

Bitcoin exchange transactions: Income tax implications to consider within the South African environment

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DECLARATION

I declare that: "Bitcoin exchange transactions: Income tax implications to consider within the South African environment" is my own work; that all sources used or quoted have been indicated and acknowledged by means of complete references, and that this mini-dissertation was not previously submitted by me or any other person for degree purposes at this or any other university.



Signature

03 May 2016

Date

ACKNOWLEDGEMENT

Firstly, I take this opportunity to thank God who has provided me with the necessary strength, focus and wisdom to complete this mini dissertation. Throughout all my studies thus far, I've learned that everything is possible through Christ who strengthens me (Philippians 4:13).

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ABSTRACT

The use of bitcoins as a medium of exchange is not yet widespread in South Africa, 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 Takealot.com. South Africa 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 (Van der Berg, 2015). Also, South Africa's first digital currency hub was launched on 11 June 2015 to create awareness of the use of bitcoins, educate the community on the benefits of digital currencies and encourage South Africans to participate in the digital currency space (Tiwari, 2015). As more and more South Africans will be introduced and educated in the use and benefits of using digital currencies, the need for proper regulatory and taxation guidance will increase.

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 first objective of this study was to determine whether bitcoins should be classified as an asset or currency when exchanged for goods, services and real currency. Secondary objectives were identified to assist in addressing this objective, namely:

- a) A discussion of the characterisation of bitcoins as either property (assets) or currency, by referring to the following:
how are the terms "asset" and "currency" interpreted from a South African tax perspective and from the perspective of other governments?
- b) analyse the taxable income consideration on bitcoin exchange transactions in other governments for the following events:
 - i. the receipt of bitcoins in exchange for goods and services (barter transactions);
and
 - ii. the sale of bitcoins in exchange for real currency;
- c) critically analyse the commentary provided by the OECD, Davis Tax Committee and the position expressed by the SARB as to the taxability of bitcoin exchange transactions; and

d) make possible recommendations or suggest the most suitable approach on how bitcoin exchange transactions should be taxed in South Africa.

The researcher did however not consider whether fluctuations in the value of bitcoins could result in foreign currency gains or losses as envisaged by section 24I of the South African Income Tax Act (Act no. 58 of 1962) and whether such fluctuations could be regarded as interest within the ambit of section 24J. Also not considered in this study are the VAT implications of bitcoin exchange transactions and the impact of any other financial regulatory legislation. However, where relevant in the context, the researcher did briefly elude to the most relevant South African Reserve Bank exchange regulation specifically relevant to currency and anti-money laundering laws.

A non-empirical study was performed to understand the current tax position in South Africa, with regards to the classification of bitcoins either as an asset or currency for bitcoin exchange transactions that may result in taxable income.

In conclusion, the current South African tax legislation does make provision for the classification of virtual currencies such as bitcoins. Therefore, based on the current taxation legislation and case law discussed in chapter four of this dissertation, virtual currencies, such as bitcoins should be classified as an asset for South African income tax purposes. It is, however, suggested that the South African authorities, such as the South African Revenue Services and the South African Reserve Bank issue appropriate guidelines in the treatment of bitcoin exchange transactions as countries such as Australia and the USA that have already embarked on this much needed guidance for virtual currency users.

Key words:

bitcoin

asset

currency

virtual currency

digital currency

cryptocurrency and

decentralised convertible virtual currency

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND, RESEARCH AREA AND LITERATURE REVIEW

Bitcoin (network) was first launched in 2009 by Satoshi Nakamoto, a pseudonym for a single programmer or group of programmers (Goodspeed, 2014:1). In recent years Bitcoin has grown rapidly throughout the world as a virtual cryptocurrency. Bitcoin is “a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodity” (Grinberg, 2011:160).

A virtual currency is a digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account and / or a store of value, but does not have legal tender status (Financial Action Task Force, 2014:4). Decentralised virtual currencies are distributed, open-source, math-based peer-to-peer virtual currencies that have not central administrating authority, and no central monitoring or oversight (Financial Action Task Force, 2014:5). Cryptocurrency refers to a math-based, decentralised convertible virtual currency that is protected by cryptography. Cryptocurrency relies on public and private keys to transfer value from one person (individual or entity) to another, and must be cryptographically signed each time it is transferred (Financial Action Task Force, 2014:5).

If not held purely as an investment, bitcoin may be exchanged for goods and services. Examples of bitcoin exchange transactions may involve the following:

- a) Buying physical goods and services using e-commerce sites: in South Africa, examples of retailers accepting bitcoins as medium of exchange for goods and services, include outdoor and leisure equipment suppliers, tax consulting and professional accounting service providers, corporate gift suppliers, travel agencies and bars and restaurants (Bitcoinzar, 2015(a));
- b) bitcoin gift cards: an easy way to turn digital currency into “real-world” goods and services (eGifter, 2015);
- c) bitcoin payment options offered by payment platform providers: these companies offer businesses the ability to easily accept payments from customers by a variety of means, such as credit or debit cards as well as bitcoins (Mybroadband, 2014; PayFast, 2015); and

d) online bitcoin auctions: another way to spend bitcoins is to sell personal luxury items such as yachts, antiques and artwork in exchange for bitcoins using online bitcoin auction platforms such as BitPremierservice (BitPremier, 2015).

BitX, South Africa's first rand-to-bitcoin exchange platform, was founded in February 2013 and is headquartered in Singapore, with a development team in Cape Town and a satellite office in Palo Alto (Bitcoin Broker, 2015). There are also other bitcoin exchange platforms such as Coinbase, Bitfinex and Bitstamp, where traditional money can be exchanged for bitcoins and vice versa. US Dollar (USD) is not the primary trading currency of bitcoin. Bitcoins can be purchased using various currencies such as ZAR, GBP and EUR (Kearney, 2014:2).

1.2 BITCOINS AS EXCHANGE MEDIUM AND POSSIBLE TAX IMPLICATIONS

Currently in South Africa there are no specific laws or regulations that address the use of virtual currencies (Fin24, 2014). There are also no published rulings, tax court decisions, relevant publications or interpretation notes focussing on the tax considerations of bitcoins as an asset, currency or barter transaction within the South African environment.

A growing number of businesses are accepting bitcoins as a method of payment in South Africa. Since October 2014, this number has grown from six to more than 19 companies to date, accepting bitcoins in exchange for goods and services (Bitcoinzar, 2015(a); Seforo, 2014:1). Goods and services range from artwork, corporate gifts, packaging materials to software support, network service solutions and architectural designs, amongst others (Bitcoinzar, 2015(a)).

According to Isom (2013:2) receiving bitcoins as payment or receiving goods or services will likely result in taxation transactions. Also, with the transfer of bitcoin in exchange for legal currency (sale), the resulting gain or loss may produce a taxable income or a potentially deductible loss respectively (Atkins *et al.*, 2014:48).

1.2.1 Characterisation of the potential gain or loss on the sale or exchange of bitcoins

A notice issued by the United States' Internal Revenue Service (IRS) stated that the character of the gain or loss (capital or revenue) generally depends on whether the virtual

currency is a capital asset in the hands of the taxpayer or held mainly for sale to customers in a trade or business (Keith, 2014:3).

Isom (2013:10) also confirms this view and suggests that how bitcoins are characterised as either property (assets) or foreign currency, affects the way bitcoins will be taxed.

1.2.2 Bitcoin exchange transactions resulting in possible gross income under the South African Income Tax Act (Act no. 58 of 1962)

According to the Margo Report (cited by Williams, 2009:81), the existing tax system in South Africa does not tax either profits or cash flow, but instead seeks to tax – in accordance with a statutory formula – an amalgam of both.

Section one of the South African Income Tax Act (Act no. 58 of 1962) defines gross income as “the total amount, in cash or otherwise, received by or accrued to or in favour of ... during such year or period of assessment, excluding receipts or accruals of a capital nature...”

In the case of the Commissioner for Inland Revenue v Delfos (1933) it was held that the tax was to be assessed in money on all receipts or accruals having a money value. It was further held that if it is something which is not money’s worth or cannot be turned into money, it is not to be regarded as income. In the case of WH Lategan v Commissioners for Inland Revenue (1926), Watermeyer expressed the opinion that the word “amount” had to be given a wider meaning and had to include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which had a money value. Based on the above, it appears that the use of bitcoins as an exchange medium may attract possible taxation implications.

Paragraph one of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) 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, defined by the South African Income Tax Act (Act no. 58 of 1962), is defined 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.” Accordingly, paragraph three of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) 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.

The term “currency” is not defined in the South African Income Tax Act (Act no. 58 of 1962) while section 15 of the South African Reserve Bank Act (Act no. 90 of 1989) affirms that the monetary unit of the Republic is the rand. According to paragraph (b) of the “local currency” definition in the South African Income Tax Act (Act no. 58 of 1962), “local currency” means the currency of the Republic. Additionally, synonyms of currency include money, legal tender and medium of exchange. Bitcoin is used as money and is used as a medium of exchange (Seforo, 2014:2). In contrast, the SARB issued a position paper on virtual currencies on 3 December 2014, stating that only the SARB is allowed to issue legal tenders in the form of bank notes and coins in South Africa, which can be legally offered in payment of an obligation and that a creditor is obliged to accept. Consequently, virtual currencies are not legal tender in South Africa and should not be used as payment for the discharge of any obligation (South African Reserve Bank, 2014:4-5). Accordingly, the possibility exists to characterise bitcoins (medium of exchange) as an asset for South African income tax purposes.

1.2.3 Bitcoin exchange transactions resulting in possible barter transactions

The barter approach recognises that bitcoins can be exchanged on an even playing field for goods and services that are of an equal value (Atkins *et al.*, 2014:53). On the contrary, the tax treatment of barter transactions is complex, since the taxpayer must know how to determine an objective (market) value of the transaction objects in order to calculate the taxable profit (Bal, 2014:179).

For example (Kearns, 2014:2): A business accepted bitcoins for the exchange of its products (computer software). At the time of the acceptance, the bitcoin value was USD \$800. When the business used the bitcoins after a few weeks to purchase other trading stock for its business, the value might be different. It might have increased to USD \$1 000 or decreased to USD \$500. To calculate the gains and losses correctly, the business needs 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. This may be a significant compliance burden. Classifying bitcoins as foreign currency for tax purposes, may result in more certainty as the same rules for taxing foreign currency gains and losses will apply.

1.3 THE POSITION OF OTHER GOVERNMENTS

The tax treatment further hinges on whether bitcoins are regarded as currency or assets in the particular jurisdiction (Kun, 2014:2).

Bal (2013:353) distinguishes between global and scheduler income tax systems. A scheduler system distinguishes income categories such as employment, investment and business income. The income tax payable is calculated for each of these income categories, considering the gross income and deductible expenses. In a global system, all receipts and expenses are considered together in the calculation of net income (Bal, 2013:353).

The scheduler income tax system of Germany has taken the lead in recognising bitcoins and incorporating them into their tax system. The German government is now recognising bitcoins as a legal form of tender and has created regulations (Isom, 2013:2). Germany's ministry of finance has formally recognised the digital currency, Bitcoin, as a unit of account which can be used for private transactions – meaning that the ministry will now be able to tax users or creators of the four-year-old virtual money (Arthur, 2013).

With regard to the United States' global income tax system, the United States Internal Revenue Service (IRS) is of the view that bitcoins be treated as a commodity for taxation purposes (Blundell-Wignall, 2014:12). In Notice 2014-21 (Keith, 2014:3) the IRS states that bitcoin is property and not currency for tax purposes.

The Davis Tax Commission (2014:56) reported that the Canadian government took the position that bitcoins were not a legal tender and further stated that taxpayers had to look to the rules surrounding barter transactions and also consider whether income or capital treatment arise on bitcoin trading.

The Australian 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. In an article by Kearns (2014:2), it was mentioned that the ATO cited two court cases and concluded that bitcoins were not currency on the basis that the use at the time and acceptance of bitcoins in the community were not sufficiently widespread and that bitcoins were not generally accepted as a medium of exchange. In addition, the supply of bitcoins will not attract General Sales Tax (GST) and paying for goods and services by bitcoins

will be regarded as a barter transaction (Court, 2015). Businesses will need to record the value of bitcoin transactions as part of their ordinary income (Kearns, 2014:2).

Submissions have also questioned what would happen if bitcoin became more widely accepted in the community as a medium of exchange: would the current tax treatment as an asset be revised to include bitcoins as foreign currency for tax purposes? (Kearns, 2014:2-3). Kearns (2014:3) views that by treating bitcoins as foreign currency for tax purposes and applying the same rules for taxing, the foreign currency gains and losses will provide more certainty in the taxation of gains and losses on the value changes that are not dependent on the characterisation of whether the particular bitcoin is a revenue asset or a capital asset.

1.4 AN OVERVIEW OF THE BITCOIN SYSTEM

Bitcoins are generated through the process of mining (Blundell-Wignall, 2014:8; CoinDesk, 2014; Goodspeed, 2014:1). A bitcoin transaction can take place between two people anywhere in the world, instantly, securely, with very low transaction fees and without the need for an intermediary, such as a bank (Goodspeed, 2014:2). The bitcoin network collects sets of the transactions in a form of a block. For a block to be validated, the miners compete to solve a complex cryptographic algorithm associated with the block. Once the algorithm has been solved, the block is validated and added to the block-chain (the general ledger) and the miner is rewarded in the form of 25 bitcoins per block. A transaction is irreversible once added to the block-chain.

A limit of 21 million bitcoins was part of the original algorithm. At the current rate of mining, this number is expected to be reached in 2140 (Kearney, 2014:1). There are currently (09 November 2015) 14,8 million bitcoins in circulation with a market capitalisation of USD \$5,7 billion (Blockchain info, 2015(a)-(b)).

Beside mining bitcoins, users can obtain bitcoins by buying those already in circulation from others or through a bitcoin exchange, such as BitX, or by accepting bitcoins as payment for goods and services (Goodspeed, 2014:3).

Bitcoins are stored in the form of electronic wallets, which serve a similar purpose as physical wallets or bank accounts. There are three main types of wallets, namely a software wallet stored on a computer's hard drive, mobile wallets that run as an application on a smartphone and web-based wallet services. Each wallet contains a

transparent public key (address) on the network. For every public key in the wallet, there is one private key that allows the spending of the funds of that address through a cryptographic digital signature affixed to a transaction. The private key is only known to the bitcoin owner. The public key is public information and is used by miners to validate transactions and to ensure that bitcoins are not spent more than once (Goldman Sachs, 2014:12; Goodspeed, 2014:3). The privacy of transacting with bitcoins in not revealing personally identifiable information may result in money laundering activities (Goodspeed, 2014:1).

1.5 MOTIVATION OF TOPIC ACTUALITY

The Davis Tax Committee (DTC), in its first interim report on Base Erosion and Profit Shifting (BEPS), stated that the use of virtual currencies such as bitcoins, was growing and South African legislators were encouraged to consider the potential impact of virtual currencies on tax compliance and monitor international developments to determine the most suitable approach for South Africa (Davis Tax Committee, 2014:56).

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 either transactions or investments. Due to the absence of specific laws or regulations to address the use of virtual currencies in South Africa, no legal protection or recourse are afforded to users of virtual currencies (National Treasury, 2014:1-4).

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 cryptocurrency world and using anonymity to evade taxes (Blundell-Wignall, 2014:12). This classification of bitcoins as a commodity is similar to a capital asset, for example stock, bonds and commodities, in other words an asset for Capital Gains Tax (CGT) purposes (Blundell-Wignall, 2014:12; Drawbaugh & Temple-West, 2014). According to Drawbaugh and Temple-West (2014) the IRS expresses the view that the character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

1.6 PROBLEM STATEMENT

The current South African Income Tax Act (Act no. 58 of 1962) needs to be evaluated whether it is feasible to accommodate the taxability of transacting in bitcoins in South Africa. From the above, the following research question can be formulated as the problem statement: Should bitcoins be characterised as an asset or currency when exchanged for goods, services and real currency?

