY"

A taxpayer or Qualified Business Unit ("QBU")[117] can adopt a foreign currency as its functional currency if it conducts its business and keeps its books in a foreign currency.[118] Normally, this will involve controlled foreign corporation ("CFC")[119] or branch of a U.S. taxpayer.[120] In such circumstances, taxpayers are not required to convert each transaction into dollars, as was the case above. Instead, they determine their business profits and losses using the foreign currency in which they do business and then convert them into U.S. dollars at year-end using the average exchange rate for the year.[121] This amount is used to determine the unit's income or loss for tax purposes. The amount determined would then increase or decrease the taxpayer's basis in the currency held by the QBU.[122]

Currency gain or loss is determined only when payments are made (or deemed to be made) from the QBU to the parent.[123] Under this approach, the taxpayer's basis in foreign currency is pooled. Thus, the gain or loss is calculated by using the spot rate[124] to determine the value paid and subtracting from that amount a proportional amount of the basis the taxpayer has in the QBU.

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113 Treas. Reg. § 1.988-2(a)(2)(iii)(B).
114 Chodorow (2016) *Florida Tax Review* p 107.
115 Treas. Reg. § 1.988-2(a)(2)(iii)(B).
116 Chodorow (2016*) Florida Tax Review* p 107.
117 QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained. https://www.law.cornell.edu/cfr/text/26/1.989(a)-1 (accessed: 30 September 2016)
118 I.R.C. § 985; Treas. Reg. § 1.985-1(c)(2)(i)
119 CFC is a corporate entity that is registered and conducts business in a different jurisdiction or country than the residency of the controlling owners. http://www.investopedia.com/terms/c/cfc.asp#ixzz4LjfsgJ9O
120 Chodorow (2016) *Florida Tax Review* p 108.
121 >http://bit.ly/1TrYgJb< (accessed: 22 May 2016).
122 Chodorow (2016) *Florida Tax Review* p 108.
123 Chodorow (2016) *Florida Tax Review* p 108.
124 The price to exchange one currency for another for immediate delivery. The spot rates represent the prices buyers pay in one currency to purchase a second currency.

3.5. TAX CONSEQUENCES OF THE IRS RULING

The consequence of the IRS decision to treat Bitcoin as property leads to the realisation of taxable gains or losses for every Bitcoin transaction, depending on what the Bitcoin user paid for. Essentially, the IRS ruling treats Bitcoin users as stock investors who must keep track of the basis of the Bitcoin (step 1) and the circumstances of the sale of the Bitcoin every time Bitcoins are exchanged for goods, services, or dollars (step 2 and 3). The U.S. Bitcoin owners are allowed a capital loss deduction of up to $3,000 of capital losses from ordinary income annually.[125] While each Bitcoin may be worth the same amount, each would have its own, possibly different basis.[126] Not only would Bitcoin users potentially incur tax liability every time they purchased something with Bitcoins, but they would also have to pay attention to which Bitcoins they spent in order to manage their tax liabilities.[127]

Additionally, the IRS states that normal compensation reporting rules apply to anyone receiving Bitcoin in return for services, including but not limited to independent contractors and Bitcoin miners.[128] Bitcoin miners must report their earnings as taxable income and pay self-employment tax, and those who mine as part of a business must pay payroll taxes. Furthermore, any Bitcoin payments made by a business exceeding $600 in value,[129] are subject to information reporting to the IRS and to the payee.[130] Notice 2014-21 makes it clear that taxpayers are subject to penalties for failure to comply with tax laws and that the notice applies retrospectively.[131] The problem that arises, however, is that the transactions are anonymous and the taxation authority would not know who to penalise.

The IRS determination to treat Bitcoins as property rather than currency has resulted in numerous issues, including a reduction in the liquidity of Bitcoins and in the number of transactions involving Bitcoins. The record-keeping aspect of treating Bitcoins like property makes reporting gains and losses on Bitcoin transactions complicated for the average taxpayer, especially for those who treat Bitcoins like cash and purchase multiple products

125 IRS publication 544 p 36.
126 Chodorow (2016*) Florida Tax Review* p 113.
127 Chodorow (2016) *Florida Tax Revie*w p 113.
128 Yu (2015) *University San Diego* p 12.
129 Such as for payment for rent, salaries, and wages
130 >http://on.wsj.com/1yzSvhw< (accessed: 9 April 2016).
131 >http://on.wsj.com/1yzSvhw< (accessed: 9 April 2016).

and services with the virtual currency from different merchants.[132] Those who use Bitcoins similar to cash must face the difficulty of determining cost basis or holding period. Bitcoin users have to maintain a clear and strict record of all purchases made with Bitcoins and "perform difficult calculations to account for the changing value of a Bitcoin".[133] The value of a Bitcoin fluctuates constantly and the IRS decision burdens taxpayers to record the value of a Bitcoin at every purchase.[134]

While it appears that the IRS decision only casts negative shadows on the economy and the network of Bitcoin users, the ruling creates some advantages for taxpayers and businesses.[135] Since Bitcoin is classified as investment property, taxpayers would treat any gains as capital gains, which is subject to lower tax rates.[136]

For businesses, there are many opportunities to capitalise on Bitcoin users who do not want to hire accountants or record the value of Bitcoin transactions every day. There is potential for a new market in Bitcoin applications that keep track of a user's basis and records gains and losses against the market value. A few services are already available for this purpose, including CoinReporting and BitcoinTaxes.[137] Additionally, by declaring Bitcoins as property, the IRS guidance opens the door for states and cities to apply sales taxes anytime someone acquires a Bitcoin.[138]

The problem remains whether or not the IRS was correct in deeming Bitcoin as property, as opposed to currency. The fact that Bitcoin is classified as property makes Bitcoin unappealing due to the intricate rules associated with investment property apply.[139]

In terms of the taxation of Bitcoin as currency, Bitcoin poses a problem for the tax system because it is designed to function as a currency, but it does not fit within the traditional understanding of foreign currency. Ironically, if Bitcoin is to fulfil supporter's anticipations that it become a wide-spread alternative currency, independent of government and third party

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132 Yu (2015) *University San Diego* p18.
133 >http://cnnmon.ie/1XGXIEy< (accessed: 9 April 2016).
134 Yu (2015) *University San Diego* p 18.
135 Yu (2015) *University San Diego* p 20.
136 This is similar to the South African position on capital gains, which will be discussed in more detail in Chapter 5 paragraph 5.6
137 >http://onforb.es/1qAx1DR< (accessed: 7 April 2016).
138 Yu (2015) *University San Diego* 20.
139 Yu (2015) *University San Diego* p 20.

intermediaries, it must have government co-operation.[140] In particular, how governments treat Bitcoin for tax purposes could have a significant impact on its adoption and use.

Although I.R.C. § 998 contains detailed rules on how to treat foreign currency, it does not define the term.[141] In addition, the term foreign currency is not defined anywhere in the Internal Revenue Code, its regulations, or in case law.[142]

If the IRS chose to label Bitcoin as currency, then there would not be any intricate rules that users would have to learn and follow. The complexities of tracking gains and losses at the fluctuating value of Bitcoin on every purchase would disappear. Instead, Bitcoin users would simply treat Bitcoin transactions like transactions involving foreign currencies, such as euros or yen.[143] The disadvantage of treating Bitcoin as currency for taxpayers, however, is that any gains or losses resulting from the fluctuating value of Bitcoin would be taxed at ordinary rates, which are higher than capital gains.

3.6. CONCLUSION

The U.S. tax position on Bitcoin is that the IRS has classified Bitcoin as property, resulting in various capital gains considerations when reporting to the IRS. While Bitcoin's main selling point is its anonymity, it attracts fraud, theft, and other illegal activities. Despite the risky nature of Bitcoin, it is still used as a form of method of payment in the U.S. Consequently, there must be regulation and the IRS's ruling provides initial guidance to taxpayers.

The complexities of record keeping are easy and likely to be solved as long as there is demand for businesses to create applications assisting in tracking gains and losses on Bitcoin transactions. Furthermore, the tax rules for investment property consider price volatility, which is a characteristic of Bitcoin.

Essentially, the issue with Bitcoin is that it is unprecedented and challenges the rules and regulations the U.S. has already established. The IRS's initiative to recognise and begin

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140 Chodorow (2016) *Florida Tax Review* p 111.
141 Chodorow (2016) *Florida Tax Review* p 115.
142 Chodorow (2016) *Florida Tax Review* p 115.
143 Yu (2015) *University San Diego* p 20.

regulating Bitcoin is a response to one of many obstacles that Bitcoin has posed in society.

The IRS's Notice may be used as a starting point from which the South African Revenue Service could base their guidance for tax reporting purposes. The classification of Bitcoin as property and the tax implications thereof in South Africa will be discussed in Chapter 5.

CHAPTER 4: AUSTRALIA'S CURRENT LEGAL REGULATORY FRAMEWORK

4.1. INTRODUCTION

Another country that has provided guidance on the tax regulations of Bitcoin is Australia. Bitcoin users in Australia are reported to be at half a million.[1] Bitcoins are still the subject of an inquiry by the Commonwealth Senate Economics References Committee ("the Senate Inquiry") due to the increasing usage of Bitcoins and lack of regulatory framework surrounding Bitcoin. ABA Technologies Pty Ltd, a company incorporated in Australia for the purpose of importing, distributing and operating Bitcoin ATMs, has installed Bitcoin ATMs in Sydney, Melbourne and Canberra and plans to roll out 100 more by the end of 2016.[2] Banks in Australia have, however, been distancing themselves from Bitcoin despite some banks initially welcoming it.[3]

Business in Australia refused to accept Bitcoin, due to the potential crimes liked to Bitcoin. This was further supported by Australian banks' decision to close the accounts of 13 Bitcoin exchanges.[4] The Australian Bankers' Association stated that the "lack of transparency and regulatory oversight raises a number of risks for users and also poses risks for the payments system, the integrity of the financial system and the erosion of the tax base".[5]

The Australian Tax Office ("ATO") published legally binding public rulings in respect of the tax treatment of Bitcoin. The "good tax" principles, first enunciated by Adam Smith in the Eighteenth-Century,[6] continue to influence Australian tax policy.[7] Australia's recent tax reform papers; the Re-Think Tax Discussion Paper,[8] and the Henry Review,[9] reiterate these principles: a tax system should "meet its purposes efficiently, equitably, transparently, and

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1 Y Kearns Japan Business Services newsletter November 2014 p 1.
2 Y Kearns Japan Business Services newsletter November 2014 p 1.
3 Y Kearns Japan Business Services newsletter November 2014 p 1.
4 > http://reut.rs/1Y2x5ts< (accessed: 18 April 2016).
5 > http://reut.rs/1Y2x5ts< (accessed: 18 April 2016).
6 Smith, The Wealth of Nations. 1776. Random House, Inc. Online version available at: Adam Smith Reference Archive, >http://bit.ly/1nCHpXo< (accessed 4 November 2016)
7 Emery (2016) *Australian National University* p 6.
8 Treasury, 2015.
9 Formally known as The Australia's Future Tax System Review.

effectively".[10] The principle which includes Bitcoin specifically, is the principle of Equity. "Equity" in the tax system dictates that the tax base "should be as comprehensive as possible"[11] and should include all forms of economic activity, including Bitcoin. Further, horizontal equity dictates that similar tax outcomes should arise from similar economic activities.[12] Bitcoin's taxation should therefore be consistent with the taxation of traditional payment systems in Australia.

