CRYPTOCURRENCY TAX IS NOT VIRTUAL 2.0

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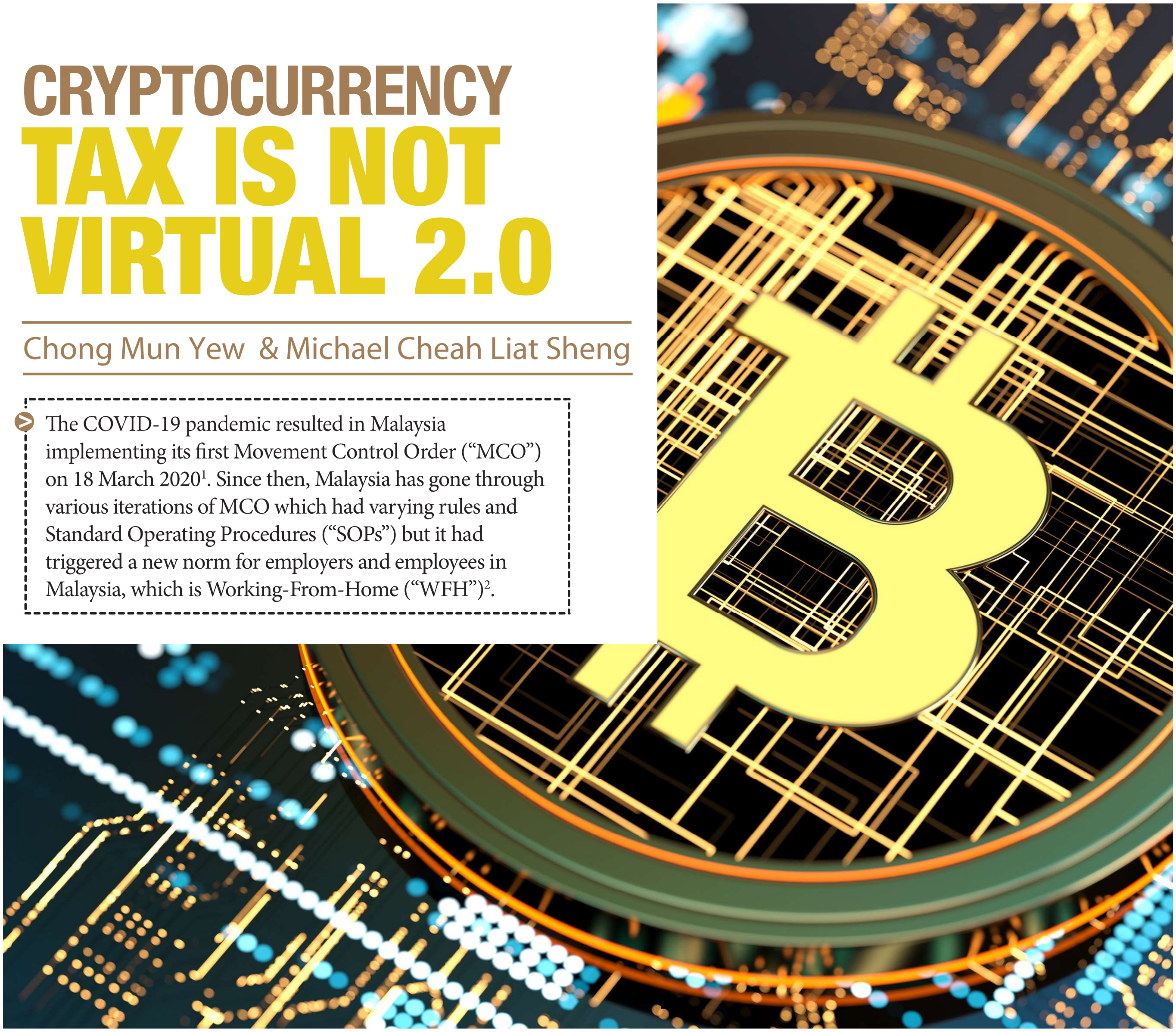
The COVID-19 pandemic resulted in Malaysia implementing its first Movement Control Order ("MCO") on 18 March 2020[1]. Since then, Malaysia has gone through various iterations of MCO which had varying rules and Standard Operating Procedures ("SOPs") but it had triggered a new norm for employers and employees in Malaysia, which is Working-From-Home ("WFH")[2].



