CRYPTOCURRENCY:
TAX IS NOT VIRTUAL

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IN AN ONLINE REPORT BY ***FINANCIAL TIMES***, "COINCHECK PROMISES REFUND AFTER USD500M CRYPTOCURRENCY HEIST" ON 28 JANUARY 2018, A JAPANESE CRYPTOCURRENCY EXCHANGE ISSUED AN APOLOGY AFTER HACKER STOLE CRYPTOCURRENCY[1] BELONGING TO 260,000 CUSTOMERS. JAPANESE CRYPTOCURRENCY EXCHANGE **COINCHECK** SAID IT WOULD REPAY CUSTOMERS AFTER FALLING VICTIM TO ONE OF THE WORLD'S BIGGEST HEISTS[2].

Given the size of the heist and the fact that it was committed digitally, this is worrying especially in today's digital age! We are all familiar with the saying: There are only two things certain in life i.e. death and taxes[3], but can cryptocurrency escape taxes? Cryptocurrency creates many new headaches for regulators in respect of the legality and taxation of this new asset class.

This article seeks to examine the premise of Bitcoin[4], the very first widely accepted digital currency and its potential effect on the taxation industry.

THE RISE OF DIGITAL CURRENCY

Prior to 2009, no one seriously foresaw the rise of digital currency. After the financial crisis highlighted the oversight by the central banks and financial institutions which lead to losses in monetary reserves, people start looking for a more secure replacement to traditional fractional reserve banking.

On 3 January 2009, Bitcoin, the very first decentralised digital currency utilising the blockchain[5], was launched by a mysterious person known only by the pseudonym Satoshi Nakamoto, whose true identity remains unknown[6]. Since then, the value of Bitcoin has steadily appreciated as the demand for the digital currency grew despite a few small dips in its short 10 year history.[7] At the same time, the increase in the demand for digital currencies has spawned more new cryptocurrencies like Ethereum and Ripple. With the introduction of more new cryptocurrencies, it increases the market capitalisation of digital currency.

WHAT IS BITCOIN?

Bitcoin is a decentralised digital currency where Bitcoins are registered with a Bitcoin address. This makes the entire system pseudonymous with transactions being recorded under pseudonyms so that the identities of the parties are kept private. Bitcoins are stored in a Bitcoin wallet. The Bitcoin wallet is basically just a collection of Bitcoin addresses. Each of the Bitcoin addresses was created with a valid private key.

Bitcoin has the characteristic of a Fiat currency which means that it is not backed by a physical commodity like gold or government guarantees. Currently, most nations utilise fiat currency to drive their economies. The biggest fiat currency would be the United States Dollar which has been a fiat currency since 1971.[8] The thing that gives a fiat currency value is its scarcity, guarantee of value from the issuing state and the laws of supply and demand.

For example, assuming the supply and demand of Bitcoin remains stable but the community was to lose faith in the value of Bitcoin, the community would then start to sell their Bitcoin bringing down the price of Bitcoin due to oversupply of Bitcoin in the market.

WHAT CAN BITCOIN BE USED FOR?

Bitcoin can be spent just like any conventional currency at any merchants that accept it. It can also be sold to people who wish to purchase Bitcoin for whatever purpose.

HOW CAN YOU OWN BITCOIN?

There are two ways in which you can own Bitcoin, the easiest way is to purchase it at one of the many new cryptocurrency exchanges. This is also the more expensive option considering the price of a Bitcoin as at 2 March 2018 is almost USD10,980.[9]

The alternative is to mine Bitcoin. Mining Bitcoin involves adding Bitcoin transaction data to the Bitcoin's global public ledger of past transactions. Each group of transactions is called a block. Blocks are secured by Bitcoin miners and built on top of each other to form the blockchain. The blockchain confirms the transactions as having taken place to the rest of the network. Bitcoin nodes running the Bitcoin programme use the blockchain to distinguish legitimate Bitcoin transactions from those transactions that attempt to re-spend coins that have

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[1] *Wikipedia, Cryptocurrency, on 12 April 2013, https://en.wikipedia.org/wiki/Cryptocurrency.*

[2] *Financial Times, Coincheck promises refund after $500m cryptocurrency heist, on 28 January 2018 https://www.ft.com/content/7b0d7660-03ea-11e8-9650-9c0ad2d7c5b5.*

[3] *Benjamin Franklin, in a letter to Jean-Baptiste Leroy, 1789 stated "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."*

[4] *Wikipedia, Bitcoin, on 12 April 2013, https://en.wikipedia.org/wiki/Bitcoin.*

already been spent elsewhere.