1.7 OBJECTIVE

To address the problem statement in paragraph 1.6 above, the following objectives are formulated to answer the research question:

1.7.1 Main objective

The main object is to determine whether bitcoins should be characterised as an asset or currency when exchanged for goods, services or real currency from a South African tax perspective.

As mentioned above, there are currently no published rulings, relevant publications or interpretation notes focusing on transacting in bitcoins in South Africa (Fin24, 2014).

1.7.2 Secondary objectives

The main objective in paragraph 1.7.1 above can be achieved by completing the following secondary objectives:

- i. A discussion of the characterisation of bitcoins as either property (assets) or currency, by referring to the following:

how the terms "asset" and "currency" are interpreted from a South African tax perspective and from the perspective of other governments. This discussion will be done in chapter two.

- ii. an analysis of the taxable income consideration on bitcoin exchange transactions in other governments specifically Australia and the United States for the following events:

- a. the receipt of bitcoins in exchange for goods and services (barter transactions);
and
- b. the sale of bitcoins in exchange for real currency.

This analysis will be done in chapter three.

- iii. critical analysis of the commentary provided by the OECD, Davis Tax Committee and the position expressed by the SARB as to the taxability of bitcoin exchange transactions (Davis Tax Committee, 2014:1-56; OECD, 2014:141-155; South African Reserve Bank, 2014:1-13). This analysis will be done in chapters four and five.
- iv. make possible recommendations or suggestions regarding the most suitable approach on how bitcoin exchange transactions should be taxed in South Africa. Possible recommendations and suggestions will be discussed in chapter six.

1.8 RESEARCH DESIGN

The research will be an applied descriptive 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 (London's Global University, 2015). Through descriptive research information is collected that will demonstrate relationships and assist in describing the world as it exists (Office of Research Integrity, 2014). The descriptive research will be supported by an exploratory research and will be qualitative in nature. The objective of an exploratory research is to provide details where a small amount of information exists (BusinessDirectory, 2015).

For the purpose of this research, a specific research question exists, which needs to be answered. To make a recommendation or offer a suggested solution to the question or problem, an analysis of the taxable income consideration on bitcoin exchange transactions in developed countries and an evaluation of the appropriateness of the current income tax position in South Africa will be needed. Exploratory research will be conducted in support of the descriptive research as there are no published rulings, relevant publication or interpretation notes available in South Africa with the focus on bitcoin exchange transactions.

The method of data collection for research will be the evaluation of secondary data, for example, academic journals, court cases, theses and reports published previously.

These will be used, analysed and compared. Secondary data is the data that has already been collected by and is readily available from other sources (MSG Team, 2015).

The main research objective will be achieved by performing a non-empirical study (Mouton, 2012:54) (literature review) to understand the current tax position in South Africa, with regards to the classification of bitcoins either as an asset or currency for bitcoin exchange transactions that may result in taxable income.

The secondary objectives will also be achieved by a non-empirical literature review on the tax position, with regards to bitcoin exchange transactions in developed countries. Two countries will be selected to complete the literature review. The countries that will be analysed during this study will include Australia and the United States of America.

The analysis that will be presented in respect of the abovementioned countries will include:

- a) How these countries interpret the terms "asset" and "currency";
- b) how these countries determine the taxability of bitcoin exchange transactions; and
- c) comparing the above with the South African tax position.

The abovementioned countries will be selected for the following reasons:

- a) These countries are currently leading the way in the classification and interpretation of bitcoins within the taxation environment;
- b) since bitcoins were first launched in 2009, these countries developed views, interpretations and guidance to taxpayers dealing and transacting in bitcoins;
- c) these countries' taxation systems compare well with the South African taxation system, in that they apply similar principles to that of South Africa, namely the resident basis for taxation purposes and Value Added Tax (VAT), as well as Capital Gains Tax (CGT) principles; and
- d) both countries are members of the OECD.

1.9 OVERVIEW

Listed below are the chapters that will be included in the study and a brief overview of its contents.

CHAPTER 1

Introduction, background, research question and objectives, research methodology

The objective of this chapter is to determine the problem statement and research objectives that the study has to achieve.

CHAPTER 2

The meaning of "asset" and "currency"

The terms "asset" and "currency" will be discussed particularly with regards to the extent of its meaning. This discussion will be done referring to, *inter alia*, the ordinary dictionary meaning of the words and the OECD and Davis Tax Committee commentary (Davis Tax Committee, 2014:1-56; OECD, 2007:44,163). A comparison will be drawn between how the taxation authorities of the United States and Australia, the OECD and South Africa are defining "asset" and "currency" to create a focus for this research.

CHAPTER 3

Taxability of bitcoin exchange transactions in Australia and in the United States

The objective of this chapter is to understand how these countries have considered the tax implications on bitcoin exchange transactions. By obtaining a better understanding of how these countries view 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 South Africa. Based on the view of what is considered an "asset" and "currency" as discussed in chapter two, characterising of the potential gain or loss on the sale or exchange of bitcoins will be analysed for the purposes of chapter three.

CHAPTER 4

Income tax considerations of bitcoin exchange transactions within the South African environment

The objective of this chapter is to understand how the tax legislation in South Africa is currently operating and how amendments can be introduced to create a sufficient base for the taxation of bitcoin exchange transactions in South Africa.

CHAPTER 5

Current South African regulation available to address bitcoin exchange transactions

The purpose of this chapter is to analyse the current monetary regulations available and to consider the commentary provided by the OECD and the Davis Tax Committee to address bitcoin exchange transactions.

CHAPTER 6

Recommendations to create a sufficient base for the taxation of bitcoin exchange transactions in South Africa

In this chapter, recommendations will be provided with regards to the international developments in determining the most suitable approach for South Africa.

CHAPTER 7

Summary and conclusion

This chapter will provide a summary of the findings in chapters 2 to 6 and will provide a conclusion as to:

- a) Whether bitcoins should be considered as an "asset" or "currency" for bitcoin exchange transactions; and
- b) whether the tax legislation in South Africa is sufficient for the taxation of bitcoin exchange transactions in South Africa.

CHAPTER 2: THE MEANING OF "ASSET" AND "CURRENCY"

2.1 INTRODUCTION

In this chapter the main and secondary objectives (paragraph 1.7.1 and 1.7.2 (i)) will be considered. In other words, the terms "asset" and "currency" will be discussed particularly with regards to the extent of their meaning. Before considering the meaning of "currency", it is important to note the difference between "currency" and "money" (Maloney, 2013). There is no globally-recognised standardised definition of "currency" or "money" (Norton Rose Fulbright, 2015:10).

Maloney (2013) explained that currency is a medium of exchange; a unit of account; it is portable, durable, divisible and fungible, whereas money carries all of the abovementioned characteristics, but in addition, is a store of value over a long period of time. He also points out that gold and silver have proven over thousands of years to be the ultimate store of value and therefore makes it the optimum form of money; they are limited in quantity and is the reason that they maintain their purchasing power.

The International Monetary Fund also defines 'money' as store of value, unit of account, or medium of exchange (Asmundson & Oner, 2012).

Before 1971 the US currency was backed by gold, meaning that foreign governments were able to take the US currency and exchange it for gold with the US Federal Reserve (Investopedia, 2013). On August 15, 1971 the former US President Richard Nixon cut the last ties between gold and the US currency, and as a result, fiat currency was created (Bullion, 2013).

The European Central Bank (ECB) defines "fiat currency" as any legal tender designated and issued by a central authority that people are willing to accept in exchange for goods and services simply because they trust this central authority (European Central Bank, 2012:9-10). Similarly, Maloney (2013) explains that fiat currencies are based solely on confidence and will always return to their intrinsic value of zero; they are not backed by gold or silver. As a result of the above, governments can now print more of the fiat currency and thus dilute the currency supply contributing to rising prices, otherwise known as inflation (Maloney, 2013).

The ECB (European Central Bank, 2015:25) recently revised its definition of "virtual currency" based on observing the characteristics of virtual currency since it issued its

previous report in 2012 on virtual currency schemes. The ECB now refers to virtual currency as “a digital representation of value, not issued by a central bank, credit institution or e-money institution, which, in some circumstances, can be used as an alternative to money.” Similarly, PricewaterhouseCoopers (PwC) (Musiala, 2015:2,5) refers to cryptocurrency (paragraph 1.1) as now being perceived having inherent value which includes the technology and network itself, the integrity of the cryptographic code and the decentralised network. Furthermore, the perceived inherent value instils confidence as it carries attributes in common with other longstanding stores of value such as gold and silver. It is worth noting that the inherent value of cryptocurrency as an alternative method to store and transmit units of value has gained acceptance from critical mass of investors, technologists, regulators, merchants, entrepreneurs and consumers (Musiala, 2015:5).

In its report on the evolving cryptocurrency market, PwC (Musiala, 2015:12) reports that governments’ attitudes around the world with regards to cryptocurrency are inconsistent when it comes to the classification, treatment and legality of this technology. Consequently, the classification of cryptocurrency as currency, capital asset, security and commodity has become the most imminent regulatory hurdle to date (Musiala, 2015:13).

Ramasastri (2014) cited two USA court cases which ruled that Bitcoin is money. The court concluded in the SEC v Shavers case that bitcoins “can be used to purchase goods or services and ...to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the US dollar, Euro, Yen and Yuan”. The court further ruled that Bitcoin investments meet the definition of investment contract, and as such are securities”. In the other USA court case namely Silkroad (cited by Ramasastri, 2014), the defendant was charged in 2013 with unlawfully operating an unlicensed money transmitting business. The court relied on upon the dictionary meaning of the term “money” and concluded that Bitcoin qualifies as “money” as it “can be easily purchased in exchange for ordinary currency, acts as a denominator of value, and is used to conduct financial transactions”.

2.2 ORDINARY DICTIONARY MEANING OF THE TERMS "ASSET" AND "CURRENCY"

The Dictionary of Business and Management (2009) defines the term "asset" as "any object, tangible or intangible, that is of value to its possessor". Similarly, "asset" is defined by the Merriam-Webster Dictionary (2015(a)) as "an item of value owned".

The Merriam-Webster Dictionary (2015(b)) defines the term "currency" as "something (as coins, treasury notes, and banknotes) that is in circulation as a medium of exchange".

The Collins English Dictionary (2012) defines the term "currency" in essence as

- "a metal or paper medium of exchange that is in current use in a particular country;
- general acceptance or circulation;
- the period of time during which something is valid, accepted or in force; and
- the act of being passed from person to person; and
- the local medium of exchange".

The abovementioned dictionary meanings of the terms "asset" and "currency" implies in summary that

- a) for something to be classified as an asset, it needs to bear value to the owner; in other words, in the context of money as being a store of value and gold and silver being regarded as the ultimate form of money, gold and silver may be considered as assets due to their properties and inherent value (Maloney, 2013); and
- b) currency is a valid medium of exchange and does not bear value; the term "currency" therefore, is based solely on confidence as a legal form of tender which people are willing to accept in exchange for goods and services (European Central Bank, 2012:10).

While the dictionary meanings provide some guidance on the meaning of these terms, the meaning of these terms should however also be considered within the context of a government's tax legislation. For the purpose of this study, the following paragraphs consider the meaning of "asset" and "currency" in the context of the tax legislation of South Africa, Australia and the United States.

2.3 SOUTH AFRICAN INCOME TAX ACT

2.3.1 Asset

Paragraph one of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) 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 South African Revenue Services’ (SARS) guide on CGT (McAllister, 2014:43) also states that, as 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.

The term “trading stock”, on the other hand, is defined in section 1 of the South African Income Tax Act (Act no. 58 of 1962) 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 (McAllister, 2014:36) 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.

In terms of the South African tax legislation, an asset for taxation purposes, excludes currency, but includes coins made from gold or platinum because of their value and properties. In this context, the definition of an “asset” can be compared to the dictionary meaning of an asset as having a value to its possessor (paragraph 2.2).

2.3.2 Currency

Although the term “currency” is not defined in the South African Income Tax Act (Act no. 58 of 1962), in paragraph (b) of section 24I of the South African Income Tax Act (Act no. 58 of 1962) “local currency” is defined as “currency of the Republic”. This section defines “foreign currency” on the other hand as “...any currency which is not local currency”.

2.4 SOUTH AFRICAN RESERVE BANK (SARB) ACT

The South African Reserve Bank Act does not define the terms "asset" and "currency". However, section 17 of the South African Reserve Bank Act (Act no. 90 of 1989) defines the term "legal tender" as "A tender, ... shall be a legal tender of payment of an amount equal to the amount specified on the note...A tender, ... shall be a legal tender of payment of money –

- (a) In the case of gold coins, ... shall be equal to the net amount at which the bank is prepared to purchase that gold coin on the day of such tender thereof; and
- (b) in the case of other coins, ... the value of each coin so tendered shall be equal to the amount specified on that coin."

Only an un-defaced and un-mutilated banknote or coin, which is lawfully in circulation in the Republic of South Africa, shall be a legal tender, whereas a gold coin on the other hand may be purchased by the SARB at the value of that which the SARB is willing to pay for on the day of such tender (South African Reserve Bank, 2014:4).

In its position paper issued on electronic money (South African Reserve Bank, 2009:3), the SARB defines electronic money as "monetary value represented by a claim on the issuer. This money is stored electronically and issued on receipt of funds, is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account on demand."

This definition appears to be in contrast with the meaning of the term "money" as discussed in paragraph 2.1, as "money" refers to gold and silver being the ultimate form of money because of their intrinsic value (Maloney, 2013). The definition of electronic money as documented in the position paper (South African Reserve Bank, 2009:3) refers to the terms "generally accepted as a means of payment", which are similar to the dictionary meaning of "currency" in paragraph 2.2.

2.5 DAVIS TAX COMMITTEE AND OECD

2.5.1 Davis Tax Committee

The Davis Tax Committee (DTC) was established by the Minister of Finance on 17 July 2013 with the objective to assess South Africa's tax policy framework and its role

in supporting the objectives of inclusive growth, employment, development and fiscal sustainability. On the international front, the DTC is required to address concerns about “based erosion and profit shifting” (BEPS). Consequently the DTC established a BEPS sub-committee which prepared an interim report on BEPS in South Africa (Davis Tax Committee, 2014:1; Kalla, 2015).

In its recent interim report on preventing BEPS in South Africa, the DTC made no direct reference to the definition or interpretation of the terms “currency” and “asset”, but made extensive reference to the OECD BEPS report which explains bitcoin to policymakers and the challenges faced by governments in the bitcoin economy (Kalla, 2015). In summary, the report concluded that:

- a) The use of virtual currencies such as bitcoins is not yet widespread but it is recommended that South African legislators consider the potential impact of virtual currencies on tax compliance and to also monitor international developments to determine the most suitable approach in South Africa (paragraph 1.5); and
- b) current exchange controls appears to be in the short term a major defence against BEPS in relation to e-commerce, virtual currencies (bitcoin) and other forms of intangible related transfer functions (The Davis Tax Committee, 2014:56).

2.5.2 OECD

Although South Africa is not a member country of the OECD, it has been awarded observer status in 2004 and is also a member of the OECD BEPS Committee. As a result, the OECD’s recommendations and commentary on its Model Tax Convention (MTC) are not legally binding, but South African courts have recognised and applied the OECD Commentary (Davis Tax Committee, 2014:18).

The term “assets” is defined by the OECD’s glossary of statistical terms (OECD, 2007:44) as “entities functioning as stores of value and over which ownership rights are enforced by institutional units, individually or collectively, and from which economic benefits may be derived by their owners by holding them, or using them, over a period of time (the economic benefits consist of primary incomes derived from the use of the asset and the value, including possible holding gains/losses, that could be realised by disposing of the asset or terminating it)”.