The WFH culture coupled with the economic uncertainties resulting from the COVID-19 pandemic worldwide has encouraged Malaysians to seriously consider investments as an additional income source or as an alternative to traditional investments such as buying shares, bonds, options, etc. One such investment opportunity is in cryptocurrency[3]. The surge of new investors in cryptocurrency has seen Luno Malaysia's[4] registering an influx of new users of 588,994 verified users in the fourth quarter of 2020, which represents over 300% quarter-on-quarter customer growth[5].

Given the upward trend of investing in cryptocurrency in Malaysia, the question then arises on whether the gains from investing in cryptocurrency is subject to tax in Malaysia. Although cryptocurrency has already been around for many years, but regulators are still trying to come to grips with the legal and tax aspects of this asset class.

This article seeks to examine the premise of cryptocurrencies and its potential effect on the taxation industry and update the previous article published in *Tax Guardian* in April 2018[6] on the same subject matter.

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 led to losses in monetary reserves, people started looking for a more secure replacement to traditional fractional reserve banking. Then, cryptocurrencies were seen as one such alternative.

Over the past twelve years, cryptocurrencies have steadily grown in value and recognition as a digital currency. Elon Musk, a well-known enthusiast of Bitcoin, through Tesla acquired $1.5 billion of Bitcoin during the first quarter of 2021 and then followed up with an announcement that Tesla's customers will be able to purchase their cars with Bitcoin[7]. This view has since changed due to recent announcement by Elon Musk on 13 May 2021 which is discussed further below.

All these together with a myriad of other factors culminated in cryptocurrencies values rising substantially in 2021. Ethereum posted a record high value of $3,616 on 7 May 2021, which represented a price gain of over 385%[8]. On the other hand, Bitcoin posted its record high value of $63,000 on 13 April 2021[9], which is double the price since the start of 2021[10]. Analysts are forecasting that cryptocurrencies, and in particular Bitcoin still have further potential for growth[11]. However, after the announcement made by Elon Musk, the prices of cryptocurrencies seem to be plunging. As can be seen, the prices of cryptocurrencies are highly volatile.

What is cryptocurrency?

Cryptocurrency is a form of decentralized digital currency that is based on blockchain[12] technology. They are secured by cryptography, thus making it almost impossible to counterfeit or double-spend[13]. For example, Bitcoins are registered with a Bitcoin address which 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.

According to CoinLore, there are currently more than 5,000 cryptocurrencies in circulation [14].

Cryptocurrencies have 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.[15] 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.

Using Bitcoin as an example, assuming the supply and demand 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 cryptocurrency be used for?

Cryptocurrency can be spent just like any conventional currency at any merchants that accept it. One such example is Tesla, which has recently announced that it will be accepting Bitcoin as a payment method for its customers to purchase their cars[16]. However, on 13 May 2021 Elson Musk said that Tesla would no longer accept bitcoin due to fossil fuel issue[17]. He has not indicated whether Tesla would accept other digital coins to replace Bitcoin. Alternatively, it can be sold to people who wish to purchase the cryptocurrency for whatever purpose.

How can you own cryptocurrencies?

One way to own cryptocurrency, which is the easiest way is to purchase it at one of the many new cryptocurrency exchanges. In Malaysia, there are three cryptocurrency exchanges registered with the Securities Commission of Malaysia which are Luno Malaysia Sdn Bhd, SINEGY Technologies (M) Sdn Bhd and Tokenize Technology (M) Sdn Bhd[18].