This chapter elaborates on the taxation of Bitcoin in Australia, specifically regarding (i) the regulatory framework; (ii) the ATO's rulings on Bitcoin.

4.2. REGULATORY FRAMEWORK

In contrast to the U.S., Australia's current regulatory framework provides for Bitcoin and other virtual currencies. The Reserve Bank of Australia ("RBA") broadly defines a "payment system" as "payment instruments by which individual payments are made or funds transferred, ranging from cash to sophisticated mechanisms on the Internet".[13]

The applicable legislation, the Payment Systems (Regulation) Act 1998 (Cth) ("PSRA"), defines a payment system as a "Funds Transfer System that facilitates the circulation of money, and includes any instruments and procedures that relate to the system".[14] As Bitcoin aids the exchange of money, it would fall within the definition of a "payment system" for the purposes of the PSRA.

The Payments System Board (PSB) of the Reserve Bank oversees the payments system in Australia. It is responsible for promoting the safety and efficiency of the payments system and through the Payment Systems (Regulation) Act 1998 and the Payment Systems and Netting Act 1998, the Reserve Bank has one of the clearest and strongest mandates in the world in relation to payments systems.

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10 Treasury 2015 p 2.
11 Treasury 2010 p 169.
12 Treasury 2010 p 169.
13 McCracken *et al.* 2013. Banking and Financial Institutions Law. p 30.
14 Marshall (2015) *Bond Law Review* p 109.

The consequence of Bitcoin being classified as a payment system is that it will be regulated by the RBA, consequently ensuring that it is safe and efficient for users. The RBA has important regulatory responsibilities for the payments system and plays a key role in its operations.[15]

In terms of section 10 of the PSRA, four principle powers vest in the RBA in designating a system as a "payment system":

(i) the power to impose an access regime on system participants;

(ii) the power to make participants in the system comply with system standards;

(iii) the power to arbitrate disputes relating to the system; and

(iv) the power to direct participants in the system.[16]

The RBA is therefore permitted to regulate a "payment system" if it is in the public interest.[17] In determining whether it is in the public interest, the RBA must have regard to, *inter alia*, whether the system is financially safe for use, the efficiency of the system and whether or not the system is materially causing or contributing to increased risk to the financial system.[18]

The RBA has acknowledged Bankcard, MasterCard, Visa, and EFTPOS debit card as payment systems.[19] It must be further noted that the RBA may grant exemptions from the PSRA,[20] and that systems will only be designated as a payment system when the performance of existing self-regulatory arrangements prove unsatisfactory.[21] In 2004, the RBA exempted purchase payment facilities from the PSRA where:

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15 >http://bit.ly/28LI5pW < (accessed: 28 October 2016)
16 Payment Systems (Regulation) Act 1998 (Cth) s 10(2).
17 Marshall (2015) *Bond Law Review* p 109.
18 Payment Systems (Regulation) Act 1998 (Cth) s 8.
19 Marshall (2015) *Bond Law Review* p 110.
20 Payment Systems (Regulation) Act 1998 (Cth) s 25.
21 McCracken *et al.* 2013. Banking and Financial Institutions Law. fn 120 p 159.

(i) the total outstanding amount is less than $1 million; or

(ii) where payments can only be made to a maximum of 50 persons; or

(iii) where its obligations were guaranteed by an authorised deposit taking institution or the government.[22]

The RBA increased the amount from $1 million to $10 million and exempted gift cards, pre-paid mobile phone accounts, loyalty schemes and electronic road toll devices from the PSRA in 2006.[23] The exchange volume of Bitcoin conversion into Australian dollars is reported to constitute approximately 4% of the total global volume of conversions, this amounts to an estimated average daily volume of US$2 226 631.[24] On these figures, it is likely that Bitcoin may not fall within the current RBA granted exceptions.

In 2013, the RBA's Payment Systems Board reported that, while low fees and fast transaction times were features of great appeal, these attributes could not solely be relied on for purposes of adopting Bitcoin as a payment system.[25] The Board settled that "given that [Bitcoin] has not been widely traded or adopted, risks and policy concerns are currently limited in the Australian context".[26]

In March 2015, the RBA reported that the risk posed by virtual currencies, including Bitcoin, to the Australian payments system remains limited.[27] Reinforced by the continued reluctance of Australian banks to support Bitcoin, very few Australian merchants currently accept Bitcoin as a means of payment. Consequently, the RBA does not foresee any significant increase in merchant use of virtual currencies or a need to designate the platform as a payment system in the near term.[28]

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22 Marshall (2015) *Bond Law Review* p 110.
23 Marshall (2015) *Bond Law Review* p 110.
24 Marshall (2015) *Bond Law Review* p 110.
25 Marshall (2015) *Bond Law Review* p 110.
26 Marshall (2015) *Bond Law Review* p110.
27 Marshall (2015) *Bond Law Review* p 110.
28 Marshall (2015) *Bond Law Review* p 111.

In Australia, the primary legislation that sets out the general principles and obligations for money laundering and terrorist financing, the Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth) ("AML/CT"), does not currently apply to Bitcoin. Section 5 of the AML/CT defines money to include e-currency. E-currency is defined narrowly as an internet-based electronic means of exchange that is:

(i) backed either directly or indirectly by precious metal or bullion; and

(ii) not issued by or under the authority of a government body.[29]

The Australian Transactions Reports and Analysis Centre ("AusTrac") indicated that due to the fact that Bitcoin is not backed by precious metal or bullion, the AML/CT does not apply.[30] In February 2014, the CEO of AusTrac observed that Bitcoin-based crime would not be a priority for the agency in the near future.[31] In justifying this position, he noted that the volatility and insecurity of Bitcoin are hindering the greater mainstream use of Bitcoin.[32] AusTrac stated:

> "digital currencies, such as those offered by Bitcoin, may become more attractive to criminal groups, particularly in response to tighter regulation and monitoring of established or traditional financial channels by both government and the traditional financial service providers themselves … at this stage, the misuse of digital currencies and virtual worlds for money laundering is still very much an emerging vulnerability … [that] may only be of use to those conducting niche crimes in the cyber environment and individual or smaller scale illicit activity".[33]

29 Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth) s 5. See also: Marshall (2015) *Bond Law Review* p 103.
30 >http://bit.ly/2eM1wCG< (accessed: 28 October 2016).
31 >http://bit.ly/Ni4Lmz< (accessed: 16 April 2016).
32 Marshall (2015) *Bond Law Review* p 103.
33 >http://bit.ly/1VH7eqJ< (accessed: 16 April 2016).

4.3. THE AUSTRALIAN TAXATION OFFICE'S ("ATO") RULINGS

In December 2014, the ATO characterised Bitcoin for taxation purposes.[34] The guidance paper and tax rulings seek to provide certainty on the ATO's treatment of crypto-currencies within the current legislative framework.[35]

The ATO released legally binding income tax determinations outlining the Commissioner's position on Bitcoin's tax characterisation, and thus, how Bitcoin receipts will be treated under the Income Tax Assessment Act 1936 (Cth) ("ITAA 1936"), the Income Tax Assessment Act 1997 (Cth) ("ITAA 1997") and the Fringe Benefits Tax Assessment Act 1986 (Cth) ("FBTA 1986").[36] The ATO based the guidance paper on several published tax determinations (TDs), namely:[37]

(i) TD 2014/25: Income tax: is Bitcoin a foreign currency for purposes of Division 775 of the Income Tax Assessment Act 1997?;

(ii) TD 2014/26: Income tax: is Bitcoin a CGT asset for the purposes of subsection 108-5(1) of the Income Tax Assessment Act 1997?;

(iii) TD 2014/27: Income tax: is Bitcoin trading stock for the purposes of subsection 70-10(1) of the Income Tax Assessment Act 1997?

The ATO's view is that Bitcoin is neither money nor a foreign currency, and the supply of Bitcoin is not a financial supply of goods and services for tax ("GST") purposes.[38] It was concluded that Bitcoin should be characterised as a commodity, not a currency. Broadly, the ATO reasoned that, whilst Bitcoin purportedly functions as money, it fails to ascribe to definitions of money or currency under the income tax and GST regimes, stating the following:

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34 Emery (2016) *Australian National Universi*ty p 7.
35 Hayes (2014) *Journal of Int Taxation* p 52.
36 Collectively referred to as "the Income Tax Acts". Emery (2016) *Australian National University* p 7.
37 Berger (2016) *NW University* p 24.
38 GST is a broad-based tax of 10% on most goods, services and other items sold or consumed in Australia. >https://www.ato.gov.au/Business/GST/< (accessed: 16 April 2016); Hayes (2014) *Journal of Int Taxation* p 52.

> "As Bitcoin is not a monetary unit recognised and adopted by the laws of any other sovereign State as the means for discharging monetary obligations for all transactions and payments in a sovereign State, it is not 'foreign currency'…. Bitcoin is not a legally-recognised universal means of exchange and form of payment by the laws of Australia or the laws of any other country. Therefore, it is not currency".[39]

On the basis of this finding, the ATO provides that, where Bitcoin is used as payment, the transaction is taxed as a barter.[40] Generally, there will be no income tax or GST implications if the individual is not in business or carrying on an enterprise and is simply paying for goods or services in Bitcoin (for example, acquiring personal goods or services on the internet using Bitcoin).[41] Where Bitcoin is used to purchase goods or services for personal use or consumption, any capital gain or loss from disposal of the Bitcoin will be disregarded (as a personal use asset) provided the cost of the Bitcoin is $10,000 or less.[42]

The different transactions and tax treatments as recommended by the ATO are discussed in more detail below:

4.3.1. INCOME TAX

Income that is subject to tax is called assessable income.[43] Generally, when calculating the assessable income of a business, for example, amounts received (or earned) in the ordinary course of running the business are included in assessable income.[44]

The ITAA requires that the assessable income of a taxpayer include profit arising from the sale by the taxpayer of any property acquired by the taxpayer for the purpose of profit-making by sale, or from the carrying on or carrying out of any profit-making undertaking or scheme.[45] Taxation ruling IT 2668 further suggests that the consideration received or receivable during a barter transaction (either in terms of cash, credit, good or services)

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39 Emery (2016) *Australian National University* p 8.
40 Emery (2016) *Australian National University* p 8.
41 Emery (2016) *Australian National University* p 8.
42 >http://bit.ly/28KPBXs< (accessed: 16 April 2016).
43 >http://bit.ly/25JczRc< (accessed: 19 June 2016).
44 > ttp://bit.ly/25JczRc < (accessed: 19 June 2016).
45 Section 25A of ITAA 1997.

represents assessable income which depends upon the nature of the consideration in the hands of the recipient.[46] Taxation ruling IT 2668 defines the term "bartering" as follows: "bartering involves the direct exchange of goods or services for other goods or services without reference to money or a money value".[47] Only those transactions which arise from the carrying on of a business would qualify as consideration and would be regarded as assessable income. [48]

It is specifically stated in section 21(1) of the ITAA that "where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given".[49] This principle has also been confirmed in the case *Federal Commissioner of Tax v. Cooke & Sherden*[50] whereby the consideration from a barter transaction would usually be in the form of money's worth.

