

School of Accountancy
Faculty of Commerce, Law and Management
University of the Witwatersrand, Johannesburg

Crypto assets as a financial service for VAT: An analysis

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Candidate: Lesego Matabane

Student number: 0612035Y

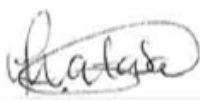
Faculty of Commerce, Law and Management

Candidate's Declaration

Name of Candidate:	Lesego Matabane
Person Number:	0612035Y
Degree:	Master of Commerce (specialising in Taxation)
Supervisor / Co-Supervisor:	Asheer Ram
School:	School of Accountancy Faculty of Commerce, Law and Management
Title of Thesis/Dissertation/ Research Report:	Crypto assets as a financial service for VAT: An analysis

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Abstract

'Crypto assets' is an umbrella term referring to digital financial assets (such as Bitcoin) founded on distributed ledger technology. The South African Revenue Service (SARS) defines crypto assets as a digital representation of value that are not issued by a central bank; thus, these assets are traded, transferred and stored electronically by individuals and entities – both natural and legal – for purposes such as payment, investment and various forms of utility (Ukwueze, 2021). The underlying technology behind crypto assets incorporates cryptography techniques (SARS, 2023).

Since their inception in 2009, crypto assets have drawn increasing attention from regulators (OECD, 2020), and cryptocurrency has emerged as a novel form of payment in recent years. This development is fuelled by the flaws in the presently dominant payment method of fiat currency, which include the centralised structure of fiat currency, high transaction costs, the time it takes to process payments (especially for foreign transactions) and the need for more confidence in the institutions managing the current monetary systems (Hamukuaya, 2021).

This report analyses whether a crypto asset can be classified as a financial service according to the South African Value-Added Tax Act, No. 89 of 1991 (VAT Act) legislation through an assessment of the features of crypto assets (also known as cryptocurrencies) and a comparison of the classification of crypto assets by South Africa to that by other countries.

According to the study's findings, South Africa has adopted the strictest approach, excluding "the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency" by categorising cryptocurrency as financial services under Section 2 of the VAT Act. The analysis also reveals that South Africa's approach to classifying cryptocurrency for VAT purposes is similar to that of other countries. Therefore, this research suggests that South Africa should broaden the investigation into categories such as the source of cryptocurrencies, nature of supply and place of supply transactions that include exchanging cryptocurrency assets for fiat money or other assets, as well as utility tokens when they are used. These suggestions might serve as further evidence that consensus about the VAT consequences of transactions involving cryptocurrency assets is still pending.

Keywords: Bitcoin, cryptocurrency, crypto asset, digital asset, financial asset, legal tender, Value-Added Tax

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ABBREVIATIONS

Abbreviation	Definitions
ATM	Automated Teller Machine
B2B	Business to Business
B2C	Business To Customer
CJEU	Court of Justice of the European Union
ECJ	European Court of Justice
EU	European Union
GST	Goods and Services Tax
HST	Harmonised Sales Tax
ICO	Initial Coin Offering
IRAS	Inland Revenue Authority of Singapore
ITO	Initial Token Offering
KYC	Know Your Customer
OECD	Organisation for Economic Co-operation and Development
OTC	Over The Counter
QST	Quebec Sales Tax
RITC	Reduced Input Tax Credit
SARB	South African Reserve Bank
SARS	South African Revenue Service
SCA	Supreme Court of Appeal
VASP	Virtual Asset Service Providers
VAT	Value-Added Tax
VATCOM	Value-Added Tax Committee

Chapter 1: Introduction

1.1 Background

A crypto asset is a digital or virtual currency that uses cryptographic technologies to facilitate secure online transactions without the need for intermediaries (Murry and Velasques, 2023). The term 'crypto' refers to the various encryption methods and techniques used to protect this currency, including elliptical curve encryption, public-private key pairs and hashing (Murry and Velasques, 2023). Cryptocurrencies can be either obtained through mining or purchased from cryptocurrency exchanges or other holders; however, not all e-commerce websites accept cryptocurrency payments. Even though Bitcoin and other popular cryptocurrencies are hardly used for retail transactions at present, their increasing value has made them attractive as trading instruments (Murry and Velasques, 2023).

