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Decoding Cryptocurrencies

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The South African Reserve Bank (SARB) issued a Position Paper on Virtual Currencies (December 2014) in which it confirmed that it is not a recognised currency, nor backed or regulated by National Treasury/SARB. Furthermore, expressed the view that “there are many legal uncertainties regarding virtual currency schemes… The lack of proper regulatory and legal framework substantially exacerbates the other risks, especially the enforcement of the principle of finality and irrevocability in the payment system”.

However, SARB issued a media statement on 13th February 2018 in regards to the establishment of the Financial Technology (FinTech) Programme with its first objective to review SARB’s position on cryptocurrencies to inform appropriate policy framework and regulatory regime.

Given that cryptocurrencies are not controlled by a centralised entity it raises a number of concerns with law enforcement agencies and tax authorities around the world because of its anonymity and lack of a reporting entity. Cryptocurrency can be used for money laundering, evasion of exchange controls, and other illicit activities. One of the greatest challenges facing cryptocurrencies is around transparency. A tax authority, such as SARS, is very dependent on information provided by third parties to verify taxpayer disclosure and to manage tax risks and compliance. Without a third party to hold to account to provide information, SARS can only rely on the taxpayer's disclosure, or audits that are resource intense.

The IASB issued Conceptual Framework for Financial Reporting defines an asset as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”, and that “physical form is not essential to the existence of an asset”.
It is generally been accepted that a cryptocurrency is an asset (on the grounds that there is sufficient control and certainty of future economic benefit).

It appears that the real issue is in regards to classification and measurement.

Cryptocurrencies are not ‘cash’ as it isn’t issued or backed by government.

Due to volatility there is a significant risk of changes in value, and can’t be ‘cash equivalent’.

As cryptocurrencies do not give the holder a contractual right or obligation to receive cash or another financial asset, it can’t be a ‘financial instrument’.

Also, is not land and building, and has no physical form, excluding ‘PPE or Investment Property’.

Could a cryptocurrency be ‘inventory’?

Inventories do not need to be in physical form, but must be held for sale in the ordinary course of business.

However, the cryptocurrencies must be traded frequently enough that such trading activity would be an entity’s ‘ordinary course of business’. Where a company accepts payment or make payments for goods or services using cryptocurrencies, the company will not meet the test. If the company is a trader in cryptocurrencies, it could be argued that the definition of ‘inventory’ has been met, but would need to measure at cost.

[Consider the guidance for broker-traders in IAS 2 ‘Inventories’]

An ‘intangible asset’ [IAS 38] is an identifiable non-monetary asset without physical substance/form.

So, cryptocurrencies appear to meet the definition of an intangible asset, as it identifiable, can be sold, exchanged or transferred individually, not cash, non-monetary asset, and have no physical form.

Intangible assets have traditionally been assets held for use in the production process, such as patents, trademarks, copyrights and other intellectual property. An intangible asset’s primary objective is to generate revenue from the company’s ordinary course of business. Cryptocurrencies are used to pay/exchange for goods or services, to incentivize or promote, and for investment purposes. An intangible asset feels very different from the use of cryptocurrencies.

It is generally accepted that fair value measurement is the most relevant measurement basis for a cryptocurrency, because it’s being used as a currency-equivalent or alternative investment vehicle.

An intangible asset can be measured at fair value, but only if there is an active market. Fair value movements must be recognised in ‘Other Comprehensive Income’.

SARS published position:

'Whilst not constituting cash, cryptocurrencies can be valued to ascertain an amount received or accrued as envisaged in the definition of "gross income" in the Act.

Following normal income tax rules, income received or accrued from cryptocurrency transactions can be taxed on revenue account under "gross income".

Alternatively, such gains may be regarded as capital in nature, as spelt out in the Eighth Schedule to the Act for taxation under the CGT paradigm.'

'Determination of whether an accrual or receipt is revenue or capital in nature is tested under existing jurisprudence (of which there is no shortage).'

2018 Draft Taxation Laws Amendment Bill:

- add to the definition of “financial instrument” in section 1 of the Income Tax Act to include “any cryptocurrency”;
- extend section 20A of the Income Tax Act (ring-fencing of losses) to include “the acquisition or disposal of any cryptocurrency”; and
- extend the list of financial services under section 2 of the Value-Added Tax Act to include “the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency”.

It will be important to differentiate between Capital or Revenue nature!

Where revenue in nature, normal income tax provisions apply, including deductions. The proposed legislative amendment will aim to ring-fence losses in terms of section 20A of the ITA.

This means that the costs of mining, acquiring, holding, selling … may qualify as deductions (including allowance for wear and tear).

SARS published guideline:

'Base cost adjustments can also be made if falling within the CGT paradigm.

Gains or losses in relation to cryptocurrencies can broadly be categorised with reference to three types of scenarios, each of which potentially gives rise to distinct tax consequences:

(i) A cryptocurrency can be acquired through so called "mining". Mining is conducted by the verification of transactions in a computer-generated public ledger, achieved through the solving of complex computer algorithms. By verifying these transactions the "miner" is rewarded with ownership of new coins which become part of the networked ledger.

This gives rise to an immediate accrual or receipt on successful mining of the cryptocurrency. This means that until the newly acquired cryptocurrency is sold or exchanged for cash, it is held as trading stock which can subsequently be realized through either a normal cash transaction (as described in (ii) or a barter transaction as described in (iii) below.'

…

'(ii) Investors can exchange local currency for a cryptocurrency (or vice versa) by using cryptocurrency exchanges, which are essentially markets for cryptocurrencies, or through private transactions.

(iii) Goods or services can be exchanged for cryptocurrencies. This transaction is regarded as a barter transaction. Therefore the normal barter transaction rules apply.'

With the proposed addition to the list of financial services under section 2 of the Value-Added Tax Act to include “the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency”, services involving cryptocurrencies will (like other financial services) be exempt from VAT in terms of section 12 of the Value-Added Tax Act.

It is important to note that a vendor will not be entitled to claim input tax deductions in regards to trading with cryptocurrencies, due to the exempt nature of the supplies.


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