TD 2014/25 recommends that where a taxpayer receives Bitcoins as payment for goods or services or uses Bitcoins to make purchases for purposes of their business, the value of the transaction will be based on the arm's length Australian dollar value in calculating the assessable income.[51] With attention to the fluctuation of the Australian dollar value of Bitcoin transactions from the time the taxpayer acquires until he disposes of the Bitcoin, such fluctuations may give rise to ordinary income or CGT consequences.[52] This will depend on the particular facts and circumstances of the taxpayer as stated in TD2014/25.

The guidance paper on tax treatment of crypto-currencies suggests that where a taxpayer carries on a business of buying and selling Bitcoin as an exchange service, the proceeds from the sale of Bitcoins are to be included in assessable income.[53] Accordingly, any expenses incurred in respect of the exchange service will be allowed as a deduction.[54] It furthermore states that when a taxpayer carries on a Bitcoin exchange service, the Bitcoins will be considered trading stock. Consequently, the taxpayer will have to account for any

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46 IT 2668 p 2.
47 IT 2668 p 1.
48 IT 2668 p 2.
49 Section 21(1) of ITAA 1997.
50 80 ATC 4140 cited in IT 2668 p 4.
51 TD 2014/25 p 2.
52 Berger (2016) *NW University* p 26-27.
53 TD 2014/25 p 3
54 TD 2014/25 p 3

Bitcoins on hand at the end of each income year as part of assessable income.[55]

4.3.2. MINING BITCOIN (ACQUISITION)

TD 2014/25 states that the process of mining through which Bitcoin are created and enter into circulation is called "Bitcoin mining".[56] Mining involves a "miner" using freely downloadable Bitcoin software to solve complex cryptographic equations. The miner essentially verifies and validates transactions involving the transfer of existing Bitcoin between other parties.[57] It helps, for example, to ensure an existing bitcoin cannot be transferred more than once by the one person.[58] The first "miner" to successfully solve an equation receives as a reward a specified number of newly created Bitcoin to their "Bitcoin address".[59] Where an individual is in the business of mining Bitcoin, any income that is derived from the transfer of the mined Bitcoin to a third party should be included in the assessable income[60] and therefore income tax is paid on the mined Bitcoin. Expenses can be claimed if they are directly related to earning of the assessable income,[61] in other words if the expenses are directly related to the mining of the Bitcoin.[62]

Losses made from the mining activity may also be subject to the non-commercial loss provisions.[63] In order to offset business loss against income, a number of requirements must be met.[64] Firstly, the business must earn other income (taxable income, total reportable fringe benefits, investment losses) that is less than $250 000.[65] If the income requirement is met, the business must meet one of four tests:

(i) The assessable income test: the business has assessable income of at least $20,000; or

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55 TD 2014/25 p 3
56 TD 2014/25 p4.
57 TD 2014/25 p4.
58 TD 2014/25 p4.
59 TD 2014/25 p4.
60 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
61 >http://bit.ly/25JczRc< (accessed: 1 June 2016).
62 An example of such expense would be the electricity required to run the mining program on the computer.
63 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
64 >http://bit.ly/1Y5q76W< (accessed: 1 June 2016).
65 >http://bit.ly/1Y5q76W< (accessed: 1 June 2016).

(ii) The profits test: the business had a profit for tax purposes in three out of the past five years (including the current year); or

(iii) The real property test: the value of real property or of an interest in real property that you used in the business on a continuing basis was at least $500,000; or

(iv) The other assets test: the value of assets (excluding real property, cars, motor cycles and similar vehicles) used on a continuing basis in carrying on the business was at least $100,000.

Bitcoin held by a taxpayer carrying on a business of mining and selling Bitcoin, will be considered to be trading stock. The taxpayer will be required to take into account any Bitcoin on hand at the end of each income year.[66] GST is payable on the supply of Bitcoin made in the course or furtherance of the Bitcoin mining enterprise. Input tax credits may be available for acquisitions made in carrying on of the Bitcoin mining enterprise.[67]

4.3.3. CAPITAL GAINS TAX ("CGT") CONSEQUENCES

Taxpayers pay tax on capital gains and it forms part of their income tax (i.e. it is not considered a separate tax).[68] A capital gain or capital loss on a capital asset is the difference between what it cost and what was received when it was dispose of.[69] IT 2668 suggests that where the transaction involves the disposal or acquisition of an asset, the CGT provisions may apply.[70]

The ATO handed down a legally binding taxation determination, whereby it stated that Bitcoin is classified as a CGT asset. In order to determine the CGT implication, it needed to be determined whether or not Bitcoin is a CGT asset as defined in section 108-5(1) of the Income Tax Assessment Act 1997. Section 108-5(1) defines the term "CGT asset" as "any kind of property; or a legal or equitable right that is not property".

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66 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
67 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
68 >https://www.ato.gov.au/General/Capital-gains-tax/< (accessed: 18 June 2016).
69 >https://www.ato.gov.au/General/Capital-gains-tax/< (accessed: 18 June 2016).
70 Berger (2016) *NW University* p 27.

In *Yanner v Eaton*[71] the High Court accepted that property refers to a description of a legal relationship with a thing, rather than the thing itself.[72] More specifically, it refers to the degree of power that is recognised in law as permissibly exercised over the thing.[73] The ATO acknowledged that there is no single test nor single determinative factor for identifying proprietary rights.[74] In the case of Bitcoin, the relevant relationship in the nature of property that must be considered is the relationship between:

(i) the object or thing, Bitcoin, being the digital representation of value constituted by three interconnected pieces of information (a Bitcoin address; the Bitcoin holding or balance in that address; and the public and private key-pair associated with that address); and

(ii) the bundle of rights (hereafter referred to as 'Bitcoin holding rights') ascribed to a person with access to the bitcoin under the Bitcoin software and by the community of Bitcoin users.[75]

The ATO ruled that the most important of these Bitcoin holding rights are the rights of control over one or more Bitcoin in the holder's Bitcoin wallet, for example, the capacity to trade a Bitcoin for other value or use it for payment.[76] There are, however, other features that support the conclusion that Bitcoin holding rights are proprietary in nature. The most compelling is that Bitcoins are treated as valuable, transferable items of property by a community of Bitcoin users and merchants.[77] In weighing all the factors, the ATO concluded that the Bitcoin holding rights amount to property within the meaning of section 108-5(1)(a) and accordingly, a person holding a Bitcoin is considered to hold a CGT asset for the purposes of that provision.[78] The disposal of Bitcoin to a third party therefore gives rise to CGT where the capital proceeds are more than the Bitcoin's base cost.[79]

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71 (1999) 201 CLR 351.
72 201 CLR 351 at 365 -7.
73 201 CLR 351 at 365 -7.
74 TD 2014/26 p 3.
75 TD 2014/26 p 4.
76 TD 2014/26 p 4.
77 TD 2014/26 p 4.
78 TD 2014/26 p 4.
79 TD 2014/26 p 5.

The disposal of Bitcoins to a third party gives rise to a CGT event and is classified as an "A1 disposal of a CGT asset" in terms of subsection 104-10(1) of the ITAA. The basic principles of calculating the capital gain or loss are contained in the provisions of subsection 116-20(1) (proceeds) and subsection 110-25(2) (base cost) of the ITAA (1997). Consequently, the value of the proceeds is the money or the market value of any other property received by the taxpayer whereas the base cost is the money or market value of any other property the taxpayer gave in respect of acquiring the Bitcoins.

In terms of subsection 118-10(3) of the ITAA, a capital gain made from a personal use asset is disregarded if the first element of the base cost is $10,000 or less. A personal use asset is a CGT asset used or kept mainly for personal use or enjoyment.[80] In addition, any capital loss made from a personal use asset is disregarded under subsection 108-20(1). An exemption threshold as high as $10,000 in value, or thousands of dollars in gains, would allow many individuals who actually hold the virtual currency as an investment vehicle to characterise investment gains as personal transactions. Proving a false declaration of the categorisation of Bitcoin would be difficult and perhaps prohibitively expensive because of enforcement costs.

TD 2014/26 in essence states that whether or not Bitcoin is used or kept mainly for personal use or enjoyment will depend on the particular facts and circumstances of each case.[81] Considerations such as the purpose for which the Bitcoin was acquired and kept and the nature of the property acquired when the Bitcoin is disposed of, plays an important role in determining whether the Bitcoin was used or kept for personal use.

The amount of money involved in the mining (acquisition) and disposal of Bitcoins plays a key role.[82] To support this role, the intention of profitmaking, the length of time the Bitcoins are held and whether the Bitcoins were held as objects of trade, are to be considered when determining whether Bitcoins were held for personal or business use.

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80 Section 108-20(2)(a) of Act 1997.
81 TD 2014/26 p 4.
82 Berger (2016) *NW University* p 31

4.3.4. GST CONSEQUENCES

GST is a broad-based tax of 10% on most goods, services and other items sold or consumed in Australia.[83] GST is regulated by A New Tax System (Goods and Services Tax) Act[84] ("GST Act"). GST is payable on the supply of Bitcoin made in the course or furtherance of the enterprise. It is calculated on the market value of the goods or services.[85] A supplier is required to charge GST on income when it makes a taxable supply and it can claim back GST when it purchases things to make this supply.

The GST Act defines the concept of taxable supply widely, with the key criteria being:[86]

(i) there must be a supply;

(ii) the supply must be for consideration;

(iii) the supply must be made in connection with an enterprise carried on by the supplier;

(iv) the supply must be connected with Australia; and

(v) the supplier must be registered or be required to be registered.