Bitcoin, which was introduced to the public by an unidentified individual or group called Satoshi Nakamoto in 2008 through a white paper, remains the most valuable and widely used digital currency. At present, there are thousands of cryptocurrencies, each having distinct specifications and serving a unique purpose. For example, Ether is marketed as the fuel for underlying intelligent contract technology, while banks use Ripple's XRP for international money transfers (Nakamoto, 2008; Ram, 2018).

As of December 2023, over 19 million bitcoins were in circulation, with a total market capitalisation exceeding \$576 billion (Murry and Velasques, 2023). Even though the limited supply of bitcoins has been capped at 21 million to prevent inflation and manipulation, recent price fluctuations and the consequent need for regulation have created uncertainty regarding the accounting treatment of cryptocurrencies (Murry and Velasques, 2023).

Although virtual currency can be used for exchanging goods and services and storing value, it is crucial to understand that virtual currencies have a legal status different from that of traditional money. In the Republic of South Africa, the South African Reserve Bank (SARB) is the only entity authorised to give legal tender (Kwabe, 2020). SARS has yet to provide specific guidance on the Value-Added Tax (VAT) treatment of cryptocurrencies as of their 2018 annual budget review. VAT refers to an indirect tax levied on the consumption of goods and services and is typically borne by the consumer (Ram, 2018). SARS previously stated that people would not be required to register for VAT specifically for the supply of cryptocurrencies (SARS, 2018).

In South Africa, cryptocurrency-based transactions are considered financial services and, thus, exempt from VAT under Section 12(a) of the Value-Added Tax Act 89 of 1991 (the VAT Act) (Kwabe, 2020). This means that VAT is not payable on the supply of cryptocurrencies, nor is the supplier required to register for VAT, even if their revenue exceeds the R1 million VAT registration threshold. However, when the goods or services are supplied by a VAT-registered vendor, the transaction is subject to VAT even if the consideration is in the form of cryptocurrency (Cliffe Dekker Hofmeyr [CDH], 2018). Moreover, if a VAT-registered person makes use of cryptocurrency to pay for goods or services, the

person can claim the VAT charged by the supplier, provided that the goods or services are bought to make taxable supplies (CDH, 2018).

When a supplier accepts cryptocurrency as payment, they must translate the value of the cryptocurrency into South African rands and issue a tax invoice to the recipient in rands (CDH, 2018). Further, the supplier must account for the VAT amount presented on the invoice as output tax. While the act of trading cryptocurrencies via brokers or exchange platforms is exempt from VAT, any fees or commissions payable with such transactions are subject to VAT. Buyers or sellers of cryptocurrencies are also not eligible to claim such VAT as input tax (CDH, 2018).

According to Section 1 of the VAT Act, a person conducting business in South Africa must register for VAT, subject to specified monetary thresholds. Concerning VAT in South Africa, an 'enterprise' is defined as an activity carried out regularly or partially in South Africa, in the course or furtherance of which goods or services are supplied for consideration. Notably, this definition does not require the enterprise or activity to be permanent or fixed in South Africa (Kristen, 2019).

Therefore, policymakers must clarify how cryptocurrencies are categorised as financial services and identify their VAT-related implications, as the discussion above appears contradictory to what has been legislated. Thus, this paper specifically examines the classification of cryptocurrency as a financial service and its VAT-related implications without discussing income tax rules related to cryptocurrency.

1.2 The research problem

This study is primarily concerned with determining whether cryptocurrencies should be classified as financial services according to the definition provided in Section 2(1)(o) of the VAT Act. For this, we assess whether cryptocurrencies fall under the definition of financial service as outlined in Section 2 of the VAT Act. The analysis takes into consideration the nature and characteristics of cryptocurrencies. Additionally, Section 12 of the VAT Act, which exempts financial services from VAT, is also examined.

1.2.2 Sub-questions

The sub-questions addressed in this paper are as follows:

- What is cryptocurrency?
- What is the South African VAT treatment for cryptocurrency?
- What are financial services?
- How do other jurisdictions treat cryptocurrencies for VAT?

The answers to these questions were explored through a qualitative research methodology. The Author undertook a content analysis of the literature by reviewing relevant journal articles, books, websites and legislation. Similarly, the regulations of other jurisdictions were described and noted, and a comparative analysis was conducted to determine the appropriateness of classifying cryptocurrencies as financial services (exempting supplies) for the purposes of VAT.

