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WEEKLY COMMENT: FRIDAY 26 AUGUST 2022

1. This is week 3 of my review of the taxation of cryptoassets (the term used by Inland Revenue to refer to virtual currencies) in New Zealand. I look at the income tax implications for individuals. And the tax implications of mining cryptoassets.

Acquiring and disposing of cryptoassets

2. Inland Revenue has listed the following ways in which an individual (or a business) could acquire or dispose of cryptoassets:

(a) Ways in which cryptoassets may be acquired:

(i) Buying cryptoassets (such as, through an online exchange, peer-to-peer or from a crypto ATM);

(ii) Mining or staking cryptoassets;

(iii) Exchanging one cryptoasset for another type of cryptoasset;

(iv) Providing goods or services in exchange for cryptoassets;

(v) Receiving new cryptoassets from a fork of a cryptoasset already held, or through an airdrop (airdrops and hard forks will be considered in next week's *Weekly Comment*);

(vi) Earning cryptoassets through cryptoasset lending or 'staking as a service' providers; and

(vii) Participating in an Initial Coin Offering (ICO) or Initial Exchange Offering (IEO);

(b) Ways of disposing of cryptoassets:

(i) Selling cryptoassets for money;

(ii) Exchanging one cryptoasset for another type of cryptoasset;

(iii) Using cryptoassets to pay for goods or services;

(iv) Giving away cryptoassets to another person; however

(v) A disposal does not include moving cryptoassets between wallets, addresses or accounts that all belong to the taxpayer.

Taxation of amounts from selling or exchanging cryptoassets

3. Amounts received from selling or exchanging cryptoassets may be taxable because the taxpayer:

   (a) Acquired cryptoassets to sell or exchange; or

   (b) Is trading in cryptoassets; or

   (c) Is using cryptoassets for a profit-making scheme.

Acquiring cryptoassets to sell or exchange

4. A taxpayer who acquires cryptoassets for the purpose of disposing of them – for example, buying or mining cryptoassets - will have to pay income tax on any profit made. If a loss is made when the cryptoassets are sold, the taxpayer may be able to claim the loss.

5. Inland Revenue's view is that almost all investors in cryptoassets will have acquired them for the purpose of sale. For example:

   (a) Speculative short-term holdings held for 1 or 2 years or less, with sales made as prices go up resulting in taxable gains, and equally, short-term disposals if prices are trending down (in which case, tax losses may be deductible);

   (b) So-called longer-term or medium-term investments, held for 3 or more years, which are nevertheless held for sale at a profit, on which gains will be taxable;

   (c) Speculative holdings acquired to sell in the short-term, but on which a decision is subsequently made to hold them long-term to derive an equivalent of interest income, on which gains will also be taxable on disposal, as the purpose at acquisition determines the tax consequences.

6. The following factors are relevant in discerning a taxpayer's purpose in acquiring cryptoassets and distinguishing between short-term acquisitions and actual long-term holdings:

   (a) If the taxpayer's purpose for getting cryptoassets is to sell or exchange them, the assets are a short-term speculative acquisition and income tax will have to be paid when the cryptoassets are sold;

   (b) If there is more than one purpose, it is the main purpose that matters;

   (c) The purpose is looked at when the cryptoassets are acquired – if it changes later, that will not matter;

   (d) If there is a plan to sell or exchange the cryptoassets at some point in the future, then there is a purpose of disposal and it does not matter how long the cryptoassets are held for before being sold or exchanged, even if it takes a few years;

   (e) Reasons why the cryptoassets were acquired such as "a long-term investment", "a hedge against inflation","portfolio diversification", or "a store of value outside the monetary system" usually still involve a purpose of eventually selling or exchanging the cryptoassets, and there will be a purpose of disposal if sale or exchange is the way to achieve the goals;

(f) What the taxpayer says is their purpose for getting cryptoassets must be supported by what they actually do, and the surrounding circumstances, including the:

  (i) Nature of the asset (for example, does it provide an income stream or any other benefits while being held);

  (ii) Circumstances of the purchase;

  (iii) Number of similar transactions;

  (iv) Length of time you hold the asset;

  (v) Circumstances of the use and disposal of the asset.

7. Inland Revenue notes that having an income stream is a factor to consider when thinking about purpose – for example, the taxpayer may:

  (a) "Stake" their cryptoassets: "proof of stake" (staking) requires an investment in the cryptoasset itself, and users are generally required to lock a certain number of cryptoassets into the network as their stake, and a pseudo-random election process selects a user to be the validator of the next block; or

  (b) Lend them to a "staking-as-a-service" provider to earn more cryptoassets: Staking-as-a-service providers and staking pools let the taxpayer earn rewards from staking via a third-party service, and the third-party service takes care of the technical aspects of the staking process.