If Bitcoins are received for goods or services as part of one's business, the value must be recorded in Australian dollars as part of ordinary income.[87] This is the same process as receiving non-cash consideration under a barter transaction. Taxation ruling IT 2668 defines the term "bartering" as follows: "bartering involves the direct exchange of goods or services for other goods or services without reference to money or a money value".[88] The fair market value, for instance, would be the value in Australian dollars that can be obtained from a reputable Bitcoin exchange.[89] Where a business purchases business items (including

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83 >https://www.ato.gov.au/Business/GST/< (accessed: 16 April 2016).
84 No 55 of 1999
85 > http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
86 Subdivision 9-A, section 9-5.
87 > http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
88 IT 2668 p 1.
89 > http://bit.ly/1rb2nkW< (accessed: 16 April 2016).

trading stock) using Bitcoin, the business is entitled to a deduction based on the arm's length value of the item acquired.[90]

The problem with barter transactions is, however, that there are two supplies subject to GST in a single transaction. It is likely to result in double administration where two GST-registered entities transact, and one pays in Bitcoin, as a single commercial transaction is treated as two legal transactions.[91] Figure 3 depicts this issue by evaluating the GST remission process using conventional currency contrasted to using Bitcoin:[92]

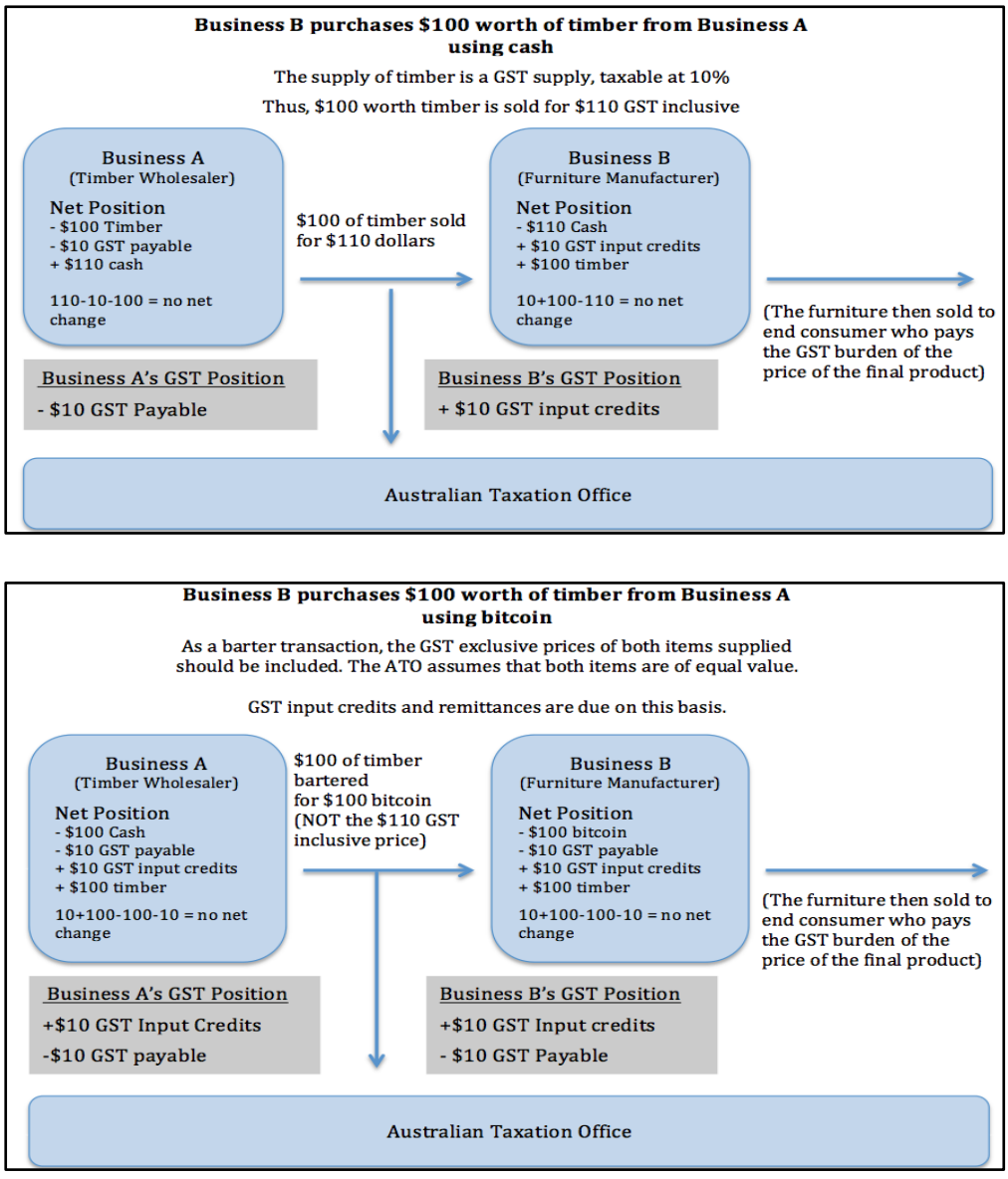

Figure 2: GST process **Source:** Emery (2016) Australian National University p 32.

90 > http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
91 Emery (2016) *Australian National University* p 9.
92 Emery (2016) *Australian National University* p 32.

When receiving Bitcoin in return for goods and services, a business will be required to pay GST on that Bitcoin. If the supply of the goods and services was a taxable supply, the business will be able to claim input tax credits on the GST charged on the Bitcoin they received as payment.[93]

This, however, gives rise to competitive disadvantage for Australian intermediaries who sell Bitcoin to Australian consumers.[94] Due to the fact that Bitcoin is not classified as money, it is not a taxed financial supply under Division 40 of the GST Act.[95] Financial supplies are input-taxed supplies[96] and do not have GST in their sales price.[97]

Consequently, Australian intermediaries must impose GST at the normal rate on consumers who purchase Bitcoin for use in Australia.[98] If the same taxpayer purchased Bitcoin from an overseas intermediary (with the ease of logging onto a different website), they may avoid paying GST through the current GST provisions, as emphasised during the Senate Inquiry, which stated, "under the design of our GST, if I go onto a U.S. Bitcoin trader's website and buy Bitcoin from them, even on the ATO's view there is no taxable transaction. Our reverse charge rules[99] do not kick in".[100]

This outcome varies from the taxation of traditional payment systems in Australia, which are treated as "input-taxed financial supplies".[101] Figure 4 illustrates GST on a purchase of a financial supply compared to GST on the purchase of Bitcoin:[102]

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93 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
94 Emery (2016) *Australian National University* p 9.
95 Emery (2016) *Australian National University* p 9.
96 Input-taxed supplies are Input-taxed sales are sales of goods and services that do not include GST in the price as defined in section 40-1 of Act 55 of 1999.
97 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
98 >http://bit.ly/1rb2nkW< (accessed: 16 April 2016).
99 Reverse charge is the payment of GST by the purchaser on goods purchased offshore and it amounts to 10%. http://bit.ly/2cWNBuC (accessed 3 October 2016)
100 The reverse charge does not kick in due to the anonymity of the purchase of Bitcoin. Emery (2016) *Australian National University* p 9.
101 Emery (2016) *Australian National University* p 9.
102 Emery (2016) *Australian National University* p 33.

Purchase of $100 of a Financial Supply	Purchase of $100 bitcoin at a bitcoin exchange (non-financial supply)
$100 x 0% GST = $100 GST inclusive price	$100 x 10% GST = $110 GST inclusive price
For a $100 outgoing, purchasers receive $100 of financial supply, minus transaction fees	For a $110 outgoing, purchasers receive $100 of bitcoin, minus transaction fees

Figure 3: GST supply versus purchase **Source:** Emery (2016) Australian National University p 33.

The Senate suggests that the GST treatment of Bitcoin is particularly detrimental for Australian Bitcoin intermediaries:[103]

> "The GST… is the main issue… [and the] most difficult problem … [which] means that it is 10% more expensive for them to acquire Bitcoin from an Australian supplier… [Thus,] very soon after the release of the ATO guidance … it became common practice for Australians to buy bitcoin from overseas suppliers… [Consequently] the Bitcoin Association of Australia is aware of a number of Australian-based bitcoin businesses moving operations offshore to remain competitive.[104] [Stakeholders therefore claim] treating digital currency as a commodity … [will] guarantee its rapid demise".[105]

In March 2016, the Australian Government released a report recognising the need for a proper policy response to the adoption of digital currency.[106] The report read:

> "the government recognizes that that the current treatment of digital currency under GST law means that consumers are 'double taxed' when using digital currency to buy anything already subject to GST. The government is committed to addressing the 'double taxation' of digital

[103] Emery (2016) *Australian National University* p 10.
[104] Senate Inquiry 2015 submission 13 p 18 – 19.
[105] Senate Inquiry 2015 submission 15 p 10.
[106] >http://bit.ly/1PfC3ME< (accessed: 1 June 2016).

currencies and will work with the industry on legislative options to reform the law relating to GST as it is applied to digital currencies".[107]

4.3.5. FRINGE BENEFITS

As determined by the ATO taxation ruling, where an employee has a valid salary sacrifice arrangement with their employer to receive Bitcoins as remuneration instead of Australian dollars, the payment of the Bitcoins is a fringe benefit and the employer is subject to the provisions of the Fringe Benefits Tax Assessment Act 1986 ("FBTAA").[108]

Fringe benefits tax ("FBT") is a tax employers pay on certain benefits they provide to their employees, including to their employees' family or other associates. The benefit may be in addition to, or part of, their salary or wages package.[109] FBT is separate from income tax and is calculated on the taxable value of the fringe benefits provided. The term "fringe benefit" is defined in subsection 136(1) of the FBTAA to mean "a benefit provided to the employee…by the employer…in respect of the employment of the employee…but does not include a payment of salary or wages".[110] The tax payable is the fringe benefits taxable amount multiplied by the rate of tax. The current FBT rate is 49%.[111]

Due to the fact that Bitcoin is not classified as money, but rather considered to be property for tax purposes, Bitcoin satisfies the definition of "non-cash benefit" and it excluded from Pay As You Go ("PAYG") withholding.[112] Under the PAYG withholding rules, employers have an obligation to collect tax from payments made to employees and some businesses so the taxpayers can meet their end-of-year tax liabilities.[113] Accordingly, the provision of Bitcoin by an employer to an employee in respect of the employee's employment in Australia will be subject to FBT on the taxable value of the fringe benefit.[114]

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107 > http://bit.ly/1PfC3ME < (accessed: 1 June 2016).
108 TD 2014/28 p 1.
109 >http://bit.ly/1UbHoKk< (accessed: 1 June 2016).
110 Section 136(1) of Act 1986.
111 >http://bit.ly/1UbHoKk< (accessed: 1 June 2016).
112 TD 2014/28 p 4.
113 > http://bit.ly/1t4vd7S< (accessed: 1 June 2016).
114 TD 2014/28 p 4.

4.4. CONCLUSION

The RBA's position on Bitcoin has been thoroughly analysed with regards to whether Bitcoin should be considered an official payment system. Payment system regulation is primarily concerned with the domestic payment system and current threats to this system remain low in light of the information provided above. Further, the current payment system legislation allows the RBA to respond to any increased threat posed by virtual currencies without the need for significant legislative reform.

It can be concluded that is fundamental to ascertain the character of Bitcoin for tax purposes. The ATO addressed the issue of characterising Bitcoin by determining that Bitcoin should be classified as a commodity or an asset. The ATO guidelines and rulings do not, however, properly cover the valuation calculations in Bitcoin exchange transactions. What is not clear, is the valuation calculation of the economic gain or loss between the time of acceptance of the Bitcoin and when using it to purchase other goods or services or exchange for other currencies. In essence the taxpayer is to trace the individual Bitcoin that was acquired at a certain date and its market value at the time of acquisition until it is actually spent to be able to calculate the gains and losses correctly. This may be a significant compliance burden. The characterisation further leads to unusual tax outcomes for GST purposes and is inconsistent with Bitcoin's commercial use. Characterising Bitcoin as money could redress the tax incongruities and increase consistency with regards to the tax treatment of Bitcoin.