The alternative is cryptocurrency mining. Let us use Bitcoin mining as

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1 *Kuok Ho Daniel Tang, Movement control as an effective measure against Covid-19 spread in Malaysia: an overview on 12 May 2021, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC7293423/.*

2 *The Star Online, Making it work from home on 28 March 2021, https://www.thestar.com.my/news/focus/2021/03/28/making-it-work-from-home.*

3 *Wikipedia, Cryptocurrency on 8 May 2021, https://en.wikipedia.org/wiki/Cryptocurrency.*

4 *Luno Malaysia on 12 May 2021, https://www.luno.com/en/exchange.*

5 *New Straits Times, Luno Malaysia manages over RM1bil DAUM on 14 April 2021, https://www.nst.com.my/business/2021/04/682203/luno-malaysia-manages-over-rm1bil-daum.*

6 *Tax Guardian Vol.11/No.2/2018/Q2 on "Cryptocurrency: Tax is Not Virtual" published in August 2018.*

7 *BBC News, Tesla: Bitcoin sales and environmental credits boost profits on 27 April 2021, https://www.bbc.com/news/business-56897457.*

8 *Reuters, Cryptocurrency ether rises to new record high over $3,600 on 7 May 2021, https://www.reuters.com/technology/crypto-currency-ether-rises-new-record-high-2021-05-06/.*

9 *CNBC, Bitcoin hits new all-time high above $63,000 ahead of Coinbase debut on 13 April 2021, https://www.cnbc.com/2021/04/13/bitcoin-hits-new-all-time-high-above-62000-ahead-of-coinbase-debut.html.*

10 *Forbes, Bitcoin Price Prediction: Why Bitcoin Could Rocket To $400,000 In 2021 on 8 April 2021, https://www.forbes.com/sites/billybambrough/2021/04/08/bitcoin-price-prediction-why-bitcoin-could-rocket-to-400000-in-2021/?sh=1cf5bb327a35.*

an example. 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 program use the blockchain to distinguish legitimate Bitcoin transactions from those transactions that attempt to re-spend coins that have already been spent elsewhere.

However, 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.

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 Internal Revenue Service classifies virtual currency as property for United States Federal tax purposes.[19] Therefore, capital gains taxes are applicable for gains on the value of virtual currency in the United States.[20]

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 cryptocurrency would not be subjected to tax.[21]

Europe

In Europe, there is no consensus on whether cryptocurrency 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 Cryptocurrency?

Bank Negara has held that digital currencies are a payment instrument that is not regulated by Bank Negara and therefore cannot be considered legal tender in Malaysia. However, the Securities Commission of Malaysia ("SC") recognises digital currencies as an investible class of assets and has prescribed digital assets as securities that is regulated under the SC's laws[22].

Is cryptocurrency subject to Malaysian income tax?

Inland Revenue Board of Malaysia ('IRBM') has yet to issue definitive guidelines on how to subject the cryptocurrency transactions to tax. However, the IRB has cited Section 3 of the Income Tax Act 1967 ("ITA") and indicated the said provision can be applied to active cryptocurrency traders. Therefore, the current provisions of the ITA can be applied to active cryptocurrency traders.

The IRB went on to say that the determination of whether the profits from cryptocurrency activities is taxable would depend on the facts and circumstances of the case to determine whether there is a pattern of the badges of trade.

If one is determined as an active trader of cryptocurrency, then the net gains from the cryptocurrency activities would be subject to income tax and would be required to be disclosed in their income tax returns under the "any other income" section[24]. Therefore, they 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.

Notwithstanding, there are a few arguments that taxpayers can raise to argue against the imposition of tax on their gains from cryptocurrency as we will discuss below. For the avoidance of doubt, these factors have been highlighted in the previous article published by CTIM in August 2018.