Bitcoin mining is getting more expensive as more and more processing power is required to compute the hash functions required to secure a block to the blockchain. This has led to many Bitcoin mining pools being set up to share in the costs of mining Bitcoin. This is akin to a joint venture with many miners from all over the world to contribute to a mining pool.

HOW DO YOU MINE BITCOIN?

To mine Bitcoins, miners must find a hash value that includes a list of all of the most recent transactions that need to be verified. Once a miner finds such a value, he or she broadcasts it to the Bitcoin network. The set of transactions are now verified, and that set becomes the next block in the Bitcoin blockchain. The miners then receive their reward for contributing their computational power to operate the Bitcoin protocol.[10] The hash rate is the number of times a hash function can be computed per second. The Bitcoin miner's expected profit is directly proportional to the hash rate of his Bitcoin mining machines.

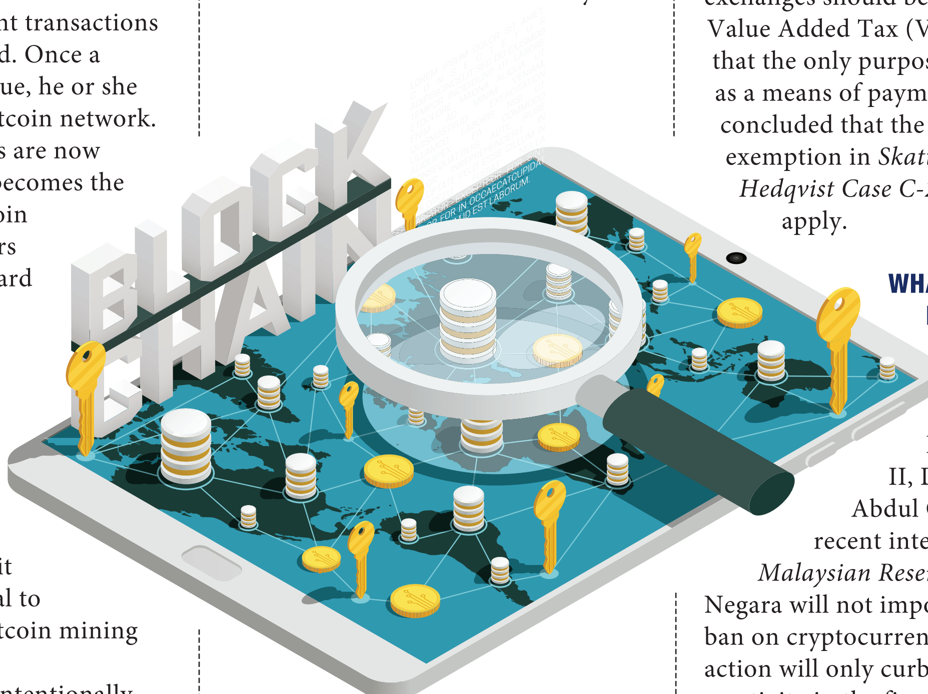
Bitcoin mining is intentionally designed to be resource-intensive and difficult, so that the number of blocks found each day by miners remains steady over time, producing a controlled finite monetary supply. The amount of computing power required to mine Bitcoin depends on the Bitcoin network's hash rate which is the measurement unit of the processing power of the Bitcoin network. The Bitcoin network must make intensive mathematical and cryptography related operations for security purposes. For example, if the Bitcoin network reaches a hash rate of 20 Th/s, it means that the network can make 20 trillion calculations per second.[11]

IS CRYPTOCURRENCY THE NEXT TAX FRONTIER?

Different jurisdictions across the world have taken a different approach in respect of the taxation of cryptocurrency. We will examine a few of the approaches below.

UNITED STATES

The United States Inland Revenue Service classifies virtual currency as property for United States Federal tax purposes.[12] Therefore, capital gains taxes are applicable for gains on the value of virtual currency in the United States.



SINGAPORE

In Singapore, the Inland Revenue Authority of Singapore has held that businesses that buy and sell virtual currencies in the ordinary course of their business will be taxed on the profits derived from trading in the virtual currency. Profits derived by businesses which mine and trade virtual currencies in exchange for money are also subject to tax.

However, like Malaysia, there is no capital gains tax in Singapore. Hence, long-term investment in Bitcoin would not be subjected to tax.[13]

EUROPE

In Europe, there is no consensus on whether Bitcoin is a currency. However, the European Court of Justice has held that Bitcoin exchanges should be exempted from Value Added Tax (VAT) on the basis that the only purpose of Bitcoin is as a means of payment, the court concluded that the 'currency' exemption in *Skatteverket v David Hedqvist Case C-264/14* should apply.