1.3 Report outline

This report is structured as follows:

Chapter 1 introduces the background and significance of the research, the problems and sub-problems identified, and the research method used. **Chapter 2** provides an insight into cryptocurrency and its workings, including the nature and characteristics of a cryptocurrency. **Chapter 3** addresses the VAT system in South Africa, explores why financial services are exempt in South Africa and considers some international perspectives (including case law). **Chapter 4** outlines the legislative and administrative approaches adopted in other jurisdictions. **Chapter 5** discusses the implications of VAT/Goods and Services Tax (GST) within the European Union and other countries. **Chapter 6** discusses whether it is correct for cryptocurrency to be classified as a financial service. Finally, **Chapter 7** concludes the study and provides the author's point of view.

Chapter 2: Cryptocurrency

2.1 Cryptocurrency

Cryptocurrency is a digital currency that operates in a decentralised manner using blockchain technology and encryption to ensure security (Vaidhyanathan and Jain, 2022). Within the scope of cryptocurrencies, blockchain is a distributed digital ledger that only authorised users can access (Vaidhyanathan and Jain, 2022). This ledger tracks transactions related to various assets, such as money, property and even intellectual property (Vaidhyanathan and Jain, 2022). Access is shared among its users, and any shared information is transparent, instantaneous and 'immutable'. Here, 'immutable' signifies that all data recorded on a blockchain are permanent and cannot be altered, even by an administrator (Vaidhyanathan and Jain, 2022).

The term 'centralised money' pertains to traditional currency, also known as fiat, regulated by institutions such as SARB. Moreover, the term 'decentralisation' in the context of cryptocurrency points to the absence of a central authority responsible for monitoring the fluctuations of a specific digital currency (Vaidhyanathan and Jain, 2022). This also implies that no one controls it and that it has no legal government backing (Wicht, 2016), making it more advantageous compared to centralised currency. Some of these advantages are listed below:

- Because all network participants have access to the same immutable information, currency owners do not need to 'trust' a central authority (Vaidhyanathan and Jain, 2022).
- Data remain available only to network users and are tightly protected. Additionally, shared ownership also necessitates that all users attest to the accuracy of the data, eliminating the possibility of data mismanagement or misinterpretation (Vaidhyanathan and Jain, 2022).

In 2008, an individual or group known by the pseudonym Satoshi Nakamoto developed the reference implementation of Bitcoin, the world's first and leading cryptocurrency (Vaidhyanathan and Jain, 2022). Although Bitcoin was introduced to the world in 2009, it was officially accepted as a payment method by major merchants only years later, beginning with WordPress in 2012 (Vaidhyanathan and Jain, 2022).

The underlying blockchain technology behind cryptocurrencies such as Bitcoin is currently employed in banking, insurance and other industries. According to projections, the cryptocurrency market is expected to reach a staggering \$4.94 billion by the year 2030, exhibiting an increase at an annual compound growth rate of 12.8% from 2021. This is due to the need to enhance the efficiency of current payment systems, the rise in worldwide remittances and the rising necessity to secure data (Vaidhyanathan and Jain, 2022).

2.2 Lifecycle of a cryptocurrency

The Organisation for Economic Co-operation and Development (OECD) provided insight into the typical 'lifecycle' of a single unit of virtual currency, considering the uniqueness of each unit.

2.2.1 Creation

When a new cryptocurrency is introduced, it is important to ensure its accessibility to interested users. This can be achieved through methods such as airdrops, initial coin offerings, mining or forging (OECD, 2020).

- **Airdrops:** Airdrop refers to the supply of free tokens to raise interest in a new token among ‘influencers’ and to improve liquidity in the initial phases of a new token project (OECD, 2020).
- **Initial Token Offering (ITO):** An ITO is the process of creating a new token to be exchanged for real money or one of the most popular virtual currencies, like Bitcoin. In contrast to security tokens or virtual currencies, the great majority of initial coin offerings (ITOs) have thus far entailed the issue of utility tokens, which are promotional tools that grant holders exclusive access to or discounts on future product or service launches. The Securities and Exchange Commission and other national organisations worked hard to control ITOs, and as a result, in 2021 and 2022, there were significantly fewer ITOs than in prior years. The market's change is reflected in this drop in ITO, as fewer rivals can match well-established virtual currencies (OECD, 2020).
- **Mining:** Cryptocurrencies are generated through the ‘mining’ procedure, where the ‘miner’ (i.e., the network participant who performs the necessary computer activities by initially solving complex mathematical equations, typically under a proof-of-work protocol) may be entitled to (i) a mining reward, paid in new tokens, and (ii) a protocol transaction fee, which is a percentage of the value of the transaction being processed and is paid from the transaction (OECD, 2020).

