Concepts of the cryptocurrency market to be vigilant of when calculating tax liability

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As the cryptocurrency market continues to evolve and mature, each new day brings a slew of new concepts that taxpayers need to be aware of, as these may have a significant impact on tax liability. In this article we aim to dispel some of the confusion surrounding these technologies, and it will serve as a handy guide when determining whether or not it has an impact.

Capital gains

As was clarified by the South African Revenue Services (SARS), cryptocurrencies are regarded as an asset held for capital gain – unless traded, bartered, or exchanged for goods and services – and should be declared as such. This is one of the more straightforward of the tax events. However, it may become slightly more complex when determining the gain or loss when a transaction takes place, mainly due to the decentralised nature of these assets.

Example:

Taxpayer A purchases one bitcoin for R100 through a local exchange after depositing fiat currency into the wallet. Fiat currency refers to traditional currencies such as the South African rand, and United States dollar. Therefore, the base cost of the bitcoin in this case will be R100 less any transaction fees. After a week, the bitcoin balloons in value to R200, but the client does not convert it back to fiat, as they exchange it for 10 Ethereum instead, as they believe it will experience similar growth.

A profit of ZAR100 is recorded as a capital gain.
Taxpayers need to remain vigilant in this regard, as the nature of these assets make it quite easy to exchange units rapidly. Furthermore, even if the cryptocurrencies haven't been exchanged for fiat currency – such as rand, a tax event will still occur. Crypto-investors should note – if they wish to move among several currencies over the course of a year – detailed records should be held. Exchanges like Valr and Luno do a good job in recording the values of each transaction so this shouldn't be too difficult once tax season comes around.

Trading income
Some individuals may actively trade cryptocurrencies on exchanges like Binance *(used as an example, since it is not possible to trade on this platform after new legal requirements were imposed*) or others, and as such this becomes revenue in nature. For instance, a taxpayer deposits fiat currency into an exchange, and starts trading asset pairs (much like some do with the EUR or USD) at margin or not.

Example:
Taxpayer B wishes to take advantage of the volatile nature of the cryptocurrency market, and deposits fiat currency into their wallet. They 'purchase' ZAR100 in BTC/USDT futures at a margin of 10 expecting it will increase in value. The value balloons to ZAR200, and the taxpayer closes the position recording a profit of ZAR1000. Right after this is done, they buy ZAR200 in ETH/USDT futures at a margin of 10 expecting the value to move similarly. At the end of the tax year, this transaction is not closed yet.

The ZAR1000 profit is recorded as trading income.
Taxpayers should be extremely careful when recording these events, since massive gains or losses could occur rapidly – and in some cases all of the investment may be lost. Expenses such as trading fees must also be taken into account, and the currency gain or loss (overall investment value in fiat) may also be considered. If continued losses are incurred by the taxpayer, SARS may apply ringfencing to this activity.

Airdrops
When developers wish to launch a new project, they – in some cases – wish to spur adoption of a specific currency by offering rewards for holding the currency or completing specific tasks such as following their social media. This is done through a lottery system, whereby the project offers a limited number of the asset, which will be distributed to a set number of wallets. Although this event does not trigger a capital gain as the asset is distributed, once it is sold for fiat currency or traded, it will.

Example:
Taxpayer C truly believes in the future prospects of TINYASSET (fictional currency asset for the purposes of this example), as it aims to reduce the time it takes for a transaction to be verified. They deposit fiat currency into their wallet, and buys one million TINYASSET for ZAR100. Due to this, they receive 100,000 TINYASSET in an airdrop event when the coin is officially launched. Once the airdrop event happened, the taxpayer exchanges the assets received during this event for BTC at ZAR100.
A capital gain of ZAR100 is recorded.

Because the asset was received and not purchased, its base cost will be zero when calculating the capital gain, once the taxpayer exchanged it for BTC.
Airdrops are an outlier, as not many investors in this asset class aim for such rewards. The risks involved generally outweigh the benefits.

Distributions and burning
Much like airdrops, some asset classes offer those that hold their currency some incentives. The method for doing so vary greatly, but in general this is done through a transaction ‘tax’, which usually amount to around 5%. This is distributed in equal parts to the holders, and a ‘burn’ wallet; ‘burning’ describes an event where an amount of the asset is transferred to an inactive wallet, reducing the amount of tradeable currency, conceptually benefiting those to hold the currency over a longer period.

Due to the fact that many of these ‘distributions’ only apply to those who hold the coin in a traditional software or physical wallet, it will never apply when trading the currency at a margin on exchanges like Binance.

Example:
Taxpayer C continues to hold their one million TINYASSET after the airdrop event (less the amount that was traded for BTC). Per the contract and whitepaper, 10% of each transaction will be distributed to all holders of the currency, and burned in equal parts. This is done instantaneously whenever a transaction occurs. As such, the taxpayer receives around 10,000 TINYASSET each day. At the end of each month the taxpayer trades the distribution for ZAR100 in BTC.
A capital gain of ZAR100 is recorded.

Because the asset distribution was received as a ‘dividend’, the base cost of this asset becomes zero. The burning event does not have any impact, unless the taxpayer disposes of the asset by voluntarily burning – disposing of – the asset into the inactive wallet. Due to the fact that this is a reward for those who hold the currency for extended periods of time – with these currencies having a long period of slow growth – its not outside the realm of possibility that SARS might consider these distributions as ‘interest’ or dividends in nature, in a bid to increase its short-term revenues at some point.

Mining
This refers to an individual who invests a considerable amount in hardware and software in a bid to profit out of the process of authenticating transactions (mining) on the Bitcoin or Ethereum network. Because the taxpayer did not initially invest in the asset directly, any and all revenues generated from the practice will be declared as income derived from business activities – much like an individual generating revenue providing consulting advice.

As time passes, this asset class will continue to introduce new and interesting dilemmas to consider when determining the tax liability of those taxpayers who wish to dive into this exciting market. Contact our cryptocurrency experts for valuable advice on how you can navigate the potential pitfalls when tax season rolls around.

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