WHAT IS THE MALAYSIAN STANCE ON BITCOIN?

Malaysia's Finance Minister II, Datuk Seri Johari Abdul Ghani said in a recent interview with the *Malaysian Reserve* that Bank Negara will not impose a blanket ban on cryptocurrencies as such action will only curb innovation and creativity in the financial sector, particularly in financial technology.[14]

On 9 January 2018, a land deal was sealed using Bitcoin in Sabah between Alexander Yee and Polycarp Chin. The land was still subject to the Real Property Gains Tax. On 27 February 2018, Bank Negara issued a policy document on Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) of Digital Currencies.[15] In the policy document, Bank Negara reiterates its stance that digital currencies are not legal tender in Malaysia. The policy paper sets out new reporting requirements for a person who provides cryptocurrency exchange services such as the exchange digital currency for money or vice versa regardless of whether they have a physical presence in Malaysia.

IS CRYPTOCURRENCY SUBJECT TO MALAYSIAN INCOME TAX?

Currently, the Inland Revenue Board Malaysia (IRBM) has yet to issue definitive guidelines on how to subject the cryptocurrency transactions to tax. However, on 19 January 2018, the chief executive officer Dato' Sri Sabin Samitah said that even if cryptocurrency businesses are not regulated in Malaysia, the businesses are still subject to Malaysian income tax pursuant to Section 3 of the Income Tax Act 1967 (ITA), where tax shall be charged upon the income any person accruing in or derived from Malaysia.[16] He said that the current provisions of the ITA are applicable to all cryptocurrency traders.

He further added that the cryptocurrency company would need to keep proper books of accounting and business records in Malaysia for the purpose of being audited by the relevant law enforcement agencies.

There are a few arguments that taxpayers can argue against the imposition of tax on their gains from cryptocurrency. A few of these arguments will be discussed below.

1. ***Foreign source income***
   Taxpayers can argue that the income gained from the cryptocurrency transaction is foreign sourced income[17] and not subject to tax, being derived from outside of Malaysia.
   This argument will likely be challenged by the IRBM as the taxpayer would be unable to prove that the transaction came from overseas.
   As discussed, the nature of Bitcoin transaction is that the address of the receiver and the sender are masked. The taxpayer would have a hard time proving that the transaction took place overseas without revealing the identity of the sender or the receiver.
2. ***Legality of cryptocurrency business***
   Although the cryptocurrency business is not regulated in Malaysia, in the tax case of *Lindsay, Woodward and Hiscox v IR Commrs (1932) 18 TC 43,* it was held that profits made from illegal trades are subject to tax. In this regard, the non-regulation of cryptocurrency does not prevent the profits from such businesses

[5] *Wikipedia, Blockchain, on 12 April 2013, https://en.wikipedia.org/wiki/Blockchain. A blockchain, originally block chain, is a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically contains a cryptographic hash of the previous block, a timestamp and transaction data. By design, a blockchain is inherently resistant to modification of the data. It is "an open, distributed ledger that can record transactions between two parties efficiently and in a verifiable and permanent way". For use as a distributed ledger, a blockchain is typically managed by a peer-to-peer network collectively adhering to a protocol for validating new blocks. Once recorded, the data in any given block cannot be altered retroactively without the alteration of all subsequent blocks, which requires collusion of the network majority.*

[6] *The Economist explains, How Does Bitcoin Work?, on 12 April 2013, https://www.economist.com/bitcoinexplained.*

[7] *Buy Bitcoin Worldwide, Bitcoin Price History Chart, on 2 March 2018, https://www.buybitcoinworldwide.com/price.*

[8] *American Monetary Association, How American became a fiat currency, 2 March 2018, http://americanmonetaryassociation.org/how-the-us-dollar-came-to-be-a-fiat-currency/.*

[9] *Coindesk, Bitcoin (USD) Price, 2 March 2018, https://www.coindesk.com/price.*

[10] *Quora, What does Bitcoin hash rate mean?, 2 March 2018, https://www.quora.com/What-does-Bitcoin-hash-rate-mean.*

[11] *Bitcoin, What is Bitcoin mining, 2 March 2018, https://www.bitcoin.com/bitcoin-mining.*

[12] *Inland Revenue Service, IRS Virtual Currency Guidance : Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply, on 2 March 2018, https://www.irs.gov/newsroom/irs-virtual-currency-guidance.*

from being taxed.