Many of the most widely used blockchains rely on proof-of-work to add new blocks to the chain. This involves mining for existing blockchains, which is of particular importance for virtual currencies such as Bitcoin and Ether (OECD, 2020). Cryptocurrencies use two primary consensus processes, proof-of-work and proof-of-stake, to validate new transactions and generate new tokens. While Bitcoin uses the proof-of-work mechanism, Cardano, ETH2 and other blockchains use proof-of-stake. To maintain a limited supply, the number of tokens that can be mined is capped (OECD, 2020). For example, Bitcoin’s maximum supply is 21 million tokens, with over 19 million in circulation as at November 2022. While, theoretically, it would take only 10 minutes to mine one bitcoin, the process can take up to 30 days (Vaidhyanathan and Jain, 2022).

- **Forging:** staking refers to the process of confirming transactions when a distribution ledger technology implements a proof-of-stake mechanism, as discussed previously (OECD, 2020).

2.2.2 Storage and transfer

Users can buy and sell cryptocurrencies through central exchanges, brokers and individual currency owners such as websites like Coinbase (Vaidhyanathan and Jain, 2022). Moreover, cryptocurrencies

can be stored in digital wallets after purchase (Forbes, 2020). A digital wallet refers to the software or hardware that enables Bitcoin storage and usage (Forbes, 2020), thus obviating the need for a physical wallet or purse to place physical currency or paper money. Each digital wallet may contain multiple digital wallet addresses. Currently, there are four prevalent categories of digital wallets for housing crypto assets (OECD, 2020):

- **Hot custodial wallet:** Also known as a ‘hot’ wallet, this is an internet-connected wallet that is managed by a third party. In this type of wallet, the user’s private keys are held by a third party as a security measure, allowing the user to access the wallet. TrustVault is an example of a third-party administrator that offers this service (OECD, 2020).
- **Hot non-custodial wallet:** Users can install a software application on their computers to maintain control of their private keys to build this kind of wallet. This is different from the wallet mentioned earlier. Two examples of hot non-custodial wallets are Copay and Electrum. (OECD, 2020).
- **Cold hardware wallet:** This physical device, like a USB or flash drive, is kept offline for security purposes and can be connected to a computer. Examples of such wallets include Trezor and Ledger Nano S (OECD, 2020).
- **A cold paper wallet:** This is a physical document that contains a user’s digital address and private key. To create one, a user can download software onto an offline computer and print the wallet before deleting it and reconnecting to the internet. Some examples of this software include Paper Wallet and Walletgenerator.net (OECD, 2020).

To safeguard token transactions, the wallets employ asymmetric cryptography, which relies on public and private keys to secure token transactions. On one hand, the digital wallet’s address represents the public key and is encrypted with a cryptographic algorithm; on the other, the user holds the private key safe to keep everything confidential (OECD, 2020).

When conducting a transaction, the sender utilises their private key to ‘sign’ it. Afterwards, the consignee and all other network users can verify the transaction’s authorisation by the correct sender and ensure that the sender has enough funds to complete the transaction using the public key. The validated transactions are combined to form a block, which is timestamped and ‘confirmed’ before being added to the blockchain ledger chronologically (OECD, 2020).

2.2.3 Exchange

While looking for potential buyers or sellers of tokens, a user can make use of a virtual currency exchange such as an over-the-counter (OTC) broker through a peer-to-peer network or a third-party intermediary. These services help exchange virtual currencies for goods and services, other types of virtual currency or fiat currency (OECD, 2020).

- **Virtual currency exchanges:** This process refers to an online service that enables consumers to buy and sell virtual currencies for either fiat currency or other cryptocurrencies. Currently, most of these services are still custodial (e.g., Coinbase and Kraken), although certain non-

custodial exchanges (which entail online peer-to-peer exchanges, thus restricting or removing the function of a centralised intermediary) do exist, albeit with low adoption rates (OECD, 2020).