In summary, the taxation implications for Bitcoin exchange transactions in Australia are as follows:

(i) Bitcoins are not regarded as money, currency or foreign currency for the purposes of Australian taxation law;

(ii) transactions involving Bitcoins give rise to the same tax consequences as barter transactions;

(iii) the proceeds from the sale of Bitcoin in exchange services will be included in assessable income at the fair market value;

(iv) taxpayers in the business of mining Bitcoins or conducting Bitcoins exchange services should apply the trading stock rules to their exchanges of Bitcoins;

(v) losses made from mining activity may also be subject to non-commercial loss provisions if requirements are met;

(vi) GST is payable on the supply of Bitcoin made in the course and furtherance of the Bitcoin mining supply;

(vii) Bitcoins are regarded as property and therefore CGT assets for CGT purposes; and

(viii) in the instance of the disposal of Bitcoins that is not carried out as part of a business operation, the gain will generally be ordinary income where the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain and the transaction was entered into in carrying out a commercial transaction.

As was noted, the Australian Government will be looking to include Bitcoin in the AML/CT policy. Further developments should therefore ensue the coming year and one could note a change in the characterisation of Bitcoin, and ultimately the tax implications thereof.

CHAPTER 5: A SOUTH AFRICAN PERSPECTIVE

5.1. INTRODUCTION

The use of Bitcoins as a medium of exchange is not yet widespread in SA. It has, however, been noted that this industry is growing at a fast rate as several online retailers are now accepting Bitcoins as a means of payment for goods and services, for example Takealot.com.[1] SA has already installed its first Bitcoin vending machine, situated in Kyalami, north of Johannesburg, to give users the ability to get Bitcoins in exchange for rand.[2]

In addition to the users of Bitcoin, the economy supporting Bitcoin has grown rapidly.[3] The three main categories of Bitcoin users are (i) Merchants, (ii) Miners[4], and (iii) Exchanges.

This chapter investigates (i) whether Bitcoin can be considered currency in SA; (ii) the background on regulations on virtual currency in SA; and (iii) the applicability of the current SA tax legislation to Bitcoin.

5.2. BACKGROUND ON REGULATIONS ON VIRTUAL CURRENCY IN SOUTH AFRICA

There is currently no legislation relating to virtual currencies that has been promulgated in SA.[5] There has also been no public consultation through which Parliament and provincial legislatures consult with interested or affected individuals, organisations and government entities before making legislative decisions.[6] Accordingly, no legal protection or recourse is afforded to users of Bitcoin in South Africa.

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1 >http://bit.ly/1Q0Tg1R< (accessed: 14 June 2016).
2 >http://bit.ly/1Q0Tg1R< (accessed: 14 June 2016).
3 Nieman (2015) *PER/PELJ* p 1993.
4 As discussed in paragraph 2.4 dealing the attaining of Bitcoin.
5 Nieman (2015) *PER/PELJ* p 1979.
6 Nieman (2015) *PER/PELJ* p 1979.

The South African National Treasury on behalf of the SARB, the Financial Services Board ("FSB"), the South African Revenue Service ("SARS") and the Financial Intelligence Centre, issued a user alert, dated 18 September 2014, warning the public to be aware of the risks associated with the use of virtual currencies for either transactions or investments.[7]

The alert defined virtual currencies as follows:

> "A virtual currency is a unit of account that is digitally or electronically created and stored. Members of the virtual community agree to accept these units as a representation of value in the same way that currency is accepted. In contrast to traditional currencies, virtual currencies operate without the authority of central banks, and are therefore not regulated. An example of virtual currency is Bitcoin….[which] is software based and uses peer-to-peer technology to operate without the involvement of the central bank or commercial banks". [8]

The alert noted that while virtual currencies can be bought and sold on various platforms, they are not defined as "securities" in terms of the Financial Markets Act. [9] "Securities" are defined in section 1 of the Financial Markets Act as:

> "(a) listed and unlisted -
>
> (i) shares, depository receipts and other equivalent equities in public companies, other than shares in a share block company as defined in the Share Blocks Control Act 59 of 1980;
> (ii) debentures, and bonds issued by public companies, public state-owned enterprises, the South African Reserve Bank and the Government of the Republic of South Africa;
> (iii) derivative instruments;
> (iv) notes;
> (v) participatory interests in a collective investment scheme as

7 SA National Treasury 2010 p 1.
8 SA National Treasury 2010 p 1.
9 19 of 2012

defined in the Collective Investment Schemes Control Act 45 of 2002 and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act; and

(vi) instruments based on an index;

(b) units or any other form of participation in a collective investment scheme licensed or registered in a country other than the Republic;

(c) the securities contemplated in paragraphs (a)(i) to (vi) and (b) that are listed on an external exchange;

(d) an instrument similar to one or more of the securities contemplated in paragraphs (a) to (c) prescribed by the registrar to be a security for the purposes of this Act."

The regulatory standards that apply to the trading of securities would therefore not apply to Bitcoin as it does not fall within the definition of securities. Due to the lack of categorisation for Bitcoin, there appears to be a need for the SA authorities to provide guidance on the taxation of Bitcoin.

The National Payment Systems Act[10] ("NPSA") gives SARB the power to use directives, position papers and circulars in terms of section 2. The NPSA further stipulates in section 12 that a contravention of a SARB directive is an offence.[11] The SARB publishes position papers in order to provide its view on specific payment system issues.[12] Although a position paper does not have the same binding power as a directive, it is usually followed because of the persuasiveness of it being issued by SARB.[13]

10 78 of 1998.
11 As per section 14 of the NPSA, any person convicted of an offence referred to in section 12 is liable to a fine not exceeding R1 million, or to imprisonment for a period not exceeding five years, or to both such a fine and such imprisonment.
12 Nieman (2015) *PER/PELJ* p 1989.
13 Nieman (2015) *PER/PELJ* p 1989.

The Financial Action Task Force ("FATF") [14] defined virtual currency in its paper Virtual Currencies Key Definitions and Potential AML/CFT Risks Report. The definition is the same as the definition used by SARB in its Position Paper on Virtual Currencies:[15]

> "(a) All non-convertible virtual currencies are centralised to a particular virtual community and cannot be exchanged for real currency;[16]
>
> (b) Convertible virtual currencies have an equivalent value in real currency and can be exchanged back and forth for a real currency. Convertible virtual currencies may be either centralised or decentralised:
>
> (i) Centralised convertible virtual currencies have a single third-party administering authority, who functions as a neutral entity between the principals in a transaction, and who controls the system. This administrator issues the currency, establishes the rules for its use, maintains a central payment ledger and has authority to redeem the currency.[17]
>
> (ii) Decentralised convertible virtual currencies are distributed, open-source, math-based peer-to-peer virtual currencies that have no central administering authority, and no central monitoring oversight. Examples of decentralised convertible virtual currencies include Bitcoin."[18]

SARB further explains that decentralised convertible virtual currencies refer "…specifically to decentralised, crypto-currencies that interact with the real economy, i.e. is exchangeable for legal tender and may be used to purchase real world goods and services".[19]

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14 The FATF is an inter-governmental body established in 1989 by the member jurisdictions, of which South Africa is one. The objectives of the FATF are to set standards and promote the effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The FATF is therefore a policy-making body which works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas. See: Nieman (2015) *PER/PERJ* p 1982.

15 Nieman (2015) *PER/PELJ* p 1982.

16 FATF 2014 p 4; SARB 2014 p 2.

17 FATF 2014 p 4-5; SARB 2014 p 2-3.

18 FATF 2014 p 4-5; SARB 2014 p 2-3.

19 SARB 2014 p 4.

The SARB also highlights risks with regards to virtual currencies, which are, *inter alia*:

(a) The lack of proper regulatory and legal framework substantially exacerbates risks associated with the enforcement of the principle of finality and irrevocability in the payment system;[20]

(b) There is no regulatory protection that would compensate the owner or user of virtual currencies for any loss that may be suffered;[21]

(c) Virtual currencies are less susceptible to freezing or seizure actions by law enforcement agencies. The identification of relevant laws applicable to the contravention and the gathering of evidence regarding a transaction can become an unattainable task;[22]

(d) The transfer of virtual currencies in and out of SA is not governed by exchange regulations. Any cross-border exchange can therefore not be authorised by SARB.[23]

It is the view of the public bodies (i.e. SARB, SA National Treasury, FSB, SARS and FIC) that the public must be aware of the risks associated with virtual currencies as there is no governmental legislation to protect them from these aforementioned risks.

Due to the fact that the alert provided no guidance on the classification of Bitcoin for tax purposes, the preceding paragraphs will analyse the classification of Bitcoin will as per the current legislative framework.

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20 FATF 2014 p 6.
21 FATF 2014 p 6.
22 FATF 2014 p 6.
23 FATF 2014 p 11.

5.3. BITCOIN CLASSIFICATION: CURRENCY

The term "currency" of the Republic is not defined in the ITA for purposes of the tax implications associated with currency.

According to paragraph (b) of the "local currency" definition in the ITA "local currency" means the currency of the Republic.[24] Further, section 15(1) of the South African Reserve Bank Act[25] ("SARB Act") states that the monetary unit of the Republic is the Rand (i.e. the local currency). Based on this, it can be concluded that Bitcoin cannot be the local currency of SA.

The SARB Act does not define the terms "asset" and "currency" in order to provide guidance for the categorisation of Bitcoin. On 3 December 2014, the SARB issued a position paper on virtual currencies, stating that only SARB is allowed to issue legal tenders in the form of bank notes and coins in SA, which can be legally offered in payment of an obligation and that a creditor is obliged to accept. Accordingly, it was held that virtual currencies are not legal tender in SA[26] and should not be used as payment for the discharge of any obligation.[27]

The ordinary dictionary meaning of currency therefore needs be ascertained. The Merriam Webster Dictionary defines "currency" as: "the money that a specific country uses; and something that is used as money".[28]

Additionally, synonyms of currency include money, legal tender and medium of exchange. Bitcoin is used as money and is a medium of exchange.[29] Due to the fact that Bitcoin is used as a medium of exchange it may be viewed as a type currency, although it is not considered local currency. The next aspect, therefore, is to consider whether Bitcoin falls within the definition of foreign currency. The ITA defines foreign currency in section 24I as "…any currency which is not local currency".

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24 Section 1 of the ITA
25 99 of 1989.
26 i.e. not a local currency of SA
27 SARB 2014 p 4-5.
28 >http://bit.ly/1Uj15yS< (accessed: 15 June 2016).
29 L Berger (2016) *NW University* p 4.

As shown above, Bitcoin cannot be classified as local currency in SA. It may, therefore, be regarded as foreign currency as it is used a medium of exchange and consequently may be classified as currency. Further, if the SA authorities were to rely on the *U.S. Securities Exchange* case,[30] then Bitcoin could be classified as foreign currency and not local currency.

If Bitcoin is classified as foreign currency, the income tax consequences must be considered.[31]

5.4. BITCOIN CLASSIFICATION: ASSET

Paragraph one of the Eighth Schedule of the ITA defines the term "asset" and includes "property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum … and …a right or interest of whatever nature to or in such property".

The SARS guide on CGT states that currency is excluded from the definition of the term "asset" per Schedule Eight. This exclusion does not apply to coins made from gold or platinum. The guide further states that coins of this nature are more valuable than ordinary legal tender and their value thus fluctuates with the price of gold or platinum.