It further defines the term "currency" as comprising "those notes and coins in circulation that are commonly used to make payments". The term "currency of transaction" is defined as "the medium of exchange in which an individual transaction occurs. It may be currency, goods, or services. The medium of exchange of one transaction (for example, disbursement) does not necessarily determine the medium of exchange of another (for example, repayment)."

2.6 INTERPRETATION OF "ASSET" AND "CURRENCY" USING VARIOUS COUNTRIES' DOMESTIC TAX LAW MEANINGS

2.6.1 Australia

2.6.1.1 Asset

The term "CGT asset" is defined in subsection 108-5(1) in the Income Tax Assessment Act (Act no. 38 of 1997) (ITAA) as "any kind of property; or a legal equitable right that is not property". The term "foreign currency" is specifically included in a list of examples of CGT assets included in subsection 108-5(2). In the case *Yanner v. Eaton*, (cited by Commissioner of Taxation, 2014(a):3-4) the High Court accepted that property refers not to a thing but a description of a legal relationship with a thing and that "property" consists of control over access. With regards to the term "property right", Taxation Determination (TD) TD 2014/26 refers to the Ainsworth test to identify a property right. This test asks whether a right is definable, identifiable and capable of assumption by third parties and permanent or stable to some degree.

The term "trading stock", on the other hand, is defined in subsection 70-10(1) of the ITAA (1997) and includes "anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business..." The term "anything" is not defined in the ITAA (1997) and therefore the Commissioner considers the ordinary meaning of the term when considering it in its legislative context. In the case *Federal Commissioner of Taxation v. Suttons Motors (Chullora) Wholesale Pty Ltd* (cited by Commissioner of Taxation, 2014(c):3) it was held that intangible property such as shares are capable of being trading stock. In another case, *John v. Federal Commissioner of Taxation* (cited by Commissioner of Taxation, 2014(c):3-4), it was held that the trading activity to which the definition applies involves the passing of a proprietary interest in the things traded.

2.6.1.2 Currency

Section 995-1 of the ITAA (1997) defines the term "foreign currency" as "a currency other than Australian currency". TD 2014/25 (Commissioner of Taxation, 2014(b):3) states that the terms "currency" and "Australian currency" are not defined in the Assessment Act and therefore take their ordinary meaning having regard to their context and the legislative purpose. As a result, these terms have legal meaning under the Australian law by virtue of the Currency Act 1965. In *Leask v. Commonwealth* (cited by Commissioner of Taxation, 2014(b):5-9), Brennan stated that "Currency consists of notes or coins of denominations expressed as units of account of a country and is issued under the laws of that country for use as a medium of exchange of wealth." TD 2014/25 (Commissioner of Taxation, 2014(b):8) further explains that the meaning of "the currency of Australia" under the Currency Act is the monetary unit established by the Act as the requisite unit of account, and means of discharging monetary obligations, for all transactions and payments that are not made according to the currency of another country.

In summary, the terms "asset" and "currency" appears to have the similarities noted in the dictionary meaning in paragraph 2.2, in that the term "asset" has an element of value whereas the term "currency" has a medium of exchange element.

2.6.2 United States of America (US)

2.6.2.1 Asset

The term "asset" is not defined in the US Internal Revenue Code (IRC), but reference is made to the meaning of "capital asset" in section 1221 of the IRC (1986) and includes property held by the taxpayer (but does not include inventory for sale to customers in the ordinary course of trade or business), depreciable property and real property used in the taxpayer's trade or business, accounts and notes receivable in the ordinary course of trade or business, certain intellectual property and supplies regularly used or consumed by the taxpayer in the ordinary course of trade or business, and certain other less commonly encountered assets.

2.6.2.2 Currency

Section 988 of the IRC (1986) provides for the treatment of foreign currency transactions. Accordingly the phrase "section 988 transaction" refers to "any transaction... if the amount

which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction ... is denominated in terms of a non-functional currency, or ... is determined by reference to the value of one or more non-functional currencies”.

Under International Financial Reporting Standards (IFRS), 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 (Accounting Tools, 2016). On the contrary, a non-functional currency is a currency other than in which an entity transacts, resulting in foreign gains or losses (International Financial Reporting Tool, 2016).

2.6.2.3 Internal Revenue Services (IRS) Notice 2014-21 (Keith, 2014:1-6)

The IRS Notice 2014-21 (Keith, 2014:1) describes how existing tax principles apply to transactions using virtual currency. The Notice is limited in scope and only addresses the US federal income tax consequences of *convertible* virtual currency transactions and not any other types of virtual currency transactions (Langhirt *et al.*, 2014).

The Notice (Keith, 2014:1) defines the term "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". In addition, the Notice (Keith, 2014:1) defines the term "real currency" as "the coin and paper money of the United States or of any other country that is designated as a legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance..."

The term "convertible virtual currency" on the other hand is defined in the Notice as having "an equivalent value in real currency, or that acts as a substitute for real currency" (Keith, 2014:1).

Based on the definition of "capital asset" in section 1221 of the IRC (1986), the following applies: if a taxpayer held the convertible virtual currency as a capital asset, like stocks or bonds, then the taxpayer may realise a capital gain or loss on the sale or exchange of the convertible virtual currency. In contrast, if not held as a capital asset, realisation of an ordinary gain or loss on the sale or exchange of the currency will occur (Lambert, 2015:13-14).

2.7 FINANCIAL ACTION TASK FORCE INTERPRETATION OF THE TERM "CURRENCY"

The Financial Action Task Force (FATF) is an inter-governmental body established in 1989 by the ministers of its member jurisdictions to combat terrorist financing, in addition to money laundering. Member jurisdictions include those of Australia, South Africa and the United States.

In its latest report on virtual currencies (Financial Action Task Force, 2015:26-27), the FATF, defined various terms in the digital environment:

"Virtual currency is a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment in any jurisdiction)."

"Fiat currency (a.k.a. "real currency," "real money," or "national currency"),

... is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. E-money is a digital transfer mechanism for fiat currency- i.e., it electronically transfers value that has legal tender status."

"Convertible (or open) virtual currency has an equivalent value in real currency and can be exchanged back-and-forth for real currency. Examples include: Bitcoin; e-Gold (defunct); Liberty Reserve (defunct); Second Life Linden Dollars; and WebMoney."

2.8 CONCLUSION

The terms "asset" and "currency" were discussed particularly with regards to the extent of their meaning and the relevant principles which are associated with these terms.

It is of great importance to note the difference between the terms "currency" and "money" as explained in paragraph 2.1. The term "money" refers to a store of value over a long period of time and is similar to the dictionary meaning of an asset which is "an item of value owned".

It is worth noting that the dictionary meaning of the terms "asset" and "currency" is similar to the interpretation of the tax legislation of both Australia and the USA. The OECD (2007) shares the same view. What is of particular interest is that the term "foreign currency" is included in the definition of "capital asset" as defined in the Australian tax legislation.

The South African tax legislation on the other hand excludes the term "currency" from the definition of an "asset" as defined in Schedule Eight of the South African Income Tax Act (Act no. 58 of 1962), but regard the term "trading stock" as part of the definition of the term "asset".

Furthermore, the term "virtual currency" is being defined by the IRC (1986), FATF (Financial Action Task Force, 2014:4) as well as the European Central Bank (European Central Bank, 2015:25) as having characteristics of both the terms "asset" and "currency" such as

- a medium of exchange (currency);
- a unit of account (currency); and / or
- a store of value (asset), but with no legal tender status.

In order to obtain a better understanding of the application of the terms contained in this chapter, Australia and the US have been selected to understand how these countries have considered the tax implications on bitcoin exchange transactions. This will be focussed on in the following chapter.

CHAPTER 3: TAXABILITY OF BITCOIN EXCHANGE TRANSACTIONS IN AUSTRALIA AND THE UNITED STATES

3.1 INTRODUCTION

Based on the view of what is considered an asset and a currency as discussed in chapter two, characterising the potential gain or loss on the sale or exchange of bitcoins will be analysed for the purposes of chapter three. In this chapter the secondary objective specified in paragraph 1.7.2 (ii) will be addressed. In other words, this chapter aims at establishing an understanding of how countries such as Australia and the US have considered the tax implications on bitcoin exchange transactions.

3.2. TAXABILITY OF BITCOIN EXCHANGE TRANSACTIONS IN AUSTRALIA

3.2.1 Current legislation and regulation

3.2.1.1 Australian Taxation Office (ATO)

The ATO released a guidance paper on the taxation treatment for transactions associated with crypto-currencies, specifically bitcoin (Australian Taxation Office, 2014). The ATO's view is that bitcoin is neither money nor foreign currency for income tax purposes and that it is regarded as an asset for CGT purposes. This view is based on the fact that the current use and acceptance of bitcoins in the community is not sufficiently widespread and that it is not a generally accepted medium of exchange (Kearns, 2014:2). The ATO based the guidance paper on several published taxation determinations (TDs), namely

- TD 2014/25: Income tax: is bitcoin a foreign currency for purposes of Division 775 of the Income Tax Assessment Act 1997?
- 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?
- TD 2014/27: Income tax: is bitcoin trading stock for the purposes of subsection 70-10(1) of the Income Tax Assessment Act 1997?

Division 775 of the ITAA (1997) provides rules for recognising foreign currency gains and losses for income tax purposes for which the meaning of the term "currency" has been discussed in paragraph 2.6.1.2. TD 2014/25 goes further, stating that "As bitcoin is not a foreign currency, Division 775 does not apply and transactions involving bitcoin give rise

to the same tax consequences as other barter transactions” (Commissioner of Taxation, 2014(b):9). The tax consequences of bitcoin exchange transactions in the context of TDs 2014/25-27 (Commissioner of Taxation, 2014:(a)-(c)) as well as the Taxation Ruling IT 2668 (Commissioner of Taxation, 1992(a)) on bartering are discussed in paragraph 3.2.2.

More recently the Australian Senate Economics Reference Committee presented a comprehensive report “Digital Currency – Game Changer or Bit Player” in August 2015. With particular reference to digital currencies under the Australian tax law, the committee was to establish a framework for regulating and taxing virtual currencies in a way that promotes the growth of the industry. In addition to the above, the committee was also tasked to address the protection of consumers and stability in this sector, amongst others (Senate Economics References Committee, 2015:1).

The report contains a recommendation that digital currency be treated as money for the purposes of the goods and services tax (GST) and that virtual currency transactions be treated in the same way as national currency transactions for GST purposes (Senate Economics References Committee, 2015:34). The impact of bitcoin transactions for GST purposes is excluded from the scope of this study. However, the differing views of whether digital currencies should be treated the same way as foreign currencies for income tax and CGT purposes have been expressed in the report and is worth noting and are addressed in paragraph 3.2.4.

3.2.1.2 Reserve Bank of Australia (RBA)

In its recent statement on 7 April 2015, the RBA reported that while bitcoins do not constitute legal tender in Australia, there is nothing to prevent two parties from agreeing to settle a payment using a digital currency. However, the RBA did point out, that in the event that it deems it necessary to take regulatory action in the payments system aspects of digital currencies, the international character of such systems could place constraints on its ability to act unilaterally (Emercy & Richards, 2015:1).

3.2.1.3 The Australian Treasury Department (ATD)

The Australian Treasury Department (2014:3) reported that the use of bitcoins for illicit transactions or money laundering remains an issue of law enforcement, rather than payment system regulation.

3.2.2 Taxable income consideration on bitcoin exchange transactions

The following bitcoin exchange transactions will be discussed in context of the current Australian income tax legislation, related rulings and relevant case law.

3.2.2.1 Receipt of bitcoins in exchange for goods and services (barter transactions)

3.2.2.1.1 What is “bartering”?

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...” (Commissioner of Taxation, 1992(a):1).

3.2.2.1.2 Consideration for inclusion in assessable income

Section 25A of the ITAA (1997) 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. 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) represents assessable income which depends upon the nature of the consideration in the hands of the recipient (Commissioner of Taxation, 1992(a):2). Therefore, only those transactions which arise from the carrying on of a business would qualify as consideration and be regarded as assessable income.

Section 21(1) of the ITAA (1997) specifically states 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”. This principle has also been confirmed in the case *F.C. of T. v. Cooke & Sherden* 80 ATC 4140; 10 ATR 696, (cited by Commissioner of Taxation, 1992(a):4)) whereby the consideration from a barter transaction would “in most cases” be in the form of money’s worth.

3.2.2.1.3 What if consideration received under bartering is not assessable income?

IT 2668 suggests that where the transaction involves the disposal or acquisition of an asset, the CGT provisions may apply (Commissioner of Taxation, 1992(a):4).

3.2.2.1.4 Valuation

Section 21A(2) of the ITAA (1997) requires that where a non-cash business benefit (whether or not convertible to cash) is income derived by a taxpayer

- (a) the benefit shall be brought into account at its arm's length value reduced by the recipient's contribution (if any); and
- (b) if the benefit is not convertible to cash - in determining the arm's length value of the benefit, any conditions that would prevent or restrict the conversion of the benefit to cash shall be disregarded.

Section 21A(5) of the ITAA (1997) further defines the term "arm's length value" as:

- (a) The amount that the recipient could reasonably be expected to have been required to pay to obtain the benefit from the provider under a transaction where the parties to the transaction are dealing with each other at arm's length in relation to the transaction; or
- (b) if such an amount cannot be practically determined - such amount as the Commissioner considers reasonable.

In other words, the valuation of the consideration arising from a barter transaction will be the market value reflecting the money value or arm's length value as applicable (Commissioner of Taxation, 1992(a):4). 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 (Commissioner of Taxation, 2014(b):9).

With attention to the fluctuation of the Australian dollar value of bitcoin transactions between the time the taxpayer acquires and disposes the bitcoin, such fluctuations may

give rise to ordinary income or CGT consequences. This will depend on the particular facts and circumstances of the taxpayer as stated in TD2014/25 (Commissioner of Taxation, 2014(b):9).

3.2.2.1.5 Deductions

Section 51AK(1) of the ITAA (1997) determines the deductibility of expenses as follows:

- a) Under an agreement:
 - i. a taxpayer incurs expenditure; and
 - ii. a non-cash business benefit is provided to the taxpayer or another person; and
- b) that benefit is not exclusively for use or application for the purpose of producing assessable income of the taxpayer; the taxpayer shall be treated, for the purposes of this Act, as if so much of the expenditure as does not exceed the arm's length value of the benefit had been incurred by the taxpayer exclusively in respect of that benefit.”

Therefore, the deduction of expenses in the form of a non-cash business benefit may not exceed the arm's length value of the benefit.

3.2.2.1.6 Sale of bitcoins in exchange for real currency

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. Accordingly, any expenses incurred in respect of the exchange service will be allowed as a deduction. It furthermore states that when a taxpayer carries on a bitcoin exchange service, the bitcoins will be considered trading stock which will result in the taxpayer to bring into account any bitcoins on hand at the end of each income year as part of assessable income (Australian Taxation Office, 2014).

Bitcoins held by a taxpayer carrying on a business of mining and selling bitcoins, or a taxpayer carrying on a bitcoin exchange business will therefore be considered trading stock as defined under subsection 70-10(1) of the ITAA (1997) (Commissioner of Taxation, 2014(c):4).

3.2.2.2 Disposing of bitcoins - considered for both bartering and exchange transactions

3.2.2.2.1 CGT asset

With reference to the definition of the term "CGT asset" as "property" or "property rights" (paragraph 2.6.1.1), TD 2014/26 recommends that for bitcoins, the bitcoin holding rights, in other words, the rights ascribed to a person with access to the bitcoins under the bitcoin software, are property in nature. To support this conclusion, factors such as bitcoins being treated as valuable items by a community of bitcoin users, an active market and the fact that a significant amount of currency changes hands between transferors and transferees of bitcoin are compelling. Bitcoin holding rights are therefore definable, identifiable by third parties, capable of assumption by third parties and sufficiently stable as per the Ainsworth test mentioned in paragraph 2.6.1.1 (Commissioner of Taxation, 2014(a):4).