- **Over-the-counter (OTC) broker:** An OTC broker facilitates the exchange of tokens that are not publicly available in exchange for fiat currency or other cryptocurrencies. These exchanges can take place offline through direct transactions or with the help of a third-party intermediary. They are commonly used when transferring significant tokens to ensure a specific market price without any price slippage during the transaction. The use of OTC brokers has seen a rise in recent times, and it is widely acknowledged that transaction volumes are higher through OTC brokers than through exchanges (OECD, 2020).

In 2018, the EU passed the fifth Anti-Money Laundering Directive, which regulates virtual asset service providers (VASPs) such as exchange platforms and brokers. However, some countries have held off from implementing this regulation. The Directive now requires compliance with know-your-customer (KYC) standards and limits the anonymity of virtual currencies and wallet providers. This regulation applies to organisations that provide services for holding, storing and transferring virtual currencies. (OECD, 2020).

2.2.4 Evolution of a token

The rules for how virtual currency operates are determined by the protocol shared by all currency users. If changes need to be made to how cryptocurrency works, a modification to this protocol is typically required. One way to improve the currency's speed is by allowing more information to be contained in each block on the blockchain, thereby speeding up transactions (OECD, 2020). These modifications are known as forks in the chain, and they require users to upgrade their protocol software. For a fork to be implemented, most of the protocol's users must consent to the change. Primarily, there are two types of forks:

- **Hard fork:** Also known as a 'chain split', a hard fork changes the protocol code to form a new version of the blockchain while keeping the old version, thus creating a new token following the modified protocol. However, the original token still operates under the initial protocol. For instance, in July 2017, a hard fork occurred in Bitcoin, forming Bitcoin Cash and Bitcoin. (OECD, 2020)
- **Soft fork:** A soft fork updates the protocol to be adopted by all users on the network without creating any new token. Modifications to a token may enhance, for instance, the rate at which transactions are processed by expanding the extent of information that can be included in each block of the chain. From the standpoint of VAT, token modifications are pertinent, but their treatment would be comparable to that of mining/forging. Services that result in the enhancement of an existing token or the creation of a new token would be subject to VAT and possibly exempt under Article 135(1)(e) of the VAT Directive as services relating to means of payment. Unlike hard forks, no new coins are created during a soft fork. A notable example of a soft fork is the SegWit fork implemented in the Bitcoin protocol in August 2017 (OECD, 2020).

2.3 The features of a cryptocurrency

- **Bitcoin is a decentralised currency.** Bitcoin can acquire digital goods in the same manner as digitally traded traditional currencies. As a decentralised currency, Bitcoin differs from fiat money and platform-based digital currencies because no one controls the Bitcoin network; its availability is managed by a process, and any individual with internet access can obtain it (Agbo and Nwadiolor, 2020). Similarly, Bitcoin has no intrinsic value because it lacks the backing provided by gold or any other precious metals (Chuen, 2015; Franco, 2015; Ram, 2018).
- **Bitcoin is flexible.** Wallets and addresses for Bitcoin can be established online without any restrictions or fee requirements. Further, as there is no localisation of transactions, cryptocurrencies are transferable between countries (Agbo and Nwadiolor, 2020).
- **Bitcoin transactions are transparent.** Each Bitcoin transaction will be broadcast to the network as a whole. These transactions are verified by mining sites or miners, who also include them in the block they are constructing and disseminate it to other sites. All transaction records are stored in the blockchain, which is publicly available and disseminated so that every miner has a copy and can verify them (Agbo and Nwadiolor, 2020).
- **Bitcoin facilitates speedy transactions.** The transactions are transmitted in a matter of seconds, and it takes miners approximately ten minutes to verify a Bitcoin transaction. As a result, it is possible to move bitcoins across any part of the world, and the transaction will typically be finalised within a few minutes (Agbo and Nwadiolor, 2020).
- **Bitcoin transaction fees are low.** No transaction fees are required to make a transfer, although the owner could choose to pay a small amount to expedite the transfer process (Agbo and Nwadiolor, 2020).
- **Bitcoin transactions and the addresses holding Bitcoin are designed to be pseudonymous, providing a layer of privacy for users.**
- **Bitcoins can be purchased.** An important aspect of cryptocurrency is its ability to purchase bitcoins, which can be done through global exchanges or computational power to create new bitcoins (Franco, 2015; Antonopoulos, 2017; Ram, 2018). To do this, complex mathematical puzzles known as 'mining' are solved using the Bitcoin software and cryptographic hash functions. When a miner successfully solves a mystery, they are granted 25 bitcoins as a reward, allowing for the production of new bitcoins through computing power (Chuen, 2015; Antonopoulos, 2017; Ram, 2018).
- **Bitcoins are used as a payment method.** The status of Bitcoin as money is a contentious issue (Franco, 2015; Ram, 2018). According to economists, to be effective, currencies usually must serve three purposes: being a means of trade, a standard for measuring value and a way to preserve wealth. Bitcoin meets these criteria in countries such as El Salvador and Central African Republic (CNN, 2021). As numerous retailers accept Bitcoin as payment (Chuen, 2015; Ram, 2018), Bitcoin has evidently become a medium of exchange (Chuen, 2015; Ram, 2018).
- **Bitcoin trades at different values on various exchanges.** Bitcoin is a commodity traded in the normal course of a business. It is partially a unit of account, as some retailers quote prices in Bitcoin, although rarely explicitly (Franco, 2015). Furthermore, Bitcoin fails as a store of value due to its price volatility (Franco, 2015). On several global exchanges, Bitcoin can be acquired