"Trading stock" is defined in section 1 of ITA and includes "anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer; …any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer's trade; but does not include a foreign currency option contract; or a forward exchange contract as defined in section 24I (1)".

The SARS's guide on CGT confirms that trading stock is an asset for CGT purposes as the definition of "asset" is not concerned with the capital or revenue nature of property.

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30 *Securities and Exchange Commission v Trendon T. Shavers and Bitcoin Savings and Trust, United States District Court*, No. 4:13-CV-416, 13 September 2014. Discussed in Chapter 3 paragraph 3.2.1.

31 Discussed in detail in paragraph 5.5.

In terms of the current SA tax legislation, an asset for taxation purposes specifically excludes currency, but includes coins made from gold or platinum. Therefore, if Bitcoin is considered to be currency, then it cannot be classified as an asset and it will attract income tax.[32] However, if it is not seen as a currency, then it may be an asset for tax purposes and the capital gains tax must be considered if the asset is capital in nature.[33]

As indicated above[34], Bitcoin is not considered to be local currency in SA. Bitcoin may, however, be regarded as foreign currency as it is a used a medium of exchange. In this instance, Bitcoin would not be regarded as an asset if it is regarded as foreign currency. Consequently, it would not attract CGT, but rather have income tax consequences as discussed in paragraph 5.5.

5.5. SA TAX LEGISLATION: INCOME TAX ACT 58 OF 1962

This paragraph provides background to the relevant tax legislation governing income tax in SA.

5.5.1. GROSS INCOME

Section 5(1) of the ITA states that income tax is payable on the taxable income received by a person or accrued to a person during the year of assessment. Taxable income is further defined in section 1 of the ITA as "the amount remaining of the gross income of any person for any year or period of assessment after deducting there from any exempt amounts from normal tax".

The term "gross income" therefore plays an important part in determining whether an amount is included in the calculation of taxable income of the taxpayer. Gross income is defined in section 1 of the ITA as:

> "…in relation to any year of assessment, means -

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32 As discussed in paragraph 5.3.
33 As discussed in paragraph 5.6.
34 As discussed in paragraph 5.3.

(i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic,

during such year of period of assessment, excluding receipts or accruals of a capital nature".

In the case of a resident,[35] it may therefore be established that there are five requirements that must be met for an amount to be considered gross income, which are:

(i) the total amount in cash or otherwise;

(ii) received by, accrued to or in favour of;

(iii) a resident;

(iv) in the year of assessment;

(v) excluding amounts of a capital nature.[36]

The first element of the definition, "total amount or otherwise",[37] shows that there needs to be an amount received or accrued for gross income to be recognised.[38] In *WH Lategan v Commission for Inland Revenue*,[39] it was stated that even without the words "whether in cash or otherwise" by virtue of the word "amount" in the gross income definition, not only money but every form of property, whether corporeal or incorporeal, which has monetary

35 Defined in section 1 of the ITA as "…in relation to a natural person as either a person ordinarily resident in South Africa or a person who meets the requirements of the physical presence test".
36 As noted as a limitation in Chapter 1, the aspect of a non-resident is not discussed in this dissertation, as it is governed by international laws and double tax agreements between countries and is out of scope for this dissertation due to the in depth nature of such.
37 Requirement (i) above.
38 Requirement (ii) above. See: S Pienaar (2008) *UP* p 19.
39 2 SATC 16.

value, will be included in the gross income definition.[40]

Therefore, if an asset or service is received instead of cash, the value of the asset or service should be included in gross income.[41] The courts have given a very wide meaning to the word "otherwise".[42] Consequently, the asset or service received can be of any nature provided it can be converted to money.[43] The fair market value of the asset must be assigned to the asset as if it was sold under fair and reasonable circumstances.[44] It was confirmed in *Lace Proprietary Mines Ltd v CIR*[45] when valuing the asset, the value normally is the market value at which the asset was initially obtained.[46]

Where the amount received is in a foreign denominated currency, section 25D of the ITA needs to be considered. It provides that amounts expressed in a foreign currency which form part of the calculation of a person's tax liability must be converted to Rand at the average exchange rate. Section 25D(3) provides a natural person or a non-trading trust with the option of applying the average exchange rate method of translation rather than the spot rate method of translation.[47]

The term "average exchange rate" is defined in section 1(1) of the ITA as "in relation to a year of assessment, the average exchange rate determined by using the closing spot rates at the end of daily or monthly intervals during a year of assessment". This rate must be applied consistently within that year of assessment. The average exchange rate is published on the SARS website.

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40 2 SATC 16 p 21.
41 S Pienaar (2008) *UP* p 20.
42 Clegg *et al*. 2008. Income Tax in South Africa par 4.11. See case law: Lategan v CIR 1926 CPD 203 at 209, 2 SATC 16 at 19. See also CIR v Butcher Bros (Pty) Ltd 1945 AD 301, 13 SATC 21 at 34; CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A), 52 SATC 9 at 21.
43 S Pienaar (2008) *UP* p 20. See case law: Lategan v CIR 1926 CPD 203 at 209, 2 SATC 16 at 19. See also CIR v Butcher Bros (Pty) Ltd 1945 AD. 301, 13 SATC 21 at 34; CIR v People's Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353 (A), 52 SATC 9 at 21.
44 Clegg *et al*. 2008. Income Tax in South Africa par 2.13.
45 9 SATC 349.
46 9 SATC 349 p 351. See also S Pienaar (2008) *UP* p 21.
47 Act 58 of 1962.

An example of how a company calculates its average exchange rate is provided in Figure 5 below:[48]

1 January 2003 to 29 February 2004	
2003	
Month	**Monthly Average Exchange Rate for Australian Dollar**
January	5.0596
February	4.9399
March	4.8524
April	4.6913
May	4.9641
June	5.2495
July	4.9974
August	4.8134
September	4.8384
October	4.8288
November	4.8212
December	4.8096
2004	
January	5.3257
February	5.2633
Total of 14 months	**69.4546**
divided by 14	**÷ 14**
Average Exchange Rate to be used for this period	**= 4.9610**

Figure 4: Example of the calculation of average exchange rate. **Source:** SARS >http://bit.ly/1tzL5QD<

A further requirement is that the income should be received by or accrued to the taxpayer.[49] In *SARS v Cape Consumers (Pty) Ltd*[50] it was held that there would be no receipt or accrual if a person has not received an amount or it has not accrued to him for his own benefit.[51]

48 >http://bit.ly/1tzL5QD< (accessed: 17 June 2016).
49 Section 1(ii) of the ITA.
50 61 SATC 91.
51 61 SATC 91 p 94.

In *Geldenhuys v CIR*[52] the term "received by" was held to mean that a taxpayer must have received by for his/her own benefit and on his own behalf.[53] A person cannot, therefore, be liable for income tax on an amount received on behalf of another person.

With regards to accrued to, the courts have tested the principle but finally decided that the most appropriate interpretation would be that income has accrued to a taxpayer when they become entitled to claim payment.[54] The meaning of 'accrued to' was held to mean became "unconditionally entitled to". If the taxpayer has to meet a condition to actually receive the amount, then it is not unconditional and it does not accrue to the taxpayer.[55]

In terms of the gross income definition, income must not be of a capital nature. The term capital is not defined in the ITA and one needs to rely on the court's interpretation of the term. Capital gains are specifically excluded from the gross income definition, but will be taxed in terms of section 26A of the ITA.[56] There are many tests in SA case law that determines whether income is of a capital nature or revenue. The most important test is that of intention of the taxpayer – i.e. what intention the taxpayer had when the asset was acquired and held.[57] Based on the above considerations, the test is a subjective test and involves consideration of all the circumstances surrounding the acquisition of and method of dealing with an asset.[58]

The most important aspect for the discussion *in casu* is that income that is revenue in nature will be classified as gross income, whereas income that is capital in nature will be taxed at the capital gains rates.[59]

The possibility exist that the definition of the term "asset" in the ITA is wide enough to include Bitcoins.[60] It is important to determine the intention of the taxpayer when disposing of an asset, as well as the intention when the asset was obtained and the intention during

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52 1947 3 SA 256 (C).
53 1947 3 SA 256 (C) p ???
54 S Pienaar (2008) *UP* p 22.
55 As held in *Mooi v CIR* (1972 AD), *CIR v People's Stores (Walvis Bay) (Pty) Ltd* (1990 A)
56 Capital amounts are taxed at a lower rate than amounts that are revenue in nature. See paragraph 5.6 in this regard.
57 De Koker *et al*. 2016. Silke. par 3.2.
58 De Koker *et al*. 2016. Silke. par 3.2.
59 Discussed in paragraph 5.5
60 As discussed in paragraph 5.4

which the asset was held.[61] In other words, if the intention of the taxpayer is to obtain Bitcoins for the purpose of making profit and has made it his business to carry it out (for example, a Bitcoin miner), the income derived from the sale of bitcoins may result in gross income under section one (revenue nature). Based on the principles enunciated by our courts, where Bitcoins, as a form of an asset that is *not* capital in nature, are exchanged or bartered for another asset, the value of the new asset constitute an amount received or accrued.[62] The Bitcoins must further be received by the taxpayer for his or her own benefit and not for a third party with no conditions required to be met.

If, however, the SA authorities deem Bitcoin to be foreign currency[63] then the receipt of the Bitcoins will be required to be converted into the rand value for purposes of the tax calculation, as per section 25D.

5.5.2. DEDUCTIONS

Where Bitcoins are used as a form of payment for goods or services, it may qualify as a deduction as per the ITA. Most deductions are allowed on the basis of the "general deduction formula" set out in section 11(a) of the ITA, which sets out what may be deducted, (the positive test) and section 23(g) of the ITA, which stipulates what may not be deducted (the negative test).[64]

The courts have laid down that section 11(a) and section 23(g) must be read together when one considers whether an amount is capable of deduction.[65]

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61 Berger (2016) *NW University* p 54.
62 De Koker *et al.* (2015) par 2.16
63 As discussed in paragraph 5.3
64 There is an additional list of special deductions set out in the ITA, most of which would not be allowable in terms of the general deduction formula, for example, the allowances for wear and tear or bad debts. De Koker *et al*. 2016. Silke. par 7.3. De Koker *et al*.2016. Silke. par 7.3. See: section 11(e) of the ITA for wear and tear allowance and section 11(i) of the ITA for bad debts allowance.
65 *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13 at 16; *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381 at 389, *ITC 1058* (1963) 26H SATC 305 at 307 (all on earlier versions of the relevant provisions). See also *Stone v SIR* 1974 (3) SA 584 (A), 36 SATC 117 at 125; ITC 1267 (1977) 39 SATC 146 at 148; *SIR v Crane* 1977 (4) SA 761 (T), 39 SATC 191 at 192 and 196; *ITC 1327* (1980) 43 SATC 47 at 48–9; *Borstlap v SBI* 1981 (4) SA 836 (A), 43 SATC 195 at 203. In *CIR v Nemojim* (Pty) Ltd 1983 (4) SA 935 (A), 45 SATC 241 at 254–5 s 11(a) alone was described as the 'general deduction formula'; it was suggested that section 23(f) and (g) represent the negative counterpart of s 11(a); and it was s 11(a) on one hand and s 23(f) and (g) on the other that were 'read together'. See also *CIR v De Beers Holdings (Pty) Ltd* 1984 (3) SA 286 (T), 46 SATC 47 at 53.