Based on the above and with regard to the definition of the term "CGT asset", bitcoins amount to property- within the meaning of paragraph 108-5(1)(a) of the ITAA (1997).

3.2.2.2.2 CGT event

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" under subsection 104-10(1) of the ITAA (1997). Accordingly, 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.

Subsection 118-10(3) of the ITAA (1997) further states that a capital gain made from a personal use asset is disregarded if the cost base of the bitcoin is USD \$10 000 or less. As a result, no income tax implications exist if the taxpayer is not in business or carrying on an enterprise when goods or services are paid for in bitcoin. Examples of personal use assets are when bitcoins are used mainly to make online purchases of items for personal use or consumption such as clothing or music. In contrast, when bitcoins were purchased to facilitate the purchase of income producing investments, they would not be personal used assets, for example, when an individual taxpayer mines bitcoins and keeps

those bitcoins for a number of years with the intention of selling them at opportune times based on favourable rates of exchange (Commissioner of Taxation, 2014(a):5-6).

3.2.2.2.3 Purpose and use

TD 2014/26, paragraph 18 to 22, 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 (Commissioner of Taxation, 2014(a):6). 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.

To support the guideline of TD 2014/26, Taxation Ruling 92/3 considers the other extreme where an isolated transaction is not carried out as part of a business operation (Commissioner of Taxation, 2014(a):6; Commissioner of Taxation, 1992(b):2): a profit (gain) from an isolated transaction is generally income when both the following elements are present:

- a) “the intention or purpose of the taxpayer in entering into the transaction was to make a profit or a gain; and
- b) the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction. “

The following important factors should be considered to determine whether an isolated transaction amounts to a business operation or commercial transaction (The Commissioner of Taxation, 1992(b):12):

- The nature of the entity undertaking the operation or transaction;
- the nature and scale of other activities undertaken by the taxpayer;
- the amount of money involved in the operation or transaction;
- the nature, scale and complexity of the operation or transaction;
- the manner in which the operation or transaction was entered into or carried out;
- the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;
- if the transaction involves the acquisition and disposal of property, the nature of that property; and

- the timing of the transaction or the various steps in the transaction.

In applying the above factors to bitcoins, the amount of money involved in the mining (acquisition) and disposal of bitcoins plays a key role. To support this role, the intention of profitmaking, the length of time the bitcoin is held and whether the bitcoins were held as an object of trade, are to be considered when determining whether bitcoins were held for personal or business use (Commissioner of Taxation, 2014(a):7).

3.2.2.2.4 Possible lack identified in guidelines and TDs

The ATO guidelines and rulings do not 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 (Kearns, 2014:2-3).

3.2.3 Reporting of taxes relating to bitcoin exchange transactions

The ATO guidance paper recommends that the following records be kept with regards to bitcoin transactions (Australian Taxation Office, 2014):

- the date of the transaction;
- the amount in Australian dollars (which can be taken from a reputable online exchange);
- what the transaction was for; and
- who the other party was (even if it's just their bitcoin address).

3.2.4 Current developments

3.2.4.1 A shift towards treating bitcoins as foreign currency for income tax purposes

In its submission to The Economics References Committee, the Australian Tax Institute claimed that the ITAA (1997) defines foreign currency to be currency other than Australian currency, and pointed out that if a foreign country decided to adopt bitcoins as legal tender, a situation would arise whereby bitcoins would fall within the meaning of

"currency of a foreign country" and "currency other than Australian currency" (Senate Economics References Committee, 2015:34).

Similarly, the Australian Digital Currency Commerce Association (ADCCA) supports this view and recommended that the definition of "currency" in the ITAA (1997) should be expanded to include digital currency. This will result in applying the same rules for taxing the foreign currency gains and losses under Division 775 of the ITAA (1997). This would provide more certainty in the taxation of the gains or losses on the value changes that is not dependent on the characterisation of whether the particular bitcoin is a revenue asset or a capital asset (Kearns, 2014:3).

3.2.4.2 Committee view: Economics References Committee

In conclusion to the issue at hand, it must be noted that whether bitcoins should be treated in the same manner as foreign currencies for income tax purposes, the committee recommended that further research and analysis should be conducted (Senate Economics References Committee, 2015:36).

3.2.5 Other compliance obligations

3.2.5.1 Payment of tax

Regulation 58 of the Income Tax Regulations (cited by Commissioner of Taxation, 1992(a):5) sets out the form in which tax may be paid, namely cash, cheques, bank notes, bank drafts, money orders, postal notes or tax stamps. Credit units arising from barter transactions are not acceptable forms of payment. Accordingly, as bitcoins are not a legal form of tender, nor are regarded as currency, it will not be accepted as a tender to settle tax obligations.

3.2.5.2 Private rulings

Bitcoins which are kept or used mainly for the purpose of profit-making or for carrying on a business, are not used or kept mainly for personal use and for these purposes the Commissioner advises in TD2014/26 that taxpayers seek private rulings (Commissioner of Taxation, 2014(a):6).

3.3 TAXABILITY OF BITCOIN EXCHANGE TRANSACTIONS IN THE USA

3.3.1 Current legislation and regulation

3.3.1.1 Internal Revenue Service (IRS)

3.3.1.1.1 Notice 2014-21

The IRS issued Notice 2014-21 on 25 March 2014 (paragraph 2.6.2.3) which provides guidance in the form of answers to frequently asked questions (Keith, 2014:1-6). According to Fuerst *et al.* (2014) notices such as Notice 2014-21 are public announcements which permits the IRS to state a position without having issued a Revenue Ruling and as such has no force and effect of law and do not bind courts.

3.3.1.1.2 Internal Revenue Code (IRC)

Gross income

Section 61 of the IRC (1986) states that “except as otherwise provided in this subtitle, gross income means all income from whatever source derived...”. Isom (2013:9) cited the landmark case, Commissioner v. Glenshaw Glass Co, in which it was determined that income under section 61 of the IRC (1986) has been realised and should therefore be taxed. Accordingly, the Supreme Court laid down that to determine if one has received gross income, a court looks at whether the taxpayer has undeniable accession to wealth, over which the taxpayer has complete control.

The first of the above mentioned requirements (accession to wealth), means that taxpayers have access to valuable resources. As bitcoins can be exchanged for real money on various internet platforms, they are considered as having value (Bal, 2013:355). PWC (Musiala, 2015:5) supports this view as bitcoins are being perceived as having inherent value (paragraph 2.1). Another view of bitcoins containing value is that of Fuerst *et al.* (2014), namely that bitcoins derive value from its finite nature, the effort required to generate new bitcoins, the value its users place on it and its acceptance as a medium of exchange. For realisation to take place (second requirement), a transaction with another party must occur that changes the taxpayer’s relationship to the asset (Bal, 2013:355). With regard to the third requirement, Bal (2013:355) cited the Supreme Court case, namely CIR v. Indianapolis P&L, where the key issue was identified as whether the taxpayer has some guarantee that he will be allowed to keep the funds: in other words, if

some other person can decide how, when, or whether the taxpayer can take actual possession, those funds are not income realized in the hands of the taxpayer. Accordingly the person who then buys bitcoins becomes their “owner” and can keep them in his on-line wallet or spend them as he sees fit and therefore can be regarded as realized income (Bal, 2013:355) .

In another interesting view on the concept of “accession of wealth” as contemplated above, Atkins *et al.* (2014:22) stated that when an individual creates something of value, they have increased their net worth. Atkins *et al.* (2014:41) further goes in stating that mining for bitcoins may be viewed as the creation of an asset, in other words, the miner eliminates the Federal Reserve Bank (FRB) within the U.S monetary system by creating and claiming original ownership of the bitcoin.

Currency

Section 988 of the IRC (1986) provides for the treatment of foreign currency transactions (paragraph 2.6.2.2). The IRC (1986) refers to the term “functional currency” as the US dollar. In their analysis of Notice 2014-21, Fuerst *et al.* (2014) explained that if bitcoins were to be classified as a currency, any gains or losses from exchanges of bitcoins for US dollars will result in recognition of ordinary income for income tax purposes, which in turn would cast significant worry for bitcoin users.

Furthermore, transacting in bitcoins for personal use, will qualify for an exclusion from the recognition of gains or losses for values not exceeding USD \$200 as determined by section 988(e) of the IRS - that is if bitcoins are treated as currency. The drawback of this policy is that a loss would be considered a non-deductible personal loss (Small, 2015:636).

Capital asset

Section 221 of the IRC (1986) is clear with regards to the definition of the term “capital asset” (paragraph 2.6.2.1). Whether an asset is capital depends on how it is held by a taxpayer (Fuerst *et al.*, 2014).

Section 1222 of the IRC (1986) differentiate between short term and long term capital gains and losses. Short term capital gains or losses are defined as gains and losses from the sale or exchange of a capital asset held for not more than one year while long term capital gains and losses arise from the sale or exchange of a capital asset held for more

than one year. Long term capital gains are generally taxed at a lower rate than ordinary income is taxed (Lambert, 2015:23).

3.3.1.1.3 US Federal Reserve System

Murphy *et al.* (2015:13) reported that the federal banking regulators have yet to issue guidance or regulations governing how banks are to deal with bitcoins. Under the current law, the federal banking regulator with the greatest responsibility over the payment system is the Board of Governors of the Federal Reserve System. Cited by Murphy *et al.* (2015:13) the Federal Reserve Chair, Janet Yellen, told the Senate Banking Committee in February 2014 that “Bitcoin is a payment innovation that’s taking place outside the banking industry. To the best of my knowledge there’s no intersection at all, in any way, between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate”.

Allen (2015:22) reported that the importance of legal tender status is perhaps overstated. Allen points out that, in the US, federal legislation provides that “United States coins and currency...are legal tender for all debts, public charges, taxes and dues,” but per the Treasury Department, this only means that such coins and currency are a legal offer of payment, meaning that no federal legislation requires that such coins and currency be accepted as payment. Allen (2015:22) also recommends that, as many countries, including the US and Australia, have ruled that bitcoins cannot serve as legal tender within their borders, it only means that written agreements to pay in bitcoins must be established upfront by contract.

3.3.1.1.4 The Department of Financial Crimes Enforcement Network (FinCEN)

FinCEN, a bureau of the U.S. Department of the Treasury, imposes anti-money laundering reporting requirements for exchangers and administrators, but not for users who obtains virtual currency to pay for goods and services (Kadochnikov, 2013). The administrator on the other hand is someone who has authority to issue and redeem virtual currency whereas an exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds or virtual currency (FinCEN, 2013:1). As from 18 March 2013, FinCEN (2013:1) requires exchangers and administrators to register as a Money Services Business (MSB), which is a type of business that provides various money related services to its customers in the form of check cashing or bill payments.

The definition also includes money transmitters, for example Western Union, Money Gram and PayPal (Kadochnikov, 2013).

Kadochinikov (2013) pointed out that with bitcoins a user can easily be considered an administrator, which must comply with reporting requirements. Mining of bitcoins may place someone in both user and administration categories, for example the miner becomes an administrator once he puts the bitcoin into general circulation, because now he is issuing virtual currency. Kadochinikov (2013) goes further in stating that FinCEN lacks the capability to enforce reporting requirements against every bitcoin miner and as a result will not be able to prosecute a bitcoin miner for not reporting all the bitcoins he generated.

Buntinx (2016) reported that software developers (software experts who transact exclusively using bitcoin) are not related to a MSB, even if the software code would make it easier to sell digital currency. In other words, these software developers as well as bitcoin miners are not responsible for accepting or transmitting money. No administrator is overseeing the Bitcoin protocol for FinCEN regulations, which also removes the need for software developers and bitcoin miners to register as a money transmitter. In Buntinx's (2016) opinion, FinCEN regulators could take a keen interest and decide to come up with a different set of rules for the future. Both bitcoin miners and developers could then be affected by these new guidelines, and it is impossible to predict what the consequences could be. The outcome could be either positive or negative for Bitcoin, miners, and developers, depending on how this block size debate turns out (Buntinx, 2016).

3.3.1.1.5 Bank Secrecy Act

Notice 2014-21 (Keith, 2014:1-6) makes no mention of the Bank Secrecy Act and its application to virtual currencies such as bitcoin (Fuerst *et al.*, 2014). The Bank Secrecy Act may require US persons to report a foreign financial account that exceeds the value of USD \$10 000 on an annual basis to the Department of Treasury by filing a FinCEN 114 Report: "Foreign Bank and Financial Accounts (FBAR)" (IRS, 2015(d)).

Section 1010.350 of the Code of Federal Regulations (CFR) (2015) defines the term "reportable accounts" to include bank accounts, securities accounts and "other financial accounts" which in turn include accounts with persons in the business of accepting

deposits, insurance accounts with a cash value or accounts with brokers or dealers in futures or options contracts.

Due to this definition, current FBAR reporting requirements do not address the treatment of bitcoin or other virtual currency, but the IRS is taking a stance toward taxpayers that fail to make the required disclosures (Fuerst *et al.*, 2014). The IRS requires all taxpayers with an FBAR filing requirement to report their foreign assets annually. With regards to a US person maintaining bitcoins in a form of a wallet on a computer server located abroad, in other words, not in a financial account or bank account, or is living abroad and keeping bitcoins on his personal computer, the question remains open whether the FBAR regulations will apply in this regard (Fuerst *et al.*, 2014).

3.3.1.1.6 State regulation

New York State

More recently (3 June 2015), New York State became the first state to establish a framework for regulating digital currency businesses, in other words, bitcoin exchanges such as itBit. The New York State Department of Financial Services (NYDFS) issued regulations providing supervision of virtual currency businesses operating in New York State (Murphy *et al.*, 2015:14-15). Final regulations require that businesses involved in transmitting, storing, buying, selling, exchanging, issuing or administering a virtual currency must be licensed by the NYDFS. Furthermore, the license will allow the bitcoin exchange for instance to bring in customers across the country in a legal manner, which then puts the onus of regulation on the State (Murphy *et al.*, 2015:15; PYMNTS, 2015).

California

The Department of Business Oversight (DBO), a state agency that regulates a variety of financial services including money transmitters, issued a statement on 27 January 2015 stating that “the ...Department...has not decided whether to regulate virtual currency transactions, or the businesses that arrange such transactions...” (Owen, 2015:1). Following the issue of this statement, Assembly Bill 1326 was introduced on 27 February 2015 and is currently being heard by the California Assembly with the aim of enacting the Virtual Currency Act. The purpose of Bill 1326 is to prohibit a person from engaging in California in the business of “virtual currency” without a license from the DBO, similar to the approach of the New York State (Broeker, 2015).

New Jersey

Bill 4478 titled “Digital Currency Jobs Creation Act” has been brought to the state legislature on 1 June 2015 with the purpose of creating a regulatory framework for bitcoin-related companies. The bill aims to achieve this goal by giving tax breaks to bitcoin-related companies located within New Jersey which reach a certain job creation threshold. Like the New York State, bitcoin businesses will also be required to register with a business licence in the effort to regulate bitcoin transactions (Hill, 2015).

The New Jersey Division of Taxation stated in its Technical Advisory Memorandum (TAM) that for corporation business tax and gross income tax purposes, it follows the federal tax treatment of convertible currency, in other words the guidelines issued by the IRS (Notice 2014-21) (New Jersey Division of Taxation, 2015:2).

Other states

As more states like Kansas and Texas consider clarifying bitcoin and digital currency legislative frameworks, it is likely that more of the states will join the ranks of the ones mentioned above. To assist regulatory measures, it appears that the states are opting to put official bitcoin license regulations in place for enactment in the near future (Broeker, 2015; PYMNTS, 2015).

3.3.2 Taxable income consideration on bitcoin exchange transactions

The following bitcoin exchange transactions will be discussed in context of the current US income tax legislation, related rulings and relevant case law.