or traded. Intriguingly, there does not appear to be a buying price parity as Bitcoin trades at different values on multiple platforms (Ram, 2018).

- **Conventional macroeconomic factors do not control Bitcoin.** Bitcoin is not susceptible to macroeconomic influences such as fiscal and economic policies (Ram, 2018). This is because Bitcoin resides outside the conventional regulatory environment for currencies with legal tender status.
- **Only 21 million bitcoins can exist (at maximum).** According to the economic theory of obtaining some value from scarcity, the highest number of bitcoins that can ever be in circulation is capped at 21 million (Nakamoto, 2008; Chuen, 2015; Ram, 2018). As at January 2022, only 18.9 million bitcoins have been mined (Blockchain Council, 2022). Given that the number of new bitcoins produced every block decreases by half every four years, it is not expected that the final bitcoin will be created until the year 2140 (Blockchain Council, 2022).
- **Bitcoins are capital investments that are used to diversify portfolios, and they are also acquired for speculative purposes:** Bitcoin is utilised for investing objectives (Ram, 2018) due to its poor correlation with other asset classes (such as bonds and stocks) (Franco, 2015; Ram, 2018).

In conclusion, cryptocurrency is frequently used to refer to any of the plethora of new digital assets currently accessible on the market. While this classification is accurate, it is overly broad and fails to encompass the various types of cryptocurrencies, their uses and how consumers, businesses and governments globally should regard them. Although multiple efforts to define 'cryptocurrencies' based on asset types and use cases are ongoing, a consensus over classifications or naming standards is needed. Because of this ambiguity, consumers and governments around the world lack a practical understanding of the many types of cryptocurrencies; consequently, regulatory, legal and tax obligations, as well as their repercussions, can be difficult to articulate, causing worry and insecurity in the business. Classification of cryptocurrencies (by considering their nature and characteristics) is a crucial step in bringing greater clarity and stability to this rapidly growing asset class.

Chapter 3: Value-Added Tax and financial services

This chapter discusses the concept of VAT, what financial services are and why they are exempt from VAT while also exploring the difficulties in taxing financial services that exempt them from VAT. Some international perspectives on this issue are also considered while referencing an indirect tax system like VAT, that is, GST.

3.1 Value-Added Tax

VAT is an indirect tax based on economic consumption. Vendors who meet specific requirements must register for and charge VAT on the taxable goods or services they provide. The collected VAT goes to the country's revenue fund and is then handed over to the government after allowable VAT inputs and other deductions (Mans, 2019). This is how the government generates its revenue. In South Africa, the VAT Act is administered by SARS, a government agency that collects the tax and ensures that the VAT law is adequately enforced (VAT 404, 2022). The VAT rate in South Africa is currently 15%. (VAT 404, 2022).