3. ***Tax Residency***
The taxpayer can move around the world to avoid being classified as a tax resident in Malaysia. Given the global nature of the cryptocurrency in general, and Bitcoin in particular, these Malaysian taxpayers can sell their Bitcoins from anywhere without the hefty cross border transaction fees. These taxpayers could run the argument that they are not tax residents of Malaysia and therefore are not subject to that the identity of the person making those gains may not be who it seems. Of course, bringing the money back for utilisation is a different issue altogether.

4. ***Income from hobby or from investment***
The taxpayers can argue that they bought cryptocurrency merely as a hobby or as a long-term investment.
However, if a business arises as a by-product of a hobby or other non-commercial activities, its profits could also be subjected to ledger will have records on the transacted prices and time of transfer. The taxpayers have to subtract the cost of the cryptocurrencies against the selling price to determine the gain or loss. In this regard, the taxpayers must keep track of their cryptocurrency transactions continuously to report the gain or loss on each cryptocurrency transaction properly.
The application of the 40 year old principles of the badges of trade from *NYF Realty Sdn. Bhd.*

Malaysian income tax. However, to note on the recent case of *Hii Yii Ann v Deputy Commissioner of Taxation of the Commonwealth of Australia & Others* where a taxpayer claimed that he was not a tax resident of Australia and the Australian Tax Office should not be able to extend its taxation hand overseas to tax a Malaysian taxpayer. Unfortunately, the taxpayer lost the case at this juncture.
The other issue to consider is who is actually making profits. In the age of Virtual Private Networks it would be possible tax.
This is seen in the tax case of *Hawes v Gardiner (37 TC 671)* where a taxpayer bred and trained dogs as his hobby. The General Commissioners found that the selling of puppies for substantial prices by the taxpayer was in the nature of trade and subjected the profits from the sale of puppies to tax.
In the current circumstances, the trading of cryptocurrency may be subjected to tax. The taxable transactions occur every time the cryptocurrency is traded in virtual exchanges. The blockchain *v Controller of Inland Revenue* could still be applicable in determining whether there is an intention to trade:

(1) ***Subject matter of the transaction***
Unlike enterprises, Bitcoin has no business, no intrinsic value, no cash flows and no balance sheet. It is a speculative instrument[18] and which is normally the subject of investment.
This is seen in the tax case of *Dr. Zanariah Binti Ramli v Ketua Pengarah Hasil Dalam Negeri,* where the Court of Appeal held that the gains made from the bond market is subject to income

tax based on the grounds that the appellant had in fact been actively trading in bonds during the period.

Numerous or repetitive acts done by the appellant would suggest the action was in the nature of a trade.

In view of the above, holding cryptocurrency would likely have the characteristic of an asset held for trading in the eyes of the IRBM.

(2) ***Period of ownership***

The period of ownership of the cryptocurrency can be controlled by the taxpayer. The benefit of holding cryptocurrency is that there are no holding costs unless the taxpayer has borrowed money to purchase this cryptocurrency. Arguably if a taxpayer has held Bitcoin since 2009, he could argue that he is a long-term investor for the currency. However, for all recent transactions, it would likely be considered an adventure in the nature of a trade and be subjected to tax.

(3) ***Frequency of transactions***

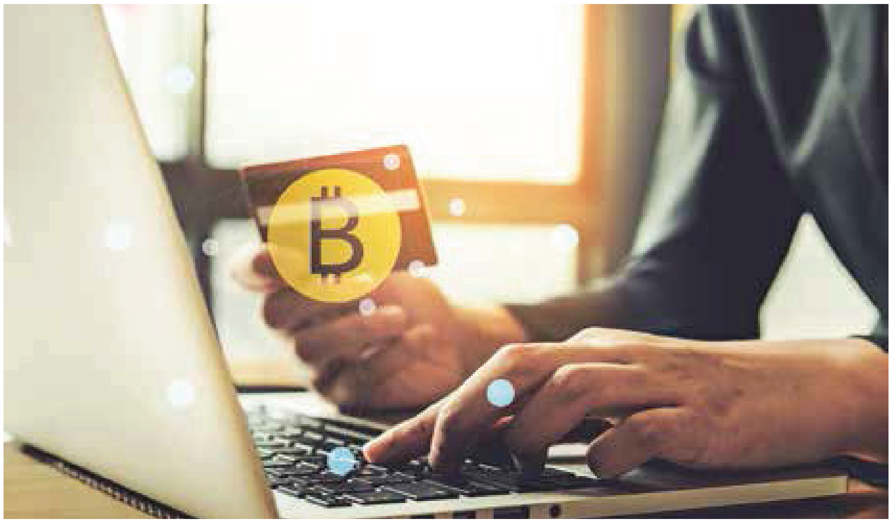
This is the easiest way to identify speculators of cryptocurrency. There will be multiple cryptocurrency transactions to and from the same address or wallet within a short period of time. All Bitcoin transactions are public, traceable and stored in the Bitcoin network. In the present case, if the IRBM is able to look behind the Bitcoin pseudonyms and identify the owner of the cryptocurrency wallet, the IRBM can further investigate the owner of cryptocurrency and tax accordingly.