3.3.2.1 Receipt of bitcoins in exchange for goods and services (barter transactions)

3.3.2.1.1 What is “bartering”?

The IRS defines the term “bartering” as follows: “Bartering is the trading of one product or service for another. Usually there is no exchange of cash...A barter exchange is any person or organisation with members or clients that contract with each other...to jointly trade or barter property or services” (IRS, 2015(a)). This definition does not apply to individuals who barter on an informal basis (TaxDebtHelp.com, 2015).

The IRS released Notice 2014-21 (Keith, 2015:1-6) which requires virtual currency to be taxed in the same way as traditional property. Small (2015:632) stated that as a result of this ruling, any transaction undertaken with bitcoins as a means of payment will be assessed tax liability under the same regulations governing barter. Accordingly the consumer is tasked to calculate on a per transaction basis the exact value of goods and services he received throughout the year and therefore each purchase will have to undergo the scrutiny of capital gains treatment (Small, 2015:632-633).

3.3.2.1.2 Consideration for inclusion in gross income for federal income tax purposes

Section 1.61-2(d)1 of the Treasury Regulations (2015), commonly referred to as Federal tax regulations, states the following with regards to compensation paid other than in cash: "...if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation."

Accordingly, where a taxpayer exchanges bitcoins for property or services, the value of the property or services received could reasonably set the amount (proceeds) of that taxpayer's gross income on the transaction (Atkins *et al.*, 2014:33-34). Certain allowable deductions as stipulated in section 162 to 199 of the IRC (1986), may be subtracted from the proceeds to arrive at a taxable gain or loss. Where the barter transaction is for personal use, no gain or loss needs to be reported (Atkins *et al.*, 2014:34).

3.3.2.1.3 Valuation

Atkins *et al.* (2014:36-37) are also of the opinion that while bitcoin values are volatile and much dependent on the efforts of the bitcoin community (users) along with the fluctuations of the current world economy, bitcoin purchases or exchange transactions may be best characterised as security under federal law. With this in mind, the subsequent sale or exchange of that bitcoin more closely mirrors the sale or exchange of existing securities than a barter transaction. As a result, the taxpayer should recognise a capital gain or loss based on the difference between the amount realised on the sale or exchange of the bitcoin, just as in any other capital transaction (Atkins *et al.*, 2014:48).

Atkins *et al.* (2014:37) go further in stating that if bitcoin transactions are subjected to bartering, taxpayers' federal income tax ramifications will be determined solely based upon the value of the bitcoin transferred on the date of the barter transaction without regard to the taxpayers' basis in that bitcoin.

More specifically, Notice 201-21 Question 5 (Keith, 2015:3) addresses the question on how the fair market value of virtual currency should be determined. The guideline states that for U.S. tax purposes, the transactions using virtual currency must be reported in U.S. dollars as of the date of payment or receipt. It is however advised that all exchange rate determinations must be reasonable and consistently applied by the taxpayer (Fuerst *et al.*, 2014).

Fuerst *et al.* (2014) believes that the existence of the "block-chain" (paragraph 1.4) should permit a taxpayer to keep track of the dates he purchased or acquired bitcoin, as well as the price of the purchase.

Another important question raised by Fuerst *et al.* (2014) is: "when a portion of those bitcoins is spent, how can the taxpayer determine which bitcoins, with which basis, were disposed of?". It is believed that the IRS could apply a Last-in-First-Out (LIFO) or First-in-First-Out (FIFO) methodology, but under current law, so long as a taxpayer can specifically identify the shares he or she wishes to sell, the taxpayer is permitted to pick and choose which shares to sell. In other words, the taxpayer could manipulate the transaction to ensure the bitcoins with the highest basis are utilised. This is in accordance with section 1.1012-1(c) of the Treasury Regulations (2015). However, if the taxpayer is unable to make a specific designation or cannot be specifically identified, the IRS will apply the FIFO method. This is in accordance with Publication 550 of the Department of Treasury (IRS, 2015(c):46-47).

3.3.2.2 Sale of bitcoins in exchange for real currency

Notice 2014-21 Question 7 (Keith, 2015:3) of the IRS deals with the gain or loss realised on the sale or exchange of virtual currency. The guideline stipulates that the character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A capital gain or loss will realise on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer. This could be in the form of stocks, bonds and other investment property. On the other hand, a taxpayer will

realise an ordinary gain or loss on the sale or exchange of virtual currency that is not a capital asset in the hands of the taxpayer, for example if the bitcoins are held mainly for sale to customers in a trade or business. Question 8 in Notice 201-21 (Keith, 2015:4) further acknowledged that when a taxpayer mines virtual currency, the fair market value of the virtual currency as of the date of the receipt is includible in gross income. Also refer to IRS's perspective on valuations above (paragraph 3.3.2.1.3).

3.3.2.3 Disposing of bitcoins – considered for both bartering and exchange transactions

Publication 544 of the Department of Treasury (IRS, 2015(b)) lists a number of disposal events of which selling or exchanging property is an example of. The IRC (1986) further refers to Section 1231 transactions which are sales and exchanges of property and either used in a trade or business. IRS's Notice 2014-21 (Keith, 2015:3-4) stipulates that capital gains are due on the sale of bitcoins if viewed as a capital asset and will be on the difference between the base price and the eventual selling price.

In his article, Bradbury (2014) discussed some disposal events and their tax implications:

- With regard to miners: when they sell the bitcoins they have mined, they will have to pay CGT on any profit that they have made while owning them, but if an individual mines bitcoin as a business, the net earnings from that business will be treated as self-employment income and will then be subject to self-employment tax;
- where bitcoins are not viewed as capital assets, for instance where they are held as inventory: if a miner (or any other business) made the selling of bitcoins their core business, any gains on the bitcoins would be taxed as an ordinary gain or loss: with regard to exchanges (exchange platforms), every transaction made by a client as well as assisting clients reporting on taxable gains, will result in an administrative burden of reporting purposes;
- with regard to investors: investors obtaining their bitcoins through exchanges must measure the fair market value on the day as the basis for capital gains realisation when they eventually sell the coins; investors who hold their bitcoins for more than a year and a day will be charged at the long-term CGT rate, which currently rests at 15%;
- with regard to consumers: if converting bitcoins to fiat currency, for example U.S dollars, and then make everyday purchases using dollars, it will be relatively easy to

report the short or long-term capital gains from that single transaction; if using the bitcoins in the wallet to purchase goods directly, then IRS should be informed of the capital gains incurred on the bitcoin at the time of the purchase;

- with regard to merchants and payment processors: the IRS requires payment processors such as BitPay, to file reports for their merchants if the number of transactions settled for merchant exceeds 200 and the gross amount of payments made to the merchant exceeds USD \$20 000; and
- with regard to companies, contractors and employees: contractors getting paid in bitcoin must declare its fair value on the day of payment as part of their gross income; companies paying salaries in bitcoin must withhold tax in the same way as they would if paying in regular fiat currency.

3.3.3 Reporting of taxes relating to bitcoin exchange transactions

3.3.3.1 Gains and losses reported on bitcoins held as capital assets – an administrative burden

Notice 2014-21 (Keith, 2015:2) explains that bitcoins be taxed as property. This means that each time a bitcoin is used to purchase goods or is sold, the taxpayer will have to record and report a gain or loss, depending on the transaction. Lambert (2015:23-24) reported that due to the lack of an authoritative resource to determine the fair market value of a bitcoin, the taxpayer is challenged in calculating the basis for each bitcoin held.

3.3.3.2 Reporting income from bartering

The fair market value of all products and services which the taxpayer received during the year of assessment in exchange for other products and services should be declared to the IRS on forms specifically developed for this purpose (TaxDebtHelp.com, 2015).

3.3.3.3 U.S. tax reporting requirements

Traditional U.S. tax reporting requirements apply to bitcoin payments as are applicable to any other transaction involving property. This is also stipulated in Notice 201-21, Question12 (Keith, 2015:5) and Question 14 (Derber, 2015).

3.3.4 Proposed regulation

Small (2015:636-640) proposed the following taxation strategies with regards to virtual currencies by adopting certain sections which currently exist within the IRC (1986):

- a) Taxing bitcoins as capital assets will appeal to investors because it permits the lower CGT rates and will also preserve the market capitalisation of bitcoins by affording the opportunity to continue to grow into an important tool of global e-commerce;
- b) simplifying the valuation of bitcoins for cost-bases purposes: under section 1274(d) of the IRC (1986), the IRS issues a revenue ruling entitled “Applicable Federal Rates” on a monthly basis, which is used to determine the tax position of certain debt instruments; put into perspective, the basis of this section can be used to develop a ruling whereby a set of criteria is developed to determine a daily reasonable price in the form of a Volume-Weighted Average Price (VWAP);
- c) carrying over the default rule from stocks and bonds, namely first-in-first-out (FIFO), will result in the most advantageous to the government in that a vast majority of bitcoins in circulation today will have a low cost basis in calculating taxable gains or losses;
- d) providing an exception for consumers who experience an insignificant profit from personal purchases; currently, transacting in bitcoins for personal use will qualify for an exclusion from the recognition of gains or losses for values not exceeding USD \$200 as determined by section 988(e) of the IRS (paragraph 3.3.1.1.2); it is suggested to lower the threshold to USD \$50 as it serves an important purpose in that users will use a large amount of micro-transactions to circumvent tax liability. By doing so, the lower threshold will ensure that the government is able to collect tax liability from bitcoin purchases;
- e) creating a tax strategy which targets the bitcoin miner community; a suggestion is to modernise the definition of the term “collectible” to include technology and digital goods with regards to taxation on collectibles which currently is defined to include only tangible property, such as gold; and
- f) adopting the traditional rules for losses sustained as a result of disposal of capital assets; the IRS currently allows that excess capital losses over capital gains be deducted up to an annual limit of USD \$3 000 and if the total net capital loss is more than the annual limit on capital loss deductions, it can be carried over to the next year of assessment and be treated as if incurred in that next year of assessment.

3.3.5 Other compliance obligations

3.3.5.1 IRS imposing penalties

Question 16 of the IRS Notice 2014-21 (Keith, 2015:6) addresses the issue of whether a taxpayer will be subject to penalties for treating transactions inconsistently with the Notice prior to its issuance date (25 March 2014). The Notice goes further explaining that taxpayers may be subject to penalties for failure to comply with tax laws, including underpaying the tax due as a result of virtual currency transactions under sections 6721 and 6722 (Keith, 2014:6).

3.3.5.2 FBAR reporting requirements

Given the filing requirements as set out in paragraph 3.3.3, US persons holding significant stores of bitcoin abroad may wish to consider complying to this filing requirement (Fuerst *et al.*, 2014). According to Winters (cited by Bennett, 2014:2) the IRS's definition of a financial account for FBAR reporting is broad enough to catch bitcoin accounts in foreign exchanges.

3.3.5.3 General

Tax compliance can only be secured if there is a full disclosure of the parties involved in the transactions. Some believe that virtual currencies could be used to facilitate tax avoidance and money laundering, as they can be easily sent undetected in and out of a country. Tax evasion could become a matter of pushing a button (Bal, 2013:355-356).

Isom (2013:18-19) suggests the following taxation preparation for uncertain bitcoin taxation treatment:

a) Retain the following records of every transaction

- all dates of bitcoin transactions;
- the exchange value on these dates;
- when bought or sold, the amount purchased and sold for in U.S. dollars;
- when exchanged for property or services, the fair market value on the date exchanged; and
- basis in any property that is relinquish in an exchange;

- b) request a private letter ruling; and
- c) consult a tax professional, when in doubt.

3.4 CONCLUSION

3.4.1 Taxability of bitcoin exchange transactions in Australia

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

- a) Bitcoins do not constitute money, currency or foreign currency for the purposes of Australian taxation law (paragraph 3.2.1.1);
- b) transactions involving bitcoins give rise to the same tax consequences as other bartering transactions (paragraph 3.2.2.1);
- c) bitcoins are regarded as property and therefore CGT assets for CGT purposes (taxpayers who use bitcoins for the purposes of personal use, the capital gain or capital loss will be disregarded to the extent that their cost base in the bitcoins is USD \$10 000 or less) (paragraph 3.2.1.1);
- d) in the case of an isolated transaction involving 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 (paragraph 3.2.2.2.3);
- e) taxpayers in the business of mining bitcoins or conducting bitcoins exchange services should apply the trading stock rules to their exchanges of bitcoins (paragraph 3.2.2.2.3);
- f) taxpayers receiving bitcoins in exchange for goods or services as part of their businesses will need to recognise the fair market value obtained from a reputable exchange of the bitcoins as assessable income (paragraph 3.2.2.1.4); and
- g) business purchases using bitcoins may be deductible, based on the arm's length value of the item acquired (paragraph 3.2.2.1.5).

Businesses providing an exchange service, buying and selling digital currency, or mining bitcoin will pay income tax on the profits. Those trading digital currencies for profit will also be required to include the profits as part of their assessable income. In contrast, those using currency for investment or business purposes may be subject to CGT when

disposing of digital currency, in the same way as shares or similar CGT assets are disposed (Wolters Kluwer, 2015).

3.4.2 Taxability of bitcoin exchange transactions in the USA

In summary, the taxation implications for bitcoin exchange transactions in the USA are as follows:

- a) Virtual currency such as bitcoins are treated as property for federal income tax purposes (paragraph 3.3.3.1);
- b) any transaction undertaken with bitcoins as a means of payment will be assessed to be a tax liability under the same regulations governing barter (paragraph 3.3.2.1.1);
- c) the character of the gain or loss realised on the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer (paragraph 3.3.2.2);
- d) the taxation implications of disposal events are summarised in paragraph 3.3.2.3, which includes events such as the selling of bitcoins subsequent to mining, sale of bitcoins by investors and consumers, amongst others; and
- e) the fair market value of virtual currency, for U.S. tax purposes should be determined in U.S. dollars as of the date of payment or receipt and must be reasonable and consistently applied by the taxpayer (paragraph 3.3.2.1.3).

The IRS recognised the growing presence of virtual currencies, including bitcoins, and published Notice 2014-21 to explain how taxpayers should report virtual currency transactions and the resulting tax consequences (Lambert, 2015:32). Taxpayers should know how bitcoins are characterised before understanding how to apply the already existing guidance to their bitcoin transactions. Accordingly, taxpayers should keep record of all bitcoin transactions and when in doubt, should consider a private letter ruling or consult a tax professional (Isom, 2013:20).

CHAPTER 4: INCOME TAX CONSIDERATIONS OF BITCOIN EXCHANGE TRANSACTIONS WITHIN THE SOUTH AFRICAN ENVIRONMENT

4.1 INTRODUCTION

Chapters four and five will consider the secondary objective (paragraph 1.7.2 (iii)). This chapter aims at understanding what current South African tax legislation is available to address bitcoin exchange transactions. The views and taxation guidance published by Australia and the USA, as well as the international developments noted in chapter three, will be considered as a basis to consider how amendments can be introduced to create a sufficient base for the taxation of bitcoin exchange transactions in South Africa. To further support this objective, chapter five will consider the commentary provided by the OECD, the Davis Tax Committee and the SARB as to the taxability of bitcoin exchange transactions.

4.2 BITCOIN USAGE IN SOUTH AFRICA

South Africa currently has three bitcoin exchange platforms, namely Ice Cubed, Altcoin Trader and BitX, all of which will accept bank deposits in exchange for bitcoins to purchase goods and services and trade bitcoins (Bitcoinzar, 2015(b)). According to Dingle (cited by Moneyweb, 2014) it's almost impossible to say how many bitcoin users there are in South Africa and how many companies accept bitcoins. Dingle (cited by Moneyweb, 2014) further states that recent observations on the BitX exchange platform showed increased activity which clearly indicates a growing interest in bitcoins. Although it is a small group of people in South Africa, rampant growth is noticeable as several online retailers are now accepting bitcoins as a means of payment for goods and services, for example Takealot.com. This merchant, in return, can exchange the bitcoins received for rand through an exchange platform such as BitX (City Press, 2015).

