A minefield of taxes lies ahead for crypto asset transactions

By Joon Chong

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The gyrations of cryptocurrency markets have delivered a first wake-up call to crypto traders and investors who thought it was an easy way to make money. The second alarm is about to go off as Sars is looking at how to tax all possible crypto activities.

Source: Supplied. Joon Chong, partner at Webber Wentzel.

Work on new tax and financial regulatory laws that will apply to crypto assets has already begun, and the South African Reserve Bank (Sarb) is taking the lead.

In a recent presentation, the deputy governor said that the Sarb was busy with various workstreams, including a regulatory framework for crypto-exchange platforms that will ensure compliance with anti-money laundering and counter the financing of terrorism measures, and enforce exchange-control regulations and tax laws. This would take a year to 18 months to finalise.

In South Africa, the term crypto asset, not cryptocurrency, is used, as the SA regulatory framework moves towards uniformity. According to the South African Revenue Service (Sars) website, a crypto asset is “a digital representation of value that is not issued by a central bank, but is traded, transferred and stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility, and applies cryptography techniques in the underlying technology".

The Income Tax Act 58 of 1962 (ITA) defines a financial instrument to include any crypto asset. The ordinary meaning of crypto asset includes cryptocurrencies, and non-currency assets such as non-fungible tokens, security tokens and utility tokens – all items that are stored on a distributed ledger on decentralised networks.

Fundamentals of taxing crypto assets

The ITA does not contain special rules for crypto assets. This means that the tax treatment of crypto assets would be determined in terms of the usual income-tax rules for financial instruments such as equity shares or unit trusts.

The disposal of crypto assets is a taxable event. The purchase of goods or services using cryptocurrencies results in the disposal of crypto assets with proceeds equal to the market value of the goods or services acquired.

The disposal of the crypto assets thus triggers tax payable and a cash outflow.

In considering whether the gains or losses from the disposal of crypto assets are capital or revenue in nature, the question, based on case law, will be whether the taxpayer was engaged in a scheme of profit making.

Was there realisation of an asset for capital gain, or the sale of an existing asset for the purpose of generating revenue?

Section 9C – deeming of gains if held for three years

If a taxpayer has held an equity share for at least three years, Section 9C deems the gains from the disposal of the share to be capital in nature, regardless of the intention.

The definition of an equity share includes shares in companies or a participatory interest in a portfolio of a collective investment scheme. It does not include crypto assets.

Section 9C arguably does not apply to the holding of crypto assets, which makes it more difficult for taxpayers to prove that their crypto gains are capital, rather than revenue in nature, and therefore subject to capital gains tax (CGT) rather than income tax.

Intention in the disposal of crypto

Below, we present three scenarios to illustrate how the intention behind crypto gains could be determined.

Scenario 1

AB, who is completing articles at a medium-sized audit firm, used personal savings to purchase cryptocurrencies as an investment, intending to hold it for at least a year. However, AB sold the cryptocurrencies two months later, for one of two possible reasons:

1a) AB sold because he needed the funds to repair his car when he had an accident. AB had a small loss but was glad to recover most of the capital put down.

1b) AB sold and made a small gain on the sale, as his risk appetite diminished at the first signs of a crash. He had also done more research and realised that he was not as comfortable with the risks as he thought he would be.

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We submit that these losses (1a) or gains (1b) are capital in nature. However, AB may find it difficult to satisfy the burden of proving a capital intention, especially if the coins were held in an exchange wallet, and not in a personal wallet. In an exchange wallet, crypto assets are stored on a platform which lends itself to easy liquidation and trading. A third party, namely the exchange, is given the right to dispose of the coins. In contrast, coins stored in a personal wallet cannot easily be traded.

If AB is on the highest marginal bracket (R1,731 601 for the 2023 tax year), crypto asset assessed losses could also be ring-fenced only to be set off against future crypto-asset gains.

Scenario 2

In this second scenario, CD works full time at a bank. She spends every spare moment researching and watching the cryptocurrency markets with a view to purchasing and selling cryptocurrencies as a long-term investment for her retirement. She realizes that one has to be quick and nimble to make a profit while investing in cryptocurrencies.

CD had 200 disposals in the first year of 10 different cryptocurrencies (testing the waters), and 1,000 disposals in the second year of 30 different cryptocurrencies.

In our view, all gains or losses in both years are likely to be considered as revenue.

Scenario 3

In this third scenario, EF works full time as a content creator for YouTube, and is a dog trainer and social influencer. EF also keeps a few machines in a spare bedroom which he uses to mine cryptocurrencies.

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In our view, the gains on disposal of the crypto assets mined would be capital in nature. EF's situation is similar to a homeowner who has a home and builds another house on the plot which is then sold after subdividing the land.

However, the gains would be more akin to be revenue from a scheme of profit making if the value of coins minted became a few million rands and the number of coins minted numbered in the hundreds, and not fractions.

When EF requires an infrastructure upgrade or has to rent more space for the machines and installs a cooling system, then in our view EF would have crossed the Rubicon and is carrying on a scheme of profit making.

The intention of the taxpayer is key in determining whether gains or losses from the disposal of crypto assets are capital or revenue in nature. However, taxpayers face an uphill battle to prove that their gains or losses are capital in nature due to the high risk and volatile nature of this asset class.

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