1. FOREIGN SOURCE INCOME

Taxpayers can argue that the income gained from the cryptocurrency transaction is foreign-sourced income[25], and therefore not subject to tax i.e. that it is derived from outside Malaysia. This argument will likely be challenged by the IRBM - in which case the taxpayer would need to prove that the transaction was indeed performed outside Malaysia. With travel restrictions on account of the pandemic, this task is made that much more difficult for the taxpayer.

The nature of cryptocurrency is such that the transactions can be performed at a click of a button on a laptop or smartphone anywhere in the world. As such, the taxpayer would have a hard time proving that the location of the transaction or the originating source of the cryptocurrency lies overseas.

2. TAX RESIDENCY

The taxpayer can move around the world to avoid being classified as a tax resident in Malaysia. As mentioned, given the global nature of the cryptocurrency in general, these Malaysian taxpayers can sell their Bitcoins from anywhere without the hefty cross border transaction fees. These taxpayers could argue that they are not tax residents of Malaysia and therefore are not subject to Malaysian income tax. However, one should take guidance from the case of ***Hii Yii Ann v Deputy Commissioner of Taxation of the Commonwealth of Australia & Others [2017] MLJU 2302*** a Malaysian taxpayer derived income from Australia and was taxed on the said income by the Australian revenue authorities. The taxpayer however claimed he is not chargeable to income tax in Australia as he was not a tax resident in Australia. His appeal against the assessment was rejected by the Australian court.

Another issue to consider is who is actually making the profits. In the age of Virtual Private Networks, the identity of the person making those gains may not be clear. The money when remitted back for utilisation is an ancillary issue.

3. 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 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.

Applying this principle, 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 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 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. v Controller*** of

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[11] *Finextra Research, Crypto forecast for the first half of 2021 on 22 January 2021, https://www.finextra.com blogposting/19799/crypto-forecast-for-the-first-half-of-2021.*

[12] *Wikipedia, Blockchain, on 3 May 2021, 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.*
Investopedia, Cryptocurrency on 7 March 2021, https://www.investopedia.com/terms/c/cryptocurrency.asp.

[13] *Investopedia, Cryptocurrency on 7 March 2021, https://www.investopedia.com/terms/c/cryptocurrency.asp.*

[14] *Forbes, What Is Cryptocurrency? on 18 December 2020, https://www.forbes.com/advisor/investing/what-is-cryptocurrency/.*

[15] *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/.*

[16] *BBC News, Tesla: Bitcoin sales and environmental credits boost profits on 27 April 2021, https://www.bbc.com/news/business-56897457.*

Inland Revenue could still be applicable in determining whether there is an intention to trade:

i. Subject matter of the transaction
Cryptocurrency is a speculative instrument that is extremely difficult to value[26] and as such is normally the subject of investment. However, even gains from investment can be subject to income tax if they are performed actively.
This is seen in the tax case of ***Dr. Zanariah Binti Ramli v Ketua Pengarah Hasil Dalam Negeri Civil Appeal No. W-01-711-12/2011****, 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 IRB.

ii. Period of ownership
The period of ownership of the cryptocurrency is one aspect which is in total control by the taxpayer. The benefit of holding cryptocurrency is that there are virtually no holding costs unless the taxpayer has borrowed money to purchase this cryptocurrency. If a taxpayer has held the cryptocurrency for a long period of time, he could argue that he is a long-term investor of 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.

ii. Frequency of transactions
This is a significant consideration 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. Most cryptocurrency transactions are public, traceable and stored on a network based on blockchain technology. In the present case, if the IRB can look behind the cryptocurrency pseudonyms and identify the owner of the cryptocurrency wallet, the IRB can further investigate the owner of cryptocurrency and tax them accordingly.

iii. 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.

iv. 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 case of cryptocurrency, the taxpayer has easy access to buying and selling of cryptocurrency via the numerous cryptocurrency exchanges available. Further, cryptocurrency is currently a very liquid asset that can be spent on goods and services just like conventional currency, albeit it not being recognised as legal tender by Bank Negara. Arguably, this badge of trade may not paint a clear picture of the intention of the taxpayer.

vi. 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.

vii. Financing
Generally, the source of financing can indicate whether an asset was purchased with the intention to trade. If the taxpayer has taken a short-term loan to purchase the cryptocurrency, it will tend to indicate that the cryptocurrency was acquired for the purpose of resale

for profit and subject the gains to tax.