In South Africa, output tax refers to the tax that sellers add to the selling price of goods or services. According to Section 7(1) of the VAT Act, supplies are charged either at the standard rate of 15% or at a zero rate (0%) (VAT 404, 2022), unless the supplies referred to are specifically exempt from VAT. Section 7(1)(a) is the VAT imposition section in the VAT Act, If a vendor purchases taxable goods or services from another vendor (i.e., the supplier), then they can claim the VAT levied on those expenses as an input tax of 15% (Greeff, 2019). This means a transaction must meet the criteria of supplying goods or services by a vendor in the furtherance of any enterprise (Greeff, 2019). This chapter delves into these conditions to ascertain whether output tax applies to crypto assets or not.

For a transaction to be subject to VAT in South Africa, it must first qualify as a supply for VAT-related purposes. Section 1 of the VAT Act states that 'supply' includes performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is affected, and any derivative of 'supply' shall be construed accordingly.

Both a supplier and a recipient must be present for a supply to occur (Greeff, 2019). Section 1 of the VAT Act defines the recipient as 'the person to whom the supply is made', whereas the supplier is the 'person delivering the goods or services'.

A barter transaction describes the act of exchanging goods or services for something other than money. An example of a barter transaction is the case of *South Atlantic Jazz Festival (Pty) Ltd v CSARS* (2015, ZAWCHC 8), where the sponsors gave the taxpayer money, goods and services for organising annual jazz festivals in Cape Town, in return for which, the taxpayer provided the sponsors with branding and marketing goods and services. The taxpayer and the sponsors were VAT suppliers, and the court ruled that they had to account for output tax on taxable supplies (Greeff, 2019).

Sections 8 and 18(3) of the Act have deeming provisions for determining if a transaction involves the supply of goods or services. However, some transactions such as ceasing to be a vendor, insurance indemnity payments, supplies to independent branches, fringe benefits and amounts exceeding considerations are considered supplies under Section 8 even if they do not meet all the requirements (Greeff, 2019).

The second requirement for a transaction to attract VAT in South Africa is that the supply should be of either goods or services. Section 1 of the Act defines 'goods' as follows:

'goods' means corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity, but excluding:

- money.
- any right under a mortgage bond or pledge of any such thing or fixed property; and
- any stamp, form or card which has a value and has been sold or issued by the state for the payment of any tax or duty levied under any Act of Parliament, except when after its original sale or issue, it is disposed of or imported as a collector's piece or investment article.

Moreover, Section 1 of the Act defines 'money' as follows:

'money' means -

- a. coins (other than coins made wholly or mainly from a precious metal other than silver) which the South African Reserve Bank has issued in the Republic by the provisions of Section 14 of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989), or which remain in circulation as contemplated in the proviso to Subsection (1) of that section, and any paper currency which under the said Act is a legal tender;
- b. i. any coin (other than coins made wholly or mainly from a precious metal) or paper currency of any country other than the Republic which is used or circulated or is intended for use or circulation as currency.
- ii. any bill of exchange, promissory note, bank draft, postal order or money order, except when disposed of or imported as a collector's piece, investment article or item of numismatic interest.

Based on the aforementioned definitions, it appears that cryptocurrency does not fall under the categories of 'goods' or 'money' as per the Act. In 2014, the South African Reserve Bank issued a position paper (2014:2–5) stating that while Bitcoin can be exchanged for legal tender, it does not have legal tender status, nor is it considered electronic money. Electronic money can be redeemed for physical currency on demand, whereas cryptocurrency can be exchanged for only cash. Wicht (2016) classified cryptocurrencies as assets for tax purposes under the South African Income Tax Act 58 of 1962.

Section 1 of the Act defines 'services' as follows:

'services' means anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money, or any stamp, form or card contemplated in Paragraph (c) of the definition of 'goods'.

When a supply is neither of goods nor particularly excluded from the definition of 'goods', it is typically classified as a supply of a service (Greeff, 2019). Section 10 of the VAT Act specifies the value of the supply, which is the basis for accounting for VAT. In the process of making those taxable supplies, the vendor may then claim VAT paid on goods or services imported or purchased for supply, use, or consumption. Only to the extent that the goods or services are purchased to make taxable supplies may the VAT be claimed. Furthermore, a vendor has the option to deduct the amounts specified in Sections 16(3)(c)–16(3)(o) (CDH, 2022).