In addition, South Africa installed its first bitcoin vending machine, situated in Kyalami, north of Johannesburg, to give users the ability to get bitcoins in exchange for rand (Van der Berg, 2015). As already mentioned, a growing number of businesses are accepting bitcoins as a method of payment and the number is increasing sporadically (paragraph 1.2). More recently, South Africa's first digital currency hub was launched on 11 June 2015 and is running in the form of BitHub, headquartered in Woodstock, Cape Town. BitHub's goals are to create awareness of the use of bitcoins, educate the

community on the benefits of digital currencies and encourage South Africans to participate in the digital currency space (Tiwari, 2015).

Africa's first bitcoin conference was held during April 2015 in Cape Town and was attended by the South African Reserve Bank, the South African Treasury Department, the Financial Intelligence Agency, some of South Africa's largest banks as well as international and local entrepreneurs, investors, corporates, start-ups, developers and enthusiasts. Topics such as bitcoin security, remittances, the Blockchain and e-commerce were discussed and debated. The next Africa bitcoin conference is scheduled to take place in March 2016 in Johannesburg.

Based on the above, there is no doubt that the use of bitcoins as a medium of exchange or payment is growing in South Africa. As more and more South Africans will be introduced and educated in the use and benefits of using digital currencies, the need for proper regulatory and taxation guidance will increase.

4.3 CURRENT SOUTH AFRICAN INCOME TAX LEGISLATION AVAILABLE TO ADDRESS BITCOIN EXCHANGE TRANSACTIONS

The following available South African tax legislation, together with the understanding of the meaning of the terms "asset" and "currency", have been identified by this study, which may assist in determining the basis on which to tax bitcoin exchange transactions in South Africa. In addition, the understanding gained in chapter three on how countries such as Australia and the USA have considered the tax implications on bitcoin exchange transactions, will be considered within the context of the South African tax legislation for recommendation, where applicable (refer to chapter five).

4.3.1 Definition of the terms "asset" and "currency"

The meaning and definitions of the above mentioned terms were discussed in chapter two. In particular, the current South African Income Tax legislation makes provision for the meaning of these terms under section 24I and Schedule Eight of the South African Income Tax Act (Act no. 58 of 1962) respectively. Chapter two also concluded that the dictionary meaning of the terms "asset" and "currency" is similar to the interpretation of the tax legislation of both Australia and the USA.

As already mentioned, the possibility exists to characterise bitcoins as an asset for South African Income Tax purposes (paragraph 1.2.2). Due to the fact that bitcoins are not yet widely accepted in South Africa as a medium of exchange, bitcoins are not likely to be classified as a "currency" yet, although the usage and knowledge about the use of bitcoins and how the bitcoin network operates are increasing at a rapid rate (paragraph 4.2).

Again, the term "asset" as defined by the Eight Schedule of the South African Income Tax Act (Act no. 58 of 1962) appears wide enough to include virtual currencies such as bitcoins as a form of property (asset). The dictionary meaning of the term "asset" implies that the asset needs to bear value to the owner (paragraph 2.2). PwC (Musiala, 2015:2) refers to cryptocurrency as now being perceived having inherent value which includes the technology and network itself, the integrity of the cryptographic code and the decentralised network (paragraph 2.1). It thus appears reasonable that bitcoins be regarded as an asset under the definition of the Eight Schedule of the South African Income Tax Act (Act no. 58 of 1962) and therefore for CGT purposes. The latest draft SARS comprehensive guide to CGT confirms that trading stock is an asset for CGT purposes (paragraph 2.3.1).

4.3.2 Capital or revenue nature?

For an amount to be taxable under the South African Income Tax Act (Act no. 58 of 1962), the amount should either result in "gross income" as defined by section one (paragraph 1.2.2) or income of a capital nature, which is subject to CGT (schedule Eight).

4.3.2.1 Intention

According to ITC 1185 (1972) 35 SATC 122 (cited by McAllister, 2011:10) the most important test for determining the capital or revenue nature of a particular receipt or accrual is the taxpayer's intention in acquiring the asset.

In CIR v Stott 1928 AD 252, 3 SATC 253 at 254 (cited by McAllister, 2011:10), Wessels stated that "The primary intention with which property is acquired is conclusive as to the nature of the receipt arising from the realisation of that property unless other factors intervene which show that it was sold in pursuance of a scheme of profit-making".

In another case, Natal Estates Ltd v SIR 1975 (4) SA 177 (A), 37 SATC 193, Holmes, JA (cited by Williams, 2009:255) stated "In deciding whether a case is one of realising a

capital asset or of carrying on a business...one must think one's way through all of the particular facts of each case. Important considerations include, *inter alia*, the intention of the owner, both at the time of buying...and when selling it (for his intention may have changed in the interim); the objects of the owner;...the activities of the owner... up to the time of deciding to sell it in whole or in part...From the totality of the facts one enquires whether it can be said that the owner had crossed the Rubicon and gone over to the business, or embarked upon a scheme of selling...for profit.”

4.3.2.2 Gross income

The definition of the term "trading stock" in section one of the South African Income Tax Act (Act no. 58 of 1962) (paragraph 2.3.1) is wide enough to include virtual currencies such as bitcoins, as the definition includes "...sale or exchange... by the taxpayer to be used...in the course of the taxpayer's trade ...". 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). Also refer to the deductibility of expenses related to the carrying on of a trade below. In accordance with section 22(1) and section 22(2) of the South African Income Tax Act (Act no. 58 of 1962), 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.

4.3.2.3 Deductibility of expenses from carrying on a trade

With regards to the deductibility of any expenses incurred in obtaining bitcoins (for example through mining), the requirements of section 11(a), read together with section 23(g) of the South African Income Tax Act (Act no. 58 of 1962) have to be met. In terms of section 11(a) the words "carrying on a trade" is a threshold requirement for the deductibility of expenditure (Williams, 2009:253).

Section 11(a) of the South African Income Tax Act (Act no. 58 of 1962) states: "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—

- a) 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) of the South African Income Tax Act (Act no. 58 of 1962) specifically prohibits the deduction of 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.

4.3.2.4 The term "trade"

The term "trade" is defined under section one of the South African Income Tax Act (Act no. 58 of 1962) 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".

In *Burgess v CIR* (1993) 55 SATC 185, it was held that "it is well established that the definition of 'trade' should be given a wide interpretation and includes a 'venture', being a transaction in which a person risk something with the object of making a profit."

The concept of the term "trade" with reference to bitcoin exchange transactions will be discussed below.

4.3.2.5 The phrase "of a capital nature"

The South African Income Tax Act (Act no. 58 of 1962) does not define the words "of a capital nature" and therefore reference to relevant case law needs to be considered for interpretation of these words.

In *Elandsheuwel Farming (Edms) Bpk v SBI* 1978 (1) SA 101 (A), 39 SATC 163 (cited by Williams, 2009:272), Corbett held that "where a taxpayer wishes to realise a capital asset he may do so to best advantage and the fact that he does just this cannot of itself convert what is a capital realisation into a business or a profit-making scheme. There are however, limits to what a taxpayer may do in order to realise to best advantage. The manner of realisation may be such that it can be said that the taxpayer has in reality gone over to the running of a business or embarked upon a profit-making scheme. The test is one of degree".

4.3.2.6 Section 24I of the South African Income Tax Act (Act no. 58 of 1962): Gains or losses on foreign exchange transactions

If for example, a miner of bitcoins or a person obtaining bitcoins for cash, holds onto these bitcoins until the value increases with the intention to sell the bitcoins when the value is at its highest price at a point in time, the proceeds from the sale might not be regarded as that of capital nature. However, the intention when obtaining the bitcoins, the period in which the bitcoins were held and the sale of bitcoins should be evaluated or considered in determining whether the proceeds on the sale of bitcoins are of revenue or capital nature. Regard must be given as to whether the taxpayer was conducting a business (conducting a "trade" as defined in section one of the South African Income Tax Act (Act no. 58 of 1962)) with the view of making a profit or whether the taxpayer kept the bitcoins as an investment, waiting for the opportune moment to sell it (*Elandsheuwel Farming (Edms) Bpk v SBI*, cited by Williams, 2009:272).

Seforo (2014:2) is of the opinion that when considering the income tax consequences for residents trading in bitcoins, section 24I of the South African Income Tax Act (Act no. 58 of 1962) comes to mind. Seforo also cited section 24I (3) to support his opinion:

"In determining the taxable income of any person...there shall be included in or deducted from the income, as the case may be, of that person –

- a) any exchange difference in respect of an exchange item of or in relation to that person, subject to subsection (10A)".

Section 24I (2) of the South African Income Tax Act (Act no. 58 of 1962) states that the provision of section 24I shall apply in respect of any:

- a) "Company;
- b) trusts carrying on any trade;
- c) natural persons who holds any amount contemplated in paragraph (a) or (b) of the definition of 'exchange item' as trading stock; and
- d) natural persons or trusts in respect of any amount contemplated in paragraph (c) or (d) of the definition of 'exchange item'".

As per section 24I of the South African Income Tax Act (Act no. 58 of 1962), the term "exchange item" means "an amount in a foreign currency –

- 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
...”

Seforo (2014:2) noted that a natural person speculating in bitcoin would have to fall within the ambit of section 24I(2)(c) in order for section 24I to be applicable to him or her. Such person would then first have to hold any amount contemplated in paragraph (a) or (b) of the definition of the term "exchange item". Secondly, those amounts would have to be held as trading stock.

Accordingly, the term "foreign currency" is defined by section 24I of the South African Income Tax Act (Act no. 58 of 1962) as follows: "...in relation to any exchange item of a person, means any currency which is not local currency".

Based on the ordinary dictionary meaning of the term "currency" in chapter two as well as the fact that bitcoins are not yet widely accepted as a medium of exchange in South Africa, doubt could be placed on the possibility that bitcoins be regarded as currency under the definition of "foreign currency" in section 24I.

On a more practical level, if bitcoins are being regulated and regarded as a form of currency in some countries abroad, then the possibility will exist that bitcoins will then fall under the definition of "foreign currency" as defined in section 24I, which will then result in the taxpayer including exchange differences in the calculation of his or her taxable income.

4.3.2.7 Capital gains tax

The definition of the term "asset" has already been dealt with under paragraph 2.2.

Paragraph two of the Eighth Schedule on CGT of the South African Income Tax Act (Act no. 58 of 1962) 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".

Paragraph 11 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) deals with disposal events which includes "the sale, donation, expropriation,

conversion, grant, cession, exchange or any other alienation or transfer of ownership of an asset...”.

As mentioned above (paragraph 4.3.1), the possibility exist that the definition of the term ”asset” is wide enough to include virtual currencies, such as bitcoins. Once again, it is important not to only determine the intention of the taxpayer when disposing of an asset, but also the intention when the asset was obtained and the intention during which the asset was held (paragraph 4.3.2.6).

According to paragraph 53 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962), a natural person or a special trust must disregard a capital gain or capital loss determined in respect of the disposal of a personal-use asset as contemplated in subparagraph (two). Subparagraph two of paragraph 53 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) defines a personal-use asset as “an asset of a natural person or a special trust that is used mainly for purposes other than the carrying on of a trade.” Subparagraph three excludes a coin made mainly from gold or platinum of which the market value is mainly attributable to the material from which it is minted or cast. Thus, the disposal of Kruger Rands will not be considered a personal-use asset.

Therefore, as per the examples provided under paragraph 3.2.2.2.2, when bitcoins are used mainly to make online purchases of items for personal use or consumption such as clothing or music, these transactions will qualify as personal-use assets under paragraph 53 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) and will therefore not be subject to CGT. In contrast, when a taxpayer mines bitcoins and keeps those bitcoins for a number of years with the intention of selling them at opportune times based on favourable rates of exchange, these bitcoins will not be regarded as personal-use assets and the gain or loss on disposal will be subject to CGT (paragraph 3.2.2.2.3).

4.3.2.8 Section 102 of the South African Tax Administration Act (TAA) (Act no. 28 of 2011)

Under section 102 of the TAA, the onus is on the taxpayer to proof that an amount is exempt or otherwise not taxable or that an amount is deductible or may be set-off.

4.4 TAXABLE INCOME CONSIDERATION ON BITCOIN EXCHANGE TRANSACTIONS UNDER CURRENT SOUTH AFRICAN INCOME TAX LEGISLATION

4.4.1 Receipt of bitcoins in exchange for goods and services (barter transactions)

4.4.1.1 What is bartering?

The term "barter" is not defined in the Income Tax Act and therefore reference to relevant case law needs to be considered.

De Koker and Williams (2015:7.24) submitted that the word "expenditure" is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. In *Caltex Oil (SA) Ltd v SIR* (cited by De Koker and Williams, 2015:7.24), it was held that in a transaction 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.

Based on the principles of the decision in *Caltex Oil (SA) Ltd v SIR* (cited by De Koker and Williams, 2015:7.24), where bitcoins (as a form of asset) be exchanged to settle an obligation, the bitcoins have to be valued in rands. Therefore, the date of valuation as well as the valuation method need to be considered and applied in a consistent manner for income tax purposes.

4.4.1.2 The term "gross income"

Section one of the South African Income Tax Act (Act no. 58 of 1962) defines "gross income" as: "...the total amount, in cash or otherwise, received by or accrued to or in favour of...".

In *Lategan v CIR* 1926 CPD 203, 2 SATC 16, Watermeyer held that "the word 'amount' must be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value".

De Koker and Williams (2015:2.16) explain that, following the definition of the term "gross income", should an asset be exchanged or bartered for another asset, the value of the

new asset constitutes an amount received or accrued. De Koker and Williams also submitted that barter or exchange transactions are therefore not excluded from the definition of "gross income", as long as it can be shown that the old asset that has been exchanged formed part of trading stock and that the asset that has been received in exchange constitutes an amount received or accrued with a monetary value.

4.4.1.3 Date for valuation purposes

De Koker and Williams (2015:2.17) submitted that "...the date for valuation of... a receipt or an accrual in the form of an asset ...goods received in barter, is the date of accrual". Section one of the South African Income Tax Act (Act no. 58 of 1962) defines "gross income" as: "...the total amount, in cash or otherwise, received by or accrued to or in favour of...".

An amount will be included in gross income on the earlier of the date of its receipt or the date of accrual (FSP Business, 2016:I03/003). The term "accrued to" means 'become entitled to' (Lategan v CIR 1926 CPD 203, 2 SATC 16) or can also mean to 'become unconditionally entitled to' (Mooi v SIR 1972 AD, 34 SATC 1). Therefore, once delivery has taken place (in an exchange transaction), the seller becomes entitled to the full sale price and in the same instance is taxable on the full sale price (FSP Business, 2016:I03/006).

4.4.1.4 Valuation of the amount received or accrued

In a more recent case (February 2015), South Atlantic Jazz Festival (Pty) Ltd v CSARS 77 SATC 254, it was held that in an ordinary arm's length barter transaction, the value that the parties attributed to the goods or supplies that were exchanged, would be a reliable indicator of their market value.

Where, for example, a taxpayer receives bitcoins as payment for goods or services or uses bitcoins to make purchases for purposes of his or her business, the value of the transaction has to be determined for inclusion in gross income. In other words, for an amount to be included in gross income it has to be revenue in nature, meaning, the taxpayer has to have the intention of making profits (paragraph 4.3.2.2). It appears that the value of the receipt of bitcoins in exchange for goods and services (in carrying on a business for profit making purposes) should be at arm's length, meaning the market value on valuation date, in other words, the date of payment or receipt (refer to South Atlantic

Jazz Festival v CSARS above). This valuation approach will then be similar to the principles applied by Australia and the USA (paragraph 3.2.2.1.4 and paragraph 3.3.2.1.3). The transaction using bitcoins should therefore be reported in rand (ZAR) as of the date of payment or receipt. With regard to the possible treatment of gains and losses on these transactions, refer to paragraph 4.4.1.4.