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. Therefore, taxpayers may even claim the interest costs or any directly related costs incurred to hold the cryptocurrency.

However, it is difficult to draw the line between capital versus revenue in an actual situation, a person may initially purchase cryptocurrency for investment purposes but subsequently uses it to settle debts. The question that arises would be – will this still be a capital transaction? If not, which value to be used for tax purposes?

Cryptocurrency Staking

An alternative method to getting returns on cryptocurrency is by staking. Staking is the holding of cryptocurrency in the cryptocurrency wallet to support the security and operations of the blockchain network[27]. By locking the cryptocurrency, the cryptocurrency exchange will provide rewards which are usually in the form of a cryptocurrency of choice of the wallet owner.

This concept would be similar to that of placing a fixed deposit with a licensed bank to earn the interest income. However, individuals earning interest income from deposits placed with licensed banks are exempted from tax[28] on the interest income. The same cannot be said for the returns earned from cryptocurrency staking where there are no specific provisions in the ITA nor any rules that exempt it from tax in Malaysia. Therefore, similar to the trading of cryptocurrency, individual and corporate taxpayers alike earning rewards from cryptocurrency staking may potentially be required to bring it to tax under Section 3 of the ITA.

So, what's next?

How to tax a decentralised currency powered by blockchain technology is still very much the question on every government regulator's mind. One thing for certain is that they have to update their respective tax laws or potentially continue losing out on a digital gold mine of tax revenue.

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[17] *Financial Times on 13 May 2021 reported that "Musk says Tesla no longer plans to accept payment in bitcoin - Cryptocurrency's price falls after chief executive goes from evangelist to critic, citing environmental impact".*

[18] *Securities Commission of Malaysia, List of Registered Digital Asset Exchanges on 5 May 2021, https://www.sc.com.my/regulation/guidelines/recognizedmarkets/list-of-registered-digital-asset-exchanges.*

[19] *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 12 May 2020, https://www.irs.gov/newsroom/irs-virtual-currency-guidance.*

[20] *Wall Street Journal on 15 May 2021 reported regarding "The IRS is Coming for Crypto".*

[21] *Inland Revenue Authority of Singapore, Income Tax Treatment of Virtual Currencies on 12 May 2021, https://www.iras.gov.sg/irashome/Businesses/Companies/Working-out-Corporate-Income-Taxes/Specific-topics/Income-Tax-Treatment-of-Digital-Tokens/.*

[22] *Bank Negara Malaysia, BNM and SC's Joint Response on "Policy confusion over cryptocurrencies" on 16 December 2021, https://www.bnm.gov.my/-/bnm-and-sc-s-joint-response-on-policy-confusion-over-cryptocurrencies-.*

[23] *The Malaysian Reserve, Active cryptocurrency traders not spared from LHDN on 5 January 2021, https://themalaysianreserve.com/2021/01/05/active-cryptocurrency-traders-not-spared-from-lhdn/.*

[24] *The Edge Markets, The Wall: Profited from trading bitcoin? Find out if you need to pay taxes on 1 March 2021, https://www.theedgemarkets.com/article/thewall-profited-trading-bitcoin-find-out-if-you-need-pay-taxes.*

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

[26] *The Malaysian Reserve, Bitcoin expected to reach another record high, but…, on 18 December 2020,*

[27] *https://themalaysianreserve.com/2020/12/18/bitcoin-expected-to-reach-another-record-high-but/. Binance Academy, What Is Staking? on 12 May 2021, https://academy.binance.com/en/articles/what-is-staking.*

[28] *Income Tax (Exemption) (No. 7) (Amendment) Order 2009*

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

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