(4) ***Alteration of property to render it more saleable***

Due to the nature of cryptocurrency, the taxpayer is unlikely to be able to alter the cryptocurrency to make it more saleable.

(5) ***Methods employed in disposing of property***

If special exertion was made to find or attract purchasers for the cryptocurrency, it might indicate an intention to sell it for profit. However, in the current circumstances, it is easy for the taxpayer to buy and sell cryptocurrency with the cryptocurrency exchanges. Further, cryptocurrency is currently a very liquid asset that can be spent on goods and services just like conventional currency. Arguably, this badge



of trade may not paint a clear picture of the intention of the taxpayer.

(6) ***Circumstances responsible for sale***
The principle here is that if the sale of cryptocurrency is occasioned by a sudden emergency or unanticipated need for funds, such facts will tend to indicate that the cryptocurrency was not acquired for the purpose of resale at a profit and that the sale was not pursuant to a profit making undertaking or scheme. This principle involves a subjective study into the surrounding circumstances relating to the sale of cryptocurrency and will be determined according to the merits of each individual case.
Based on the analysis of badges of trade above, the cryptocurrency speculators may be considered as engaging in an adventure in the nature of a trade and their gains will be taxable.

IS THERE AN UPSIDE?

On the bright side, if the taxpayer is held to be engaging in an adventure in the nature of a trade, all expenses wholly and exclusively incurred in earning that income will be deductible under Section 33(1) of the ITA provided that they are not specifically disallowed under Section 39 of the ITA. However, it is difficult to draw the line between capital versus revenue in an actual situation where a person may initially purchase cryptocurrency for investment purposes but subsequently uses it to settle debts. The question that arises would be, is this still a capital transaction? If not, which value to be used for tax purposes?

For speculators, they might even be able to claim their interests costs paid to hold the cryptocurrency.

On the other hand, for Bitcoin miners, expenses such as electricity and salary may be eligible for tax deductions and the Bitcoin mining computers may be eligible for capital allowances pursuant to Schedule 3 of the ITA.

SO WHAT'S NEXT?

The IRBM has fired the first salvo in opening an investigation into Luno, it remains to be seen whether their enforcement actions would be limited to cryptocurrency exchanges or will it be expanded to the numerous merchants that have started accepting cryptocurrencies in their businesses.

How to tax a decentralised currency powered by blockchain technology is the question on every government regulator's mind. It is clear that the tax laws have to play catch up or potentially lose out on a digital gold mine of tax revenue.

Disclaimer: This article does not seek to address all tax issues associated with cryptocurrency and all views expressed are purely the personal opinion of the author.

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[13] *Inland Revenue Authority of Singapore, Income Tax Treatment of Virtual Currencies, on 2 March 2018, https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Specific-topics/Income-Tax-Treatment-of-Virtual-Currencies/.*

[14] *The Malaysia Reserve, No ban on cryptocurrency tradings, says Johari, on 2 March 2018, https://themalaysianreserve.com/2018/01/02/no-ban-cryptocurrency-tradings-says-johari/.*

[15] *Bank Negara Malaysia, Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) – Digital Currencies (Sector 6), on 2 March 2018, http://www.bnm.gov.my/index.php?ch=57&pg=538&ac=680&bb=file.*

[16] *The Star Online, IRB: Cryptocurrency not regulated but traders are still subject to Malaysian income tax law, on 2 March 2018, https://www.thestar.com.my/tech/tech-news/2018/01/19/irb-cryptocurrency-not-regulated-but-traders-still-subject-to-malaysian-income-tax/.*

[17] *Paragraph 28 Schedule 6 of the Income Tax Act 1967.*

[18] *Starbizweek, Bitcoin: Utter pipedream, on 10 February 2018, https://www.thestar.com.my/business/business-news/2018/02/10/bitcoin-utter-pipedream/.*

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