Sections 11(a) and 23(g) of the South African Income Tax Act (Act no. 58 of 1962) makes provision for the deduction of expenses incurred in carrying on a trade (paragraph 4.3.2.3). In other words, these expenses may be deducted from the proceeds of the transaction to arrive at a taxable gain or loss.

4.4.2 Sale of bitcoins in exchange for real currency

Paragraph 4.3.2.6, refers to the section 24I of the South African Income Tax Act (Act no. 58 of 1962) and the possible taxation implications of a miner of bitcoins or a person obtaining bitcoins for cash. The intention of the taxpayer in obtaining bitcoins, the period during which the bitcoins was held and the sale of the bitcoins, is most important as this will determine whether the proceeds from the sale will be regarded as either revenue or capital in nature.

The ATO and IRS appears to share the same view in that, where a taxpayer carries on a business of mining and selling bitcoins or carries on a bitcoin exchange service, will result in the bitcoins being regarded as 'trading stock' (paragraph 3.2.2.1.6 and paragraph 3.3.2.1.3). This view has been included in the taxation guidelines of the respective countries.

As already mentioned, sections 22(1) and 22(2) of the South African Income Tax Act (Act no. 58 of 1962) is available to address tax implications on 'trading stock'.

4.5 REPORTING OF TAXES RELATING TO BITCOIN EXCHANGE TRANSACTIONS

4.5.1 Payment of tax

SARS's external guide on payment rules (SARS, 2015(b):7-9) sets out the form in which tax may be paid, namely cash, cheques and bank notes, for example. As bitcoins are not a legal form of tender, nor are they regarded as currency, it will not be accepted as a

tender to settle tax obligations (South African Reserve Bank, 2014:4-5). Both the tax authorities of Australia and the USA do not accept bitcoins as a means to settle taxation obligations on this same principle.

4.5.2 Private rulings

No private rulings have been issued to date on virtual currency transactions by SARS, although this should be considered by taxpayers with regards to the alert that was issued to the South African public by the National treasury, SARB, the FSB, SARS and the Financial Intelligence Centre (National Treasury, 2014:3) (paragraph 1.5).

4.6 POSSIBLE AMENDMENTS TO THE SOUTH AFRICAN INCOME TAX ACT IN ORDER TO CREATE A SUFFICIENT BASE FOR THE TAXATION OF BITCOIN EXCHANGE TRANSACTIONS IN SOUTH AFRICA.

4.6.1 Possible amendments to the South African Income Tax Act

Based on the understanding obtained about the tax implications of bitcoin exchange transactions in countries such as Australia and the USA (chapter three) as well as the identification of currently available South African tax legislation for bitcoin exchange transactions (this chapter), the following possible amendments to the South African Income Tax Act (Act no. 58 of 1962) have been identified to support a sufficient base for the taxation of bitcoin transactions in South Africa:

- a) The definition of the term "asset" per paragraph one of Schedule Eight of the Income Tax Act should be amended to include virtual currencies such as bitcoins (paragraph 4.3.1).
- b) As bitcoins are not yet widely accepted in South Africa as a medium of exchange, bitcoins are not likely to be classified as a currency. It is therefore submitted that the term "local currency" as defined in section 24I of the South African Income Tax Act (Act no. 58 of 1962), be amended to rather exclude virtual currencies such as bitcoins. This proposed amendment will, therefore, offer clarity in that in the event of some countries abroad accepting bitcoins as a currency, that bitcoins will fall outside the definition of the term "foreign currency" as defined in section 24I. If not amended, it may cause concern in that section 24I will be applicable to bitcoin exchange transactions. Moreover, the normal Exchange Control Regulations (1961) will apply to these transactions. The definition of the term "foreign currency" as per the

Exchange Control Regulations should have the similar meaning and reference to the definition of section 24I in the South African Income Tax Act (Act no. 58 of 1962).

- c) Paragraph 53 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) defines the term "personal-use asset". It is therefore submitted that this definition be amended to make provision for instances where bitcoins are used by a natural person to make online purchases of items for personal use or consumption such as clothing or music (paragraph 4.3.2.7). Accordingly, any capital gain or loss can be disregarded for CGT purposes.
- d) Guidelines should be drafted and supported by both SARS, the SARB and the National Treasury of South Africa to include general taxation and regulatory guidelines on bitcoin exchange transactions for which the aim should be to raise awareness and educate South African taxpayers.

4.6.2 Terms and definitions per the South African Income Tax Act

The following terms and definitions per the South African Income Tax Act (Act no. 58 of 1962) appears to be sufficient in the taxation of bitcoin exchange transactions:

- a) the definition of the term "trading stock", as it is wide enough to include virtual currencies, such as bitcoins (paragraph 4.3.2.2);
- b) the deductibility of expenses, namely section 11(a) read with section 23(g) (paragraph 4.3.2.3); and
- c) the term "trade" as defined under section one (paragraph 4.3.2.4).

4.7 CONCLUSION

Van Rooyen, head of business development and growth at South Africa's BitX (cited by Ogundeji, 2015), stated that "regulation will 'protect the consumer and weed out all the bad players' and 'give businesses' (and investors) a lot more clarity and confidence in what can be done in the space, which in turn will attract more capital and innovation to the sector".

Van Rooyen also indicated that BitX has already started to build a compliance framework, working closely with governments, regulators and financial institutions, focusing on adopting financial community best practices (Ogundeji, 2015).

Chapter six will include recommendations as to the most suitable approach on how bitcoin exchange transactions should be taxed in South Africa.

CHAPTER 5: CURRENT SOUTH AFRICAN REGULATION AVAILABLE TO ADDRESS BITCOIN EXCHANGE TRANSACTIONS

5.1 INTRODUCTION

In this chapter, the secondary objective (paragraph 1.7.2 (iii)) will be considered. The purpose of this chapter is to analyse the current monetary regulations available and to consider the commentary provided by the OECD and the Davis Tax Committee to address bitcoin exchange transactions

The SARB together with the National Treasury (the Ministry of Finance) constitute the monetary authority of South Africa, each with its own regulations regarding foreign exchange transactions.

5.2 SOUTH AFRICAN RESERVE BANK (SARB) AND NATIONAL TREASURY OF SOUTH AFRICA

Only the SARB is allowed to issue legal tender (paragraph 2.4) in the form of bank notes and coins in South Africa which can be legally offered in payment of an obligation. A creditor is therefore obliged to accept it as a settlement of debt. In its position paper the SARB states that decentralised virtual currencies such as bitcoins are not legal tender in South Africa and should not be used as payment for the discharge of any obligation in a manner that suggests they are a perfect substitute of legal tender (South African Reserve Bank, 2014:4-5). The definition of "legal tender" in the SARB Act (1989) does not include virtual currencies (Crawford, 2015).

In addition, the department of National Treasury of South Africa stated in its user alert on virtual currencies that the use of virtual currencies, such as bitcoins, depends on the other participant's willingness to accept them as a form of payment. Therefore, any merchant may refuse bitcoins as a payment instrument without being in breach of the law (National Treasury, 2014:2).

The Reserve Bank of Australia (RBA) also do not regard bitcoins as legal tender, but pointed out that there is nothing to prevent two parties from agreeing to settle a payment

using digital currency (paragraph 3.2.1.2), in other words parties may agree to discharge an obligation to pay.

Similarly, the USA's federal legislation provides that the United States' coins and currency are legal tender for all debts, public charges, taxes and dues, in other words, they are only legal offers of payment and that there is no requirement that these be accepted as payment (paragraph 3.3.1.1.3).

Based on the above, it appears that agreements to pay in bitcoins must be established upfront by means of a contract (paragraph 3.3.1.1.3) between the payer and payee.

5.3 EXCHANGE CONTROL REGULATIONS

The term "foreign currency" is defined by the Exchange Control Regulations (1961) as "any currency which is not legal tender in the Republic, and includes any bill of exchange, letter of credit, money order, postal order, promissory notes, traveller's cheque or any other instrument for the payment of currency payable in a currency unit which is not legal tender in the Republic".

This definition of the term "foreign currency" does not explicitly exclude virtual currencies such as bitcoins, although it might be interpreted that bitcoins might fall under the term "other instrument". The term "other instrument" is in return not defined by the Exchange Control Regulations (1961).

Therefore, if bitcoins fall under the definition of "foreign currency" per the Exchange Control Regulations (1961), then the exchange control regulations (limits) will be applicable to bitcoins under this act.

5.3.1 Private individuals (natural persons)

The Exchange Control Manual of the Financial Surveillance Department (previously known as the Exchange Control Department of the SARB) deals with the following exchange control regulations (1961) for private individuals (natural persons):

Section O – 6.1.1:

"...Authorised Dealers may allow private individuals (natural persons) who are taxpayers in good standing and over the age of 18 years, to invest up to a total amount of

R10 million per calendar year, for investment purposes abroad, but, prior to the transfer of any funds, a duly electronically completed "Tax clearance certificate (in respect of foreign investments)", issued by the South African Revenue Service, must be presented to the bank..."

Section H – 2.2.2:

"...Residents (natural persons), who are over the age of 18 years may be permitted to avail of a single allowance within an overall limit of R1 000 000 per individual per calendar year, without the requirement to obtain a Tax Clearance Certificate, which may be apportioned as follows: Monetary gifts and loans...foreign capital allowance..."

According to Leo (Notes by Leo, 2014), if regarded as an investment, in other words an asset, bitcoins can be classified as either local or offshore investments, in which case the following may be interpreted:

- For offshore bitcoin investments (buying bitcoins in a foreign currency via an offshore exchange), South African residents can purchase offshore bitcoins via an authorised dealer using their R1 million discretionary or R4 million annual allowance; for example, an individual can decide to transfer USD \$2 000 from First National Bank South Africa to the Bitstamp.net exchange in order to buy bitcoins as an offshore investment. The USD \$2 000 will then reduce the available R1 million discretionary allowance; and
- for local bitcoin investments (buying bitcoins in South African Rand via a local exchange like BitX.co.za), these transactions may not be regarded as offshore investments as long as the bitcoins are ring-fenced within the ZAR currency and not converted to any foreign currency; therefore, the exchange control limits will not be applicable to local bitcoin transactions denominated in ZAR.

The South African National Surveillance Department has not issued any guidance yet with regards to local and offshore investments related to bitcoin transactions.

5.3.2 South African companies

Section O – 6.1.2 of the Exchange Control Regulations (1961) states that "in line with broader efforts to cut out red tape for small and medium sized businesses, the current application process for approval from the Financial Surveillance Department, before

undertaking new foreign direct investment, has been removed for company transactions below R1 billion per applicant company per calendar year. Prior approval from the Financial Surveillance Department is required for investments exceeding R1 billion per applicant company per calendar year”.

Based on the view of Leo mentioned above, if a South African company considers bitcoins as an investment, consideration needs to be taken with regards to the classification as either offshore or local investments and the application of Section O – 6.1.2 of the Exchange Control Regulations (1961).

5.4 OTHER REGULATIONS

5.4.1 Anti-money laundering reporting requirements

As mentioned in paragraph 3.3.1.1.4, FinCEN already imposed anti-money laundering reporting requirements for exchangers and administrators of virtual currencies. FinCEN also provided guidance in which the circumstances under which virtual currency users could be categorised as Money Services Businesses (MSBs). MSBs, therefore must enforce Anti-Money Laundering (AML) and Know Your Client (KYC) measures in identifying the people that they’re doing business with (Bitcoin school, 2015).

5.4.2 Automatic Exchange of Information (AEOI)

During 2013 the National Treasury and SARS announced the start of negotiations with the US Treasury to enter into an inter-governmental agreement (IGA) with respect to the USA’s Foreign Account Tax Compliance Act (FATCA) (SARS, 2015(a)).

South Africa’s Financial Institutions have to collect and report on certain required information under FATCA and the OECD Common Reporting Standard on financial accounts with effect from 1 July 2014. SARS will then exchange the information with the US Treasury through a process of Automatic Exchange of Information (AEOI) under the legal framework provided by the double taxation agreement that exists between South Africa and the US. These reporting requirements do not address the treatment of bitcoin or other virtual currencies, but SARS is taking a stance toward taxpayers that fail to make the required disclosures (SARS, 2015(a)).

5.4.3 Davis Tax Committee and OECD

Paragraph 1.5 makes reference to the view of the Davis Tax Committee and the OECD. Due to the fact that the use and acceptance of bitcoins as a medium of exchange is increasing in South Africa and based on the content of this study, the importance of legislators to become involved in the developing of a suitable approach, not only for taxation purposes, but also for regulatory purposes, continues to be of increased importance.

5.5 CONCLUSION

While the perceived benefits of bitcoins have enticed new users, merchants, investors and businesses, the innovative nature of bitcoins raised regulatory concerns. Regulators from abroad, however, have seemingly struggled to decide how and whether to regulate virtual currency. As a result, the legal and regulatory response domestically and abroad has to date been varied (Meridith & Tu, 2014:296). With this said, the regulatory response thus far suggests that the United States is willing to accommodate the continued use of virtual currency so long as the risks associated with it can be mitigated to an appropriate degree (Meridith & Tu, 2014:301).

CHAPTER 6: RECOMMENDATIONS TO CREATE A SUFFICIENT BASE FOR THE TAXATION OF BITCOIN EXCHANGE TRANSACTIONS IN SOUTH AFRICA

6.1 INTRODUCTION

The aim of this chapter is to consider the secondary objective (paragraph 1.7.2 (iv)), namely to make possible recommendations or suggest the most suitable approach on how bitcoin exchange transactions should be taxed in South Africa.

6.2 REGULATIONS IN SOUTH AFRICA

- a) As bitcoins do not have legal tender status in South Africa, it does not prevent any two parties from accepting bitcoins as a form of settling an obligation. Therefore, it can be recommended that agreements to pay in bitcoins must be established upfront by means of a written contract between the payer and payee (paragraph 3.3.1.1.3).
- b) The South African National Surveillance Department should consider to issue guidelines in respect of bitcoin transactions for investment purposes and the application or consideration of the discretionary or annual allowances for private individuals (paragraph 5.3.1).
- c) The Exchange Control Regulations (1961) does not explicitly consider virtual currencies in the definition of the term "foreign currency". It is therefore recommended that this definition be reconsidered to either include or exclude virtual currencies. If virtual currencies would fall within the definition of the term "foreign currency", then the normal exchange control limits will apply to virtual currencies, in which case it should be directly linked to the definition of "foreign currency" under the South African Income Tax Act (Act No. 58 of 1962) – refer to paragraph 5.3, for further discussion.
- d) With regard to anti-money laundering reporting requirements (paragraph 5.4.1) in terms of FinCEN's approach, AML and KYC practices (Bitcoin school, 2015) should be considered for the South African regulatory environment as miners of bitcoins in South Africa might fall under this reporting requirement when the miner puts the bitcoin into general circulation (issuing virtual currency).

- e) Under the Intergovernmental Agreement (IGA) between South Africa and the USA, consideration needs to be taken to address the reporting requirements of bitcoin or other virtual currencies (paragraph 5.4.2).
- f) As some states in the USA are opting to put official bitcoin license regulations in place (paragraph 3.3.1.1.6), this form of regulation might assist the regulation and transparency of bitcoin transactions within the South African regulatory and taxation environment.

6.3 SOUTH AFRICAN INCOME TAX ACT

- a) Based on the discussion whether bitcoins should be considered an asset for CGT purposes (paragraph 4.3.1), consideration needs to be taken to amend the definition of the term "asset" as defined in the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) to include virtual currencies, such as bitcoins.
- b) Regarding the definition of "foreign currency" under section 24I of the South African Income Tax Act (Act no. 58 of 1962), the possibility exists that bitcoins fall under this definition, that is, if regarded as a currency other than the local currency (the rand). An indicator does exist that bitcoins cannot yet be regarded as currency, it is not yet widely accepted as a medium of exchange and a legal form of tender.

On the other hand, and as already mentioned (paragraph 4.3.2.6), if bitcoins are being regulated and regarded as a form of currency in countries other than South Africa, then the possibility will exist that bitcoins will then fall under the definition of "foreign currency" as defined in section 24I.