8. If a taxpayer does not have an income stream while cryptoassets are held, Inland Revenue maintains this strongly suggests the taxpayer acquired them for the purpose of selling or exchanging them, because the only benefit obtained is when the cryptoassets are sold or exchanged - this is similar to Inland Revenue's position on gold bullion as set out in QB 17/08 "Are proceeds from the sale of gold bullion income", *Tax Information Bulletin* Vol. 29, No. 10, November 2017, pages 9 – 16, which is that:

  (a) Amounts derived on the disposal of gold will be income under s CB 4 if the gold was acquired for the dominant purpose of disposal;

  (b) In the case of gold bullion, the Commissioner considers that this is particularly so, as bullion does not provide annual returns or income while it is held, nor does it confer other benefits (which other investments that do not provide income while held might);

  (c) The Commissioner therefore considers that, for gold bullion, the nature of the asset is a factor that strongly indicates that it was acquired for the dominant purpose of ultimately disposing of it;

  (d) There may sometimes be situations where the Commissioner may accept that the dominant purpose in acquiring gold bullion was to retain it for reasons other than eventual disposal - for example, there may be circumstances where bullion is acquired for the dominant purpose of building up a diversified portfolio of property that the person will not necessarily realise, or as a long-term investment that the person will not necessarily realise;

  (e) Ascertaining what a person's subjective purpose was at the time they acquired property is a very fact-specific assessment: the particular circumstances of the situation need to be carefully considered, and any assertion that gold was not acquired for the dominant purpose of disposal would need to be supported by clear and compelling evidence.

9. If there is an income stream from the cryptoassets while held, for example, from staking, Inland Revenue maintains that:

    (a) Just because there is an income stream does not mean that the cryptoassets were not acquired for the main purpose of selling or exchanging them;

    (b) If the taxpayer sells or exchanges cryptoassets for a profit and claims they did not acquire them for the purpose of selling or exchanging them, they will need clear and compelling evidence to support their claim.

Trading in cryptoassets

10. Inland Revenue has listed the following factors to determine whether a taxpayer is in the business of trading or dealing in cryptoassets:

    (a) The main way is by looking at the frequency of transactions (meaning how many transactions are made, how often they are made, and over what period of time) and how much time and effort is put into buying, selling or exchanging crypto assets: Inland Revenue has provided the example of part-time taxi driver “Wiremu” who was in the business of trading in cryptoassets because,, for 18 months, he invested $30,000 in the cyptoasset market, spent 4-5 hours per day checking and studying the market, used several cryptocurrency exchnages and often made multiple transactions per day;

    (b) Other factors include: the reasons for the transactions, whether the activity is organised and systematic, how long the cryptoassets are held and the amount invested;

    (c) It is likely there is a business of trading in cryptoassets if there are a high number of transactions, a lot of time and effort is spent managing the cryptoasset portfolio and work is done on the cryptoasset portfolio on a fairly continuous basis;

    (d) If the taxpayer has a full-time job and spends some spare time buying and selling cryptoassets, they are probably not a trader unless the activity is highly organised and structured (but gains may still be taxable if the cryptoassets were bought for the purpose of selling or exchanging them): Inland Revenue has provided the example of “Mizuki” who is not a trader because, although she has set up an automatic payment to a cryptocurrency exchange and the exchange deposits the Bitcoin into her wallet every week, she only keeps a casual eye on the market and occasionally buys and sells bitcoin;

    (e) A taxpayer who is a trader might have some cryptoassets that are separate from the trading business, in which case, clear and compelling evidence will be required to show that they were not part of the trading business when they were bought and sold (however, gains may still be taxable if the cryptoassets were bought to sell or exchange or a profit-making scheme is being carried on).

Using cryptoassets for a profit-making scheme

11. Inland Revenue's stated views are as follows:

    (a) Cryptoasset activity may be a profit-making scheme if:

        (i) There is a coherent plan of action (a scheme);

        (ii) The plan was entered into for the purpose of making a profit;

    (b) A general plan is all that is needed – it does not need to be written down or exact: Inland Revenue has provided the example of "Tai", who is carrying on a profit-making scheme because he carried out a speculative plan to make a profit from a scheme as a whole by acquiring a type of cryptoasset, staking it with an exchange and earning more cryptoassets, and eventually selling them;

    (c) If there is more than one purpose for going into the scheme, it is the main purpose that is important – if the main purpose of going into the scheme is to make a profit, amounts received are taxable.

Mining cryptoassets

12. Mining cryptoassets is a process that creates new blocks and achieves consensus (agreement) on the blocks to add to the blockchain. Blocks contain transactional information such as time, value and participants in a trade. Each block contains many transactions. Different consensus models are possible, for example:

    (a) Proof of work – involving using computer resources to validate cryptoasset transactions and maintain the blockchain transaction ledger;

    (b) Proof of stake - which requires an investment in the cryptoasset itself – users are generally required to lock a certain number of cryproassets into the network as their stake, and a pseudo-random election process selects a user to be the validator of the next block.