Section 11(a) allows for the deduction of "expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature". Section 23(g) provides that "[n]o deductions shall in any case be made in respect of the following matters, namely . . .'(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade". [66]

The general deduction formula comprised by section 11(a) and 23(g) may therefore be broken down into the following elements:[67]

(i) what has been incurred must be an expenditure or loss;

(ii) it must have been actually incurred;

(iii) during the year of assessment;

(iv) in the production of the income;

(v) it must not constitute an expenditure or loss of a capital nature, and

(vi) if it is claimed as a deduction against income derived from trade, it must, either in part or in full, constitute moneys that were laid out or expended for the purposes of trade.

The term "trade" is defined under section 1 of the ITA and includes "every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent… or any design… or any trade mark…, or any copyright…, or any other property which is of a similar nature".

The word "expenditure" is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash.[68] In *Caltex Oil (SA) Ltd v SIR*[69] it was held that in a transaction

66 Act 58 of 1962.
67 De Koker *et al*.2016. Silke par 7.3.
68 De Koker *et al.* (2015) par 7.24
69 1971 (1) SA 665 (AD), 37 SATC 1 p 16.

of barter, the asset (in this case the commodity) promised in satisfaction of the obligation incurred, would have to be valued in rands and its value would constitute the amount of the expenditure incurred.

Bitcoins may therefore qualify for a deduction if it was used to settle an obligation in the production of trade. Based on the principles of the decision in *Caltex Oil (SA) Ltd v SIR* where Bitcoins (as a form of assets) are exchanged to settle such obligation, the Bitcoins have to be valued in rands.

Speculation of Bitcoin may fall into the definition of trade and therefore section 24I must be considered. Section 24I of the ITA[70] is of importance with regards to taxpayers speculating in Bitcoin.[71] According to section 24I(3) when determining the taxable income of a person[72], the exchange difference of an exchange item must be included or deducted.

In order for section 24I to be applicable to a natural person speculating in Bitcoin, the person would have to fall within the ambit of 24I(2)(c).[73] For this to be the case, such a person would first have to hold any amount contemplated in paragraph (a) or (b) of the definition of "exchange item". Secondly, those amounts would have to be held as trading stock.

Included in the definition of "trading stock" in section 1(a)(i) of the ITA is "anything…purchased or in any other manner acquired by a taxpayer for the purposes of…sale or exchange by the taxpayer or on behalf of the taxpayer".[74] Bitcoins may qualify as trading stock in terms of this very wide definition because they are purchased for the purpose of sale.

In addition, Bitcoins must fall within the ambit of paragraph (a) or (b) of the definition of "exchange item". "Exchange item" of or in relation to a person means an "amount in a foreign currency -

70 58 of 1962.
71 >http://bit.ly/28BD7X2< (accessed: 14 June 2016).
72 "Persons" are defined to be companies, trusts carrying on any trade or natural persons.
73 >http://bit.ly/28BD7X2< (accessed: 14 June 2016).
74 58 of 1962.

(a) which constitutes any unit of currency acquired and not disposed of by that person;

(b) owing by or to that person in respect of a debt incurred by or payable to such person."[75]

According to paragraph (a), an "exchange item" must be an amount in foreign currency which constitutes a unit of currency acquired and not disposed of.[76] Foreign currency is defined in section 24I as "any currency which is not local currency" and in this scenario Bitcoin could be classified as foreign currency.

Therefore, a taxpayer speculating in Bitcoin must include the gain or loss of the foreign exchange in their taxable income as per section 24I. Therefore, for example, as at 17 June 2016, the exchange rate for one Bitcoin equalled ZAR11 281.64.[77] This is regarded as the spot rate and SARS would need to provide the average rate for the months for the year of assessment for Bitcoin for guidance to taxpayers.
Therefore, any foreign exchange gain or loss on the exchange of Bitcoin, if classified as foreign currency, must be included in the abovementioned taxpayers' taxable income.

5.6. CAPITAL GAINS

Capital gains and capital losses made on disposal of assets are subject to CGT as per the Eighth Schedule to the ITA. Section 26A of the ITA provides that a taxable capital gain must be included in taxable income. It is therefore not a separate tax, but rather forms part of income tax.[78] Capital gains or losses are therefore declared in the annual income tax return.

Paragraph two of the Eighth Schedule of the ITA determines that the provisions of this schedule will be applied to the disposal on or after the valuation date of "any asset of a resident…and…any asset which is attributable to a permanent establishment of that person in the Republic".

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75 Section 24I(1) of Act 58 of 1962.
76 >http://bit.ly/28BD7X2< (accessed: 14 June 2016).
77 >http://www.coindesk.com/price/< (accessed: 17 June 2016).
78 SARS 2015 CGT p 3.

Paragraph three of the Eight Schedule of the ITA states that a capital gain will arise for a year of assessment, in respect of the disposal of an asset, and is equal to the amount by which the proceeds received or accrued in respect of that disposal, exceed the base cost of that asset. Paragraph one of the Eighth Schedule of the ITA defines the term "asset" to include property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum. A disposal is defined in Paragraph one of the Eighth Schedule of the ITA as "any event … which results in the creation, variation, transfer or extinction of an asset, and includes the sale…exchange or any other alienation or transfer of ownership of an asset".

The definition of "asset" as per Schedule Eight states that currency is excluded from the terms and is consequently not considered to be an "asset" for CGT purposes.[79] This exclusion does not apply to coins made from gold or platinum.[80] The guide further states that coins of this nature are more valuable than ordinary legal tender and their value thus fluctuates with the price of gold or platinum.[81]

If Bitcoin were to be classified as foreign currency[82] it would not be classified as an asset for capital gains purposes and therefore would not attract CGT.

The term "trading stock", on the other hand, is defined in section 1 of the ITA and includes:

> "anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer; …any consumable stores and spare parts acquired by the taxpayer to be used or consumed in the course of the taxpayer's trade; but does not include a foreign currency option contract; or a forward exchange contract as defined in section 24I(1)".[83]

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79 See also: SARS CGT p 4.
80 SARS 2015 CGT p 4.
81 SARS 2015 CGT p 4.
82 As discussed in paragraph 5.2.
83 Section 24I was discussed in paragraph 5.5.1

The SARS' guide on CGT confirms that trading stock is an asset for CGT purposes as the definition of "asset" is not concerned with the capital or revenue nature of property.[84]

If trading stock is, however, classified as revenue in nature, section 22 of the ITA would be applicable. In accordance with section 22(1) and section 22(2) of the ITA, any trading stock on hand at the end of a year of assessment is added back when determining taxable income and the opening balance of trading stock is deducted when determining taxable income.[85]

The CGT inclusion rate for individuals is 40%, and for other taxpayers is 80%, as from 2016. Consequently this inclusion rate is multiplied by the capital gain and included into the taxpayers income tax calculation, whereby the capital gain would be taxed at the taxpayers' tax rate (for example, 28% for companies). Therefore, the effective tax rate of a capital gain is less than normal income tax, as only a portion of the full gain is included in the tax calculation.

Capital gains has various exclusions, *inter alia*:

(i) Personal-use assets, which include personal belongings such as a artwork, stamp collection, furniture and household appliances and other assets used mainly (that is, more than 50%) for a non-trade purpose;

(ii) Lump sum payments from pension, pension preservation, provident, provident preservation and retirement annuity funds (approved retirement funds);

(iii) Prizes or winnings from gambling, games or competitions which are authorised by, and conducted under, the laws of South Africa, for example, the National Lottery; or

(iv) Donation or bequest of an asset to an approved public benefit organisation.

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84 SARS 2015 CGT p 4.
85 See section 22 of the ITA. See also: L Berger (2016) *NW University* p 50.

The definition of "asset", as discussed above,[86] is possibly wide enough to include Bitcoin. The intention of the taxpayer disposing of the Bitcoin must be considered in order to determine whether the asset was capital in nature for CGT purposes or revenue in nature of income tax purposes.[87]

5.7. VALUE ADDED TAX ACT 89 OF 1991

Value-Added Tax ("VAT") is an indirect tax on the consumption of goods and services in the economy in terms of the Value Added Tax Act[88] ("VAT Act").[89] Revenue is raised for government by requiring certain businesses to register and to charge VAT on the taxable supplies of goods and services.[90] VAT is charged at 14% for standard rate supplies and 0% for zero rate supplies.[91] Vendors, as defined by the VAT Act, have the responsibility of levying VAT and paying it over to the state after deducting permissible VAT inputs and other deductions.[92]

In order for a transaction to attract VAT in terms of VAT Act, there should be a supply of goods or services by a vendor in the course or furtherance of an enterprise, on the importation of any goods in the Republic, on the supply of any imported service.[93]

The definition of a supply in section 1 of the VAT Act includes a sale, a rental agreement, an instalment sale agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is affected.[94] The definition of a supply can therefore be seen to be wide. Goods are defined in section 1 of the VAT Act as corporeal movable things, fixed property, any real right in any such thing or fixed property and electricity.

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86 Discussed in paragraph 5.4.
87 As discussed in paragraph 5.5.1.
88 89 of 1991.
89 >http://bit.ly/24Qck4A< (accessed: 16 June 2016).
90 This is similar to GST in Australia, as discussed in Chapter 4 paragraph 4.3.4. > http://bit.ly/24Qck4A< (accessed: 16 June 2016).
91 A standard-rated supply is a supply of goods or services by a vendor which is subject to VAT at the standard rate of 14%. The supply of all goods and services are taxable at the standard rate, unless it is specifically zero-rated under section 11 or exempt under section 12 of the VAT Act. See: >http://bit.ly/24Qck4A< (accessed: 16 June 2016).
92 SARS 2016 VAT Guide p ii.
93 Section 7(1)(a), 7(1)(b) and 7(1)(c). Also see: Johnston (2013) *International Business* p 72.
94 Johnston (2013) *International Business* p 72.

The supply itself must have been made by a vendor. A vendor is defined in section 1 as any person who is registered for VAT or is required to be registered for VAT as per section 23 of the VAT Act.[95] Section 23(1) states that a person is obliged to register for VAT if his or her taxable supplies exceed one million rand. As per section 7, in order for such supply to attract VAT, it should be made in the course or furtherance of an enterprise.[96] The VAT Act defines an enterprise in section 1 as any enterprise or activity, carried on regularly or continuously in SA or partly in SA.[97]

For example, where a taxpayer is mining and supplies Bitcoin and such supply exceeds R1 million, then the taxpayer is obliged to register as a VAT vendor. The supply of the Bitcoin may be subject to VAT should it not be an exempt supply.[98]

With effect from 1 April 2015, a non-resident supplier of electronic services will be liable to register in respect of the supply of electronic services where at least any two of the following three circumstances apply:[99]

(i) Electronic services are supplied to South African residents; or

(ii) Payment for such electronic services originates from a South African bank account; or

(iii) The recipient has an address (e.g. residential, business or postal) in South Africa, and the total value of taxable supplies of electronic services has exceeded R50 000.