Consideration therefore has to be taken to redefine the term "foreign currency" to exclude virtual currencies, such as bitcoins from this definition. In doing so, it will also have to conform to the definition of the term "foreign currency" under the Exchange Control regulations (paragraph 5.3).

- c) With regard to barter transactions (where bitcoins are exchanged for goods and services), guidelines should be considered for the following:
 - Where the barter transaction is for personal use, that no gain or loss need to be reported for Income Tax purposes (paragraph 4.6.1);

- valuation date (paragraph 4.4.1.3);
 - valuation determination, with particular reference that all exchange rate determinations must be reasonable and consistently applied by the taxpayer (paragraph 4.4.1.4); and
 - treatment of exchange rate differences per section 24I (paragraph 4.3.2.6).
- d) With regard to the CGT implications for bitcoin transactions, guidelines and recommendations should be considered for the following:
- To lower the administration burden for reporting purposes, a limit on the base cost of the bitcoin should be considered which will result in no income tax implications if the taxpayer is not in business or carries on a trade when goods or services are paid for in bitcoin (paragraph 3.3.4);
 - the ATO's Taxation Ruling 92/3 considers the other extreme where an isolated transaction is not carried out as part of a business operation; consideration needs to be taken into account for such isolated transactions and the possible tax implications thereof (Commissioner of Taxation, 1992(b):2) (paragraph 3.2.2.2.3); and
 - paragraph 53 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) defines the term "personal-use asset"; it is therefore submitted that this definition be amended to make provision for instances where bitcoins are used by a natural person to make online purchases of items for personal use or consumption such as clothing or music (paragraph 4.6.1). Accordingly, any capital gain or loss can be disregarded for CGT purposes.
- e) In order to encourage tax and regulatory compliance, tax breaks could be offered to those taxpayers (natural persons or companies) which are in compliance with the tax and regulatory requirements. New Jersey in the USA is a good example in this regard (paragraph 3.3.1.1.6).
- f) With regard to taxpayers who mines bitcoins as a form of trade, guidelines should be considered for the valuation of the trading stock (bitcoins); an answer must be provided for the question which methodology will apply, LIFO or FIFO? (paragraph 3.3.2.1.3); by applying a default rule in that FIFO be regarded as the only valuation methodology, it will result in the most advantageous to the government (SARS).

- g) The IRS requires payment processors such as BitPay to file reports for their merchants if the number of transactions settled for merchants exceeds 200 and the gross amount of payments made to the merchants exceeds USD \$20 000. This measure may also assist SARS to get informed if gains were incurred on bitcoin transactions (paragraph 3.3.2.3).
- h) Another manner to reduce the administration burden is to provide an exception for consumers who experience an insignificant profit from personal purchases. The IRS currently allows for an exclusion from the recognition in bitcoins for personal use if the gains or losses for values do not exceed USD \$200 (paragraph 3.3.4). The same strategy may be considered for South African consumers.
- i) In general, guidelines to taxpayers should advise taxpayers to seek private rulings when bitcoins are kept or used mainly for the purpose of profit-making or investment, or to facilitate purchases or sales in the course of carrying on business.
- j) In simplifying the valuation of bitcoins in exchange transactions, a valuation method or platform can be developed whereby a set of criteria is developed to determine a daily reasonable price in the form of a Volume-Weighted Average Price (VWAP). This recommendation was made by Small (2015:636-640) to the IRC (1986) (paragraph 3.3.4), which could also be considered for the South African regulatory and taxation environment;
- k) Isom (2013:18-19) suggests possible ways for taxpayers in preparation of uncertain bitcoin tax treatment. These suggestions may also be considered for inclusion in the guidelines for South African tax purposes:
- Retain records of every transaction;
 - request a private letter ruling; and
 - consult a tax professional when in doubt.

6.4 CONCLUSION

Regard must be given to the fact that the taxability of bitcoin exchange transactions in South Africa should be aligned with the South African regulatory environment. This will support the consistency between the taxation and regulatory environment.

CHAPTER 7: SUMMARY AND CONCLUSION

7.1 INTRODUCTION

As stated in paragraph 1.7.1 the main objective of this study was to determine whether bitcoins should be classified as an asset or currency when exchanged for goods, services and real currency from a South African tax perspective.

Secondary objectives (paragraph 1.7.2) were identified to answer the problem statement:

- (i) To determine the characterisation of bitcoins as either property (assets) or currency. This was done in chapter two.
- (ii) To analyse the taxable income consideration on bitcoin exchange transactions in Australia and the USA. This analysis was done in chapter three.
- (iii) To critically analyse the commentary provided by the OECD, Davis Tax Committee and the position expressed by the SARB as to the taxability of bitcoin exchange transactions. This analysis was done in chapters four and five.
- (iv) To make possible recommendations or suggest the most suitable approach on how bitcoin exchange transactions should be taxed in South Africa. This was done in chapter six.

7.2 THE VIEW OF THE AUSTRALIAN TAXATION OFFICE (ATO) AND REGULATORY ENVIRONMENT

The terms “CGT asset” and “foreign currency” as defined in the Income Tax Assessment Act of 1997 (ITAA) have similar meaning to the ordinary dictionary meaning of these terms. The ordinary dictionary meaning of the term “asset” refers to an object having value, whereas the term “currency” is defined as a generally accepted medium of exchange.

The ATO released a guidance paper on the taxation treatment of cryptocurrency transactions. This guidance paper is in return supported by tax determinations which deals with questions relating to whether bitcoins are considered as foreign currency, a CGT asset or trading stock (paragraph 3.2.1.1).

For the purposes of the Australian taxation law, transactions involving bitcoins have the same tax consequences of bartering transactions as bitcoins are regarded as “property” or CGT assets (Commissioner of Taxation, 2014(b):9). Bitcoins are therefore not regarded as “money”, “currency”, or “foreign currency” (paragraph 3.2.1.1).

Any gains or losses derived from mining bitcoins or conducting bitcoins exchange services will be regarded as ordinary income. The trading stock rules should be applied and as a result, any related business expenses incurred may be deductible, based on the arm’s length value on date of trading (paragraph 3.2.2.2.3).

On the other hand, where the intention of the taxpayer is to obtain bitcoins for investment purposes and then subsequently disposed of them, the possible gain or loss will be subject to CGT in the same way shares or similar CGT assets are disposed of (Wolters Kluwer, 2015).

A possible lack in the ATO guidelines and rulings on the taxation treatment for transactions associated with cryptocurrencies was identified, which deals with 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, services or exchanges (paragraph 3.2.2.2.4).

With regard to the regulatory environment, the Reserve Bank of Australia (RBA) does not regard bitcoins as a legal form of tender. What is of interest is that the Australian Digital Currency Commerce Association (ADCCA) recommended that the definition of the term “currency” in the ITAA (1997) should be amended to include digital currency such as bitcoins. In addition, the Economics References Committee suggested that further research be done on whether bitcoins should be treated in the same manner as foreign currencies for income tax purposes (paragraph 3.2.4).

7.3 THE VIEW OF THE US INTERNAL REVENUE SERVICES AND REGULATORY ENVIRONMENT

The term “asset” is not defined in the US Internal Revenue Code (IRC), but reference is made to the meaning of “capital asset” in section 1221 of the IRC (1986) which excludes a range of assets such as inventory for sale to customers, amongst others. Also, the term “currency” is not defined in the IRC (1986), however section 988 of the IRC (1986) provides for rules regarding the treatment of foreign currency transactions (paragraph 2.6.2).

The IRS issued Notice 2014-21 (answers to frequently asked questions) which defines terms such as “virtual currency”, which is “a digital representation of value that functions as a medium of exchange.. or a store of value”. What is of interest, is that this definition carries both similarities to the dictionary meaning of the terms “asset” and “currency” (Keith, 2014:1-6).

In its Notice 2014-21 (Keith, 2014:2), the IRS requires that virtual currency is to be taxed in the same way as traditional property. Similar to the Australian taxation treatment of bitcoin exchange transactions, transactions undertaken with bitcoins will have the same taxation consequences as barter transactions. However, Notice 2014-21 (Keith, 2014:3) suggests that the character of the gain or loss on the sale or exchange of virtual currencies, such as bitcoins, depends on whether the virtual currency is held as a capital asset in the hands of the taxpayer. Accordingly, 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.

Bradbury (2014) discussed the taxation consequences on the sale or exchange of bitcoins for various types of taxpayers. In essence and similar to the taxation treatment by the ATO: if a taxpayer mines bitcoins as a business, the net earnings will be subject to self-employment tax. On the other hand, investors who held their bitcoins for more than a year and a day will be charged at the long-term CGT rate, which is a lower rate opposed to the short-term CGT rate. Where consumers use bitcoins in the form of an on-line wallet to purchase goods directly, the IRS should be informed of the capital gains at the time of the purchase. Furthermore, companies paying salaries in bitcoins must withhold tax in the same way they would if paying in regular fiat currency.

With regard to the regulatory environment, the federal legislation provides that the U.S. Dollar currency is a legal tender for settling debts but the Treasury Department takes the view that this currency is a legal offer of payment, meaning that no federal legislation requires that this currency be accepted as payment (Allen, 2015:22). The Foreign Bank and Financial Accounts (FBAR) reporting requirements do not address the treatment of bitcoins or other virtual currency. The study referred to the regulation of bitcoin exchange transactions in US states such as the New York State, California, New Jersey and other states in general (paragraph 3.3.1.1.6). In conclusion, businesses involved in transmitting, storing, buying, selling, exchanging, issuing or administering a virtual

currency must be licensed by the respective state's regulatory body. This will provide the appropriate regulatory supervision over virtual exchange transactions.

7.4 THE VIEW OF THE SOUTH AFRICAN REVENUE SERVICES (SARS) AND REGULATORY ENVIRONMENT

Section 24I and Schedule Eight of the South African Income Tax Act (Act no. 58 of 1962) provides reference to the terms "currency" and "asset" respectively. The dictionary meaning (paragraph 2.2) of the term "asset" implies that the asset needs to bear value to the owner. When considering the meaning of the term "asset" as defined by the Eighth Schedule, it appears to be wide enough to include virtual currencies, such as bitcoins as a form of property (asset). Also, due to the fact that bitcoins are not yet widely accepted in South Africa as a medium of exchange, bitcoins are not likely to be classified as a "currency" under section 24I of the South African Income Tax Act (Act no. 58 of 1962).

To date, SARS has not issued any guidance paper on the taxation treatment of virtual currency exchange transactions. However, SARS participated together with the Financial Services Board and the Financial Intelligence Centre in the issue of a user alert to the South African public. In essence no legal protection or recourse will be afforded to users of virtual currencies (National Treasury, 2014:3).

The study obtained an understanding of what current South African tax legislation is available to address bitcoin exchange transactions (chapter four). In summary, the following South African tax legislation and relevant case law were identified to apply to bitcoin exchange transactions:

- a) 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. In this regard, two case law rulings were cited by this study: CIR v Stott and Natal Estates Ltd v SIR, (paragraph 4.3.2.1). Furthermore, in the Elandsheuwel Farming (Edms) Bpk v SBI case, cited in this study (paragraph 4.3.2.5), it was held that a taxpayer may realise a capital asset to his best advantage without it being converted to a business or a profit-making scheme. However, the intention of the taxpayer should be considered and evaluated as stated above;
- b) if the intention of the taxpayer is to obtain bitcoins for the purpose of making a profit (bitcoin miner), then sections 22(1) and 22(2) of the South African Income Tax Act

- (Act no. 58 of 1962) will come into effect as the taxpayer will have to account for trading stock (defined by section one) in determining his taxable income;
- c) with regards to the deductibility of any expenses incurred in obtaining bitcoins (for the purpose of making a profit), both sections 11(a) and 23(g) of the South African Income Tax Act (Act no. 58 of 1962) are available;
 - d) for taxpayers trading in bitcoins, the provisions of section 24I of the South African Income Tax Act (Act no. 58 of 1962) 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; and
 - e) where a taxpayer uses bitcoins to make online purchases of items for personal use or consumption, these transactions will qualify as personal-use assets under paragraph 35 of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) 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 (paragraph 5.2) that decentralised virtual currencies are not legal tender in South Africa and should not be used as payment for discharge of any obligation to settle debt. The current Exchange Control Regulations does not explicitly consider virtual currencies in the definition of “foreign currency” as defined by the Exchange Control Regulations (1961). If bitcoins fall under this definition the possibility exists that exchange control regulations will be applied to bitcoin exchange transactions.

7.5 VIEW OF THE RESEARCHER

The researcher is of the opinion that the main and secondary objectives were met in answering the research question, namely, whether bitcoins should be characterised as an asset or currency when exchanged for goods, services and real currency.

In view of the meaning of the terms “asset” and “currency” in context of the dictionary meaning, the interpretation of these terms from the South African tax perspective and that of other developed countries such as Australia and the USA, it is evident from the study that bitcoins should be characterised as an asset for South African tax purposes.

In the light of the growing interest in bitcoin usage internationally, several countries such as Australia, the USA, Germany, China and the UK have already taken the lead in

classifying bitcoins and evaluating the impact of bitcoin exchange transactions within the respective tax and regulatory environments. Due to the volatile nature of bitcoins and their susceptibility to criminal and money-laundering activities, these authorities have established additional regulatory requirements for transacting in bitcoins.

The researcher believes that with no proper rulings, guidance papers and interpretation notes on bitcoin exchange transactions, that in the context of the South African tax and exchange control environments, the risk exist that the South African tax base can be eroded as taxpayers may get involved in illicit transactions, as a result of tax avoidance and money-laundering activities. Also, due to the absence of specific laws or regulations to address the use of virtual currencies in South Africa, no legal protection or recourse will be afforded to users of virtual currencies (paragraph 1.5). The researcher submits that the need for the South African taxation and regulatory authorities to release guidance on bitcoin exchange transactions is of critical importance to assist in the protection of the South African tax base.

In conclusion, the researcher submits that the current South African tax legislation is sufficient to address bitcoin exchange transactions. Based on the understanding obtained in chapter four on what current South African tax legislation is available to address bitcoin exchange transactions, it is evident that bitcoins should be classified as an asset for South African taxation purposes. This classification agrees to the views set by developed countries such as Australia and the USA. However, it is recommended that the definition of the term “asset” (paragraph one of the Eighth Schedule of the South African Income Tax Act (Act no. 58 of 1962) and “foreign currency” (section 24I of the South African Income tax Act (Act no. 58 of 1962)) be amended to specifically consider virtual currencies such as bitcoins. Also, the definition of the term “foreign currency” per the South African Income Tax Act (Act no. 58 of 1962) should coincide with the same definition under the Exchange Control Regulations (1961) for consistency purposes in the regulatory environment.

7.6 SUGGESTIONS FOR FURTHER RESEARCH

The following suggestions have been identified for further research:

- a) Bitcoin and cross-border tax evasion;
- b) collection of tax – intermediaries and the impact on withholding taxes;
- c) permanent establishment-rules within virtual economies;

- d) the enforcement of the taxability of virtual currency exchange transactions; and
- e) the impact of virtual currency exchange transactions regarding the VAT Act.

7.7 CONCLUSION

In summary it can be concluded that the current South African tax legislation does make provision for the classification of virtual currencies such as bitcoins. Therefore, based on the current taxation legislation and case law discussed in chapter four, virtual currencies, such as bitcoins should be classified as an asset for South African income tax purposes. It is however suggested that SARS and the regulatory environment should issue appropriate guidelines in the treatment of bitcoin exchange transactions as both Australia and the USA has already embarked on this much needed guidance for virtual currency users.

As Van Rooyen (cited by Ogundeji, 2015) expressed the importance of providing regulatory (and taxation) guidance to users of bitcoins, this will assist in regulating and reporting on transactions using bitcoins as a medium of exchange, but will also protect the consumer and give businesses (and investors) a lot more clarity on how to transact legally.

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