13. Miners can receive cryptoasset rewards in return for verifying additions to the blockchain digital ledger. The verifying process is a service that miners provide to the blockchain digital ledger.

14. A proof of work miner may choose to mine cryptoassets alone, or as part of a mining pool, in which miners combine (pool) their processing power to earn rewards. They split the rewards proportionally to their individual contributions.

15. Some people choose to take part in proof of stake mining through a third party staking-as-a-service provider, or a staking pool, rather than staking on their own. Staking-as-a-service providers and staking pools lets a miner earn rewards from staking via a third-party service. The third-party service takes care of the technical aspects of the staking process for the miner.

GST implications of mining

16. In most cases, cryptoassets obtained from mining (such as transaction fees and block rewards) are taxable. The mining services provided will be subject to GST:

    (a) However, as the service is provided to a blockchain digital ledger outside of New Zealand it will be zero rated;

    (b) The GST input on the costs that relate to the mining service can be claimed for GST purposes.

Income tax implications of mining

17. A miner of cryptoassets, may have to pay tax because of:

    (a) Being in the business of mining cryptoassets; or

    (b) Carrying on a profit-making scheme; or

    (c) Earning ordinary income from providing mining services; or

    (d) Mining cryptoassets for the purpose of disposal.

Business of mining cryptoassets

18. Cryptoasset mining is generally an activity aimed at making a profit, not a hobby. If cryptoasset mining activity is a business, profits will be taxable. This will include:

    (a) Mining rewards when received; and

    (b) Profits from the sale of mining rewards.

19. Cryptoassets will be trading stock and the tax rules for trading stock will apply.

20. Factors to consider when deciding if cryptoasset mining is a business include:

    (a) The duration or intended duration of the mining activity;

    (b) The size of the operation and number of transactions;

    (c) The time, money and effort put into the mining activity;

    (d) The regularity of the pattern of the mining activity;

    (e) Proceeds from the mining activity;

    (f) Whether there is an intention to make a profit;

    (g) The nature of the mining activity.

21. Inland Revenue has provided the example of "Lucas", who is in the business of mining cryptoassets, and has a taxable activity for GST purposes, because:

    (a) He bought all the hardware and software and built a mining rig with 8 GPUs and started mining from home;

    (b) He later joined a mining pool to ear rewards on a more regular basis;

(c) He regularly monitored and maintained his mining operation to keep it running well;

(d) He made a good profit despite the electricity costs; and

(e) He sold some cryptoassets through the process, and eventually sold the remainder and stopped mining.

22. The tax consequences of Lucas' mining operation would be as follows:

(a) Income tax would be payable on the rewards and transaction fees earned;

(b) Income tax would be payable on the profits made from the sale of cryptoassets earned;

(c) The services would be zero-rated for GST as they are provided to a blockchain outside NZ;

(d) GST input tax can be claimed on the costs of the mining activity (such as power and the purchase of computer equipment).

Mining cryptoassets for a profit-making scheme

23. The mining activity may fall short of a being a business if it is a small operation and is only carried on for a short time. However, if the main purposes for mining cryptoassets is to make a profit, there may be a profit-making scheme. See paragraph 11 above on using cryptoassets for a profit-making scheme. Staking rewards may also be earned through a third-party staking-as-a-service provider, rather than directly.

24. If the cryptoasset mining activity is a profit-making scheme, tax will be payable on any profits earned from the scheme, which will include, similarly to a mining business:

(a) Income tax on mining rewards when received;

(b) Income tax on profits from selling mining rewards;

(c) If the scheme includes proof-of-stake mining, income tax on profits from selling the staked cryptoassets.

Mining cryptoassets for ordinary income

25. Ordinary income is income that is not dealt with by another specific part of the tax legislation. To decide if an amount is ordinary income, it will be necessary to consider the true nature of the payment as it relates to the taxpayer For example considering why the payment was made and what was done in order to receive it. There is usually repetition and regularity to ordinary income although a one-off payment can also be ordinary income in some cases.

26. Mining cryptoassets that is not a business or a profit-making scheme may result in ordinary income. See also paragraph 4 onwards above on acquiring cryptoassets to sell or exchange.

Mining cryptoassets as a hobby

27. Inland Revenue has stated on its website that cryptoasset mining is generally an activity aimed at making a profit, not a hobby. A person mining cryptoassets will generally either be in business or carrying out a profit-making scheme.

28. A hobby is an activity done mainly for pleasure or enjoyment in spare time. In very limited circumstances a cryptoasset mining activity may be a hobby. This will depend on the specific facts and circumstances of the person's situation. However, even if a mining activity is a hobby, tax may still need to be paid when:

    (a) Receiving cryptoassets if they are ordinary income from providing a service;

    (b) Selling cryptoassets if they were mined or the purpose of selling them.

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