The VAT Act defines “electronic service” as "those electronic services prescribed by the Minister by regulation...”.[100] On 28 March 2014 National Treasury published regulations[101] listing various “electronic services”. These services are divided into categories, including

95 S 1 of the VAT Act.
96 See also: Johnston (2013) *International Business* p 72.
97 Act 89 of 1991.
98 Exempt supplies are dealt with in section 12 of the VAT Act. These are the supply of any goods or services that will be exempt from VAT and include, inter alia, supply of financial services.
99 SARS 2016 VAT Guide p ii.
100 Section 1 of Act 89 of 1991.
101 Government Gazette No 37489, Notice R 221

education, games and games of chance, internet-based auction services, miscellaneous services including e-books, audio-visual content, still images and music and subscription services. It includes the provisions of these services "by means of an electronic agent, electronic communication, or the Internet".[102] There are exclusions from the definition, such as software applications and many cloud-based services such as online storage or virtual servers.[103]

The supply of wallet storage facilities for Bitcoin or the supply of Bitcoin software program would be regarded as online storage and fall within the exclusion of the definition of electronic services. Consequently, a non-resident supplying Bitcoin wallet storage facilities provided would not have to register and pay for VAT in SA.

5.8. CONCLUSION

To date, SARS has not issued any guidance paper on the tax treatment of virtual currency exchange transactions. However, SARS together with the Financial Services Board and the Financial Intelligence Centre issued of a user alert to the South African public. In essence no legal protection or recourse will be afforded to users of virtual currencies in terms of the alert.

Section 24I and the Schedule Eight of the ITA provides reference to the terms “currency” and “asset” respectively. When considering the meaning of the term “asset” as defined by the Eighth Schedule, it appears to be wide enough to include Bitcoins as a form of property (asset). SA authorities may, on the other hand, classify Bitcoin as foreign currency, as Bitcoin is used as a medium of exchange.

With the current SA tax framework in mind, what is of importance is to determine the capital or revenue nature of transacting in Bitcoins by assessing the intention of the taxpayer when obtaining Bitcoins, keeping Bitcoins and at the time of disposing or exchanging Bitcoins. If the intention of the taxpayer is to obtain bitcoins for the purpose of making a profit (e.g.

[102] GG Notice No 37489, Notice R 221.
[103] >http://bit.ly/1UcN2IJ< (accessed: 15 June 2016).

Bitcoin miner), then sections 22(1) and 22(2) of the ITA will come into effect as the taxpayer will have to account for trading stock in determining his taxable income.

Both sections 11(a) and 23(g) of the ITA are available for purposes of deductibility of expenses. Where taxpayers are trading in Bitcoins, the provisions of section 24I of the ITA will be available to determine the taxation consequences in the exchange of bitcoins. However, this may result in the taxpayer including exchange differences of a revenue nature in determining taxable income. Where Bitcoins are used to make online purchases of items for personal use or consumption, these transactions will qualify as personal-use assets and will therefore not be subject to CGT when disposed of.

With regard to the regulatory environment, the SARB explicitly stated in its position paper that decentralised virtual currencies are not legal tender in SA and should not be used as payment for discharge of any obligation to settle debt. There is an absence of specific laws or regulations on virtual currencies in SA, which leads to no legal protection or recourse. It is submitted that there is a need for taxation and regulatory guidance on Bitcoin exchange transactions to protect the SA tax base.

CHAPTER 6: CONCLUSION

6.1. INTRODUCTION

As indicated in the introduction, the main research question of this study was whether Bitcoins should be characterised as an asset, currency or legal tender for taxation of Bitcoin transactions with regards to the South African Income Tax Act.[1]

The study comparatively explored two countries, specifically Australia and the U.S., which have published tax regulations on Bitcoin and addressed the issue of categorisation of Bitcoin. The study further addressed secondary objectives that derived from and supported the primary objective.[2]

6.2. BITCOIN BACKGROUND AND OPERATION

It was determined through the investigation that Bitcoin is a virtual crypto-currency and was developed by Satoshi Nakamoti in 2009. It is a type of anonymous online fund that is not issued or guaranteed by any Government.[3]

Bitcoin transactions are authenticated through cryptography, which is secure from any third party. Each Bitcoin and each user is encrypted with a unique identity.[4] This characteristic makes it anonymous and difficult to trace for revenue authorities, which consequently leads to criminal activities, such as tax evasion.[5] This leads to the primary object of how revenue authorities can tax Bitcoin transactions.

6.3. THE VIEW OF THE OECD

The OECD issued the BEPS action plan which dealt with the taxation of virtual currencies. It established that the main policy issue countries need to address is the tax treatment of capital gains of Bitcoin, as well as the tax evasion through the anonymity of Bitcoin

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1 As discussed in paragraph 1.4.
2 As per paragraph 1.4.2.
3 As shown in paragraph 2.1 and 2.2.
4 As discussed in paragraph 2.3.
5 As examined in paragraph 2.5.

transactions.[6] Australia and the U.S. are member countries in the OECD and SA is a non-member with which the OECD has working relationships. SA makes use of the OECD policies as guides for its own policies.

The inquiry into the OECD action plan indicated that the place of supply for digital business to consumer services should follow the destination principle. Alternatively, the concept of "virtual permanent establishment" could be created and defined in order to create a connection that would apply to electronic commerce operations.[7]

6.4. THE VIEW OF THE U.S. IRS AND AUSTALIAN ATO

This dissertation investigated the framework and tax implications of Bitcoin in the U.S. and Australia. The enquiry into the two countries created an understanding of the technicalities surrounding Bitcoin, in order to provide guidelines and insight for the South African authorities for regulating Bitcoin transactions.

The IRS issued Notice 2014-21 defines the term "virtual currency" as "*a digital representation of value that functions as a medium of exchange…or a store of value*". In the notice, the IRS requires that virtual currency be taxed in the same way as traditional property. Similar to the Australian taxation treatment, Bitcoin transactions undertaken by taxpayers will have the same taxation consequences as barter transactions. The nature for the gain or loss, however, depends on whether the virtual currency is held as a capital by the taxpayer. Therefore, where Bitcoins are held mainly for sale to customers in a trade or business and subsequently disposed of, the gain or loss on the sale or exchange of the virtual currency will not be regarded as a capital asset in the hands of the taxpayer and will be taxed as ordinary income.

For the purposes of Australian tax law, transactions involving Bitcoins have the same tax consequences of bartering transactions due to the fact that Bitcoins are regarded as "property" or CGT assets. Bitcoins are therefore not regarded as "money", "currency", or "foreign currency".[8]

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6 As discussed in paragraph 2.6
7 As enunciated in paragraph 2.6.
8 As discussed in paragraph 4.3.

Any gains or losses derived from mining Bitcoins or conducting Bitcoin exchange services will be regarded as ordinary income. Any related business expenses incurred may be deductible, based on the arm's length value on the date of trading. On the other hand, where the intention of the taxpayer is to obtain Bitcoins for investment purposes and then subsequently disposes of them, the possible gain or loss will be subject to CGT in the same way shares or similar CGT assets are disposed of. Possible shortfalls were identified in the ATO guidelines and rulings on the taxation treatment of virtual currencies and it was concluded that Bitcoin should rather be classified as "currency" for ease of reporting tax for Bitcoin transactions.

6.5. SOUTH AFRICAN AMENDMENTS

The study obtained an understanding of what current South African tax legislation is available to address Bitcoin exchange transactions.[9] To date, the SA authorities have not published any legislation or guidance on the taxation treatment of virtual currency exchanges.

Based on the study, however, the following possible amendments to the SA regulatory framework was identified to support a sufficient base for the taxation of Bitcoin transactions in SA:

(i) The definition of the term "asset" as per the Eighth Schedule of the ITA be widened to include virtual currencies such as Bitcoin;

(ii) The definition of "foreign currency" in terms of section 24I of the ITA, the possibility exists that Bitcoins fall under this definition, that is, if regarded as a currency other than the local currency (the rand);

(iii) The term "local currency" or "foreign currency" could be amended to include virtual currencies, such as Bitcoin. The tax processes for currencies are easier for taxpayers to account for, as opposed to asset and consequently CGT processes;

[9] As per Chapter 5.

(iv) The term “personal-use asset” for CGT purposes, could be amended to include instances where Bitcoin is used by a natural person to make online purchases of items for personal use or consumption;

(v) Guidelines should be drafted and supported by SARS, the SARB and the National Treasury of SA to include general taxation and regulatory guidelines on Bitcoin exchange transactions with the aim of educating SA taxpayers and providing clarity on the tax treatment of Bitcoin transactions;

(vi) In order to encourage tax and regulatory compliance, tax breaks could be offered to taxpayers which are in compliance with tax and regulatory requirements.

With no proper rulings, guidance papers and interpretation notes on Bitcoin transactions, there is a major risk that the tax base can be eroded as taxpayers may get involved in criminal activities and consequently tax avoidance and money-laundering activities. There is further no protection or recourse that is afforded to virtual currency users. The research suggests that it is of major importance that guidance be released by the SA authorities to assist in the protection of the users, as well as the SA tax base.

6.6. CONCLUSION

To conclude, it was shown through this investigation that the current SA legislation and framework is sufficient to bring Bitcoin in line with the legal structure and address the tax concerns. However the exact classification of Bitcoin in relation to taxation is not clear. As a consequence of this, guidelines on the reporting of Bitcoin transactions should be published to minimise tax avoidance and erosion of the tax base.

Based on the research conducted, it may be concluded that the most effective tax method would be to cater for both income tax consequences, as well as capital gains tax consequences. Therefore, to expand the “foreign currency” and “asset” definitions to include Bitcoin.

The “foreign currency” definition will apply where the taxpayer intention is not of a capital nature, for instance normal day-to-day transactions. This will result in income tax consequences for individuals on the sliding scale and for companies at 28%.[10]

The “asset” definition can be expanded to include capital Bitcoin transactions, where the intention of the taxpayer was, for example, investment purposes. This will therefore ensure that Bitcoin transactions are taxed for CGT purposes. The taxpayer will be taxed at an effective rate that is less than that of the normal tax rate.

The higher income tax rate for the foreign currency categorisation may be disadvantageous for tax payers, as opposed to Bitcoin being included in the definition of “asset’ and having a lower CGT rate. This is, however, an advantage for the SA government in order to obtain more funds for the economy. However, the ease of converting the value Bitcoin in terms of section 25D of the ITA will make the foreign currency classification more worthwhile for tax payers. This is as opposed to calculating capital gains on each Bitcoin transaction, which involves keeping note of the elements needed for the calculation, such as the base cost and proceeds.

An aspect that was out of scope for this dissertation was the issue of how SARS will enforce compliance if Bitcoin is considered a foreign currency. This has therefore created an opportunity to research further into this topic and to discover ways of enforcement of payment of taxes on Bitcoin.

[10] As discussed in paragraph 5.5.

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