The third requirement for a transaction to be subject to VAT in South Africa must comprise the supply of goods or services by a 'vendor' (Greeff, 2019). This indicates that a vendor must collect output tax on the selling price of their taxable goods. Section 1 of the Act defines a 'vendor' as 'any person who is registered or is required to be registered under the VAT Act (VAT 404, 2022). For this study, all parties participating in cryptocurrency transactions are assumed to be SARS-registered VAT merchants (Greeff, 2019).

The fourth requirement for a transaction to be subject to VAT in South Africa is that it must involve a vendor's provision of goods or services in the course or furtherance of an 'enterprise' for consideration. Proviso (v) excludes from the definition of 'enterprise' any activity to the extent to which it involves the making of exempt supplies. In general, the term 'enterprise' refers to any activity conducted continuously or regularly, wholly or partially, by any person, in the course or furtherance of which goods or services are supplied for consideration, whether for profit or not (Greeff, 2019). Section 1 of the Act defines 'consideration' as follows:

consideration, in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain).

If all four of the aforementioned requirements for a transaction are completed, the selling price of the goods or services must be subject to output tax. However, there is no output tax on cryptocurrency as it is considered an exempt supply (Greeff, 2019), and proviso (v) excludes such an activity from being deemed to be an enterprise. Section 12 of the Act outlines the exempt supplies, while Section 12(1) of the Act lists the provision of financial services as an exempt supply that may apply to transactions using cryptocurrency. This may occur if cryptocurrency is exchanged for the South African

and; consequently, it is necessary to establish if such a transaction may qualify as an exempt supply, a discussion on which is provided in the next section.

3.2 Financial services

Section 2 of the VAT Act defines the term 'financial services' as follows:

(1) For the purposes of this Act, the following activities shall be deemed to be financial services:

- (a) The exchange of currency (whether effected by the exchange of banknotes or coins, by crediting or debiting accounts, or otherwise);
- (b) the issue, payment, collection or transfer of ownership of a cheque or letter of credit;
- (c) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of debt security;
- (d) the issue, allotment or transfer of ownership of an equity security or participatory security;
- (e)
- (f) the provision by any person of credit under an agreement by which money or money's worth is provided by that person to another person who agrees to pay in the future a sum or sums exceeding in the aggregate the amount of such money or money's worth;
- (g)
- (h)
- (i) the provision, or transfer of ownership, of a long-term insurance policy or the provision of reinsurance in respect of any such policy: Provided that such activity shall not be deemed to be a financial service to the extent that it includes the management of a pension fund;
- (j) the provision, or transfer of ownership, of an interest in a pension fund;
- (k) the buying or selling of any derivative or the granting of an option:
Provided that where a supply of the underlying goods or services takes place, that supply shall be deemed to be a separate supply of goods or services at the open market value thereof:
Provided further that the open market value of those goods or services shall not be deemed to be a consideration for a financial service as contemplated in this paragraph;
- (l)
- (m)
- (n)
- (o) **the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency.**

In South Africa, cryptocurrency transactions are exempt from VAT (Ukwueze, 2021). Vendors selling or supplying cryptocurrencies cannot charge output VAT, and vendors cannot claim input VAT deductions for subsequent cryptocurrency purchases (Kwabe, 2020). It is important to note here that the word 'cryptocurrency' is not defined in the VAT Act, and the only reference to cryptocurrency can be found in the definition of financial services quoted above. There are no other sections or provisions that specifically refer to cryptocurrency or the VAT treatment thereof.

3.2.1 Financial services and VAT

According to the Davis Tax Committee report published on 30 September 2015, tax exemptions were considered an anomaly to the rationale of VAT. Exemptions contradict the fundamental idea of VAT as a tax on all consumption and weaken the neutrality and effectiveness of VAT (DTC, 2015). South Africa has a few VAT exclusions, including those for financial services that do not charge a fee.

The report notes that (non-fee-based) financial services are excluded from taxation since they are difficult to assess (Benedict, 2011; DTC, 2015; Merrill, 2011). While there may be a consensus that the provision of financial services to a final customer should be taxed, establishing the consideration for the provision is difficult, as no explicit price is made frequently for the supply (DTC, 2015). Thus, most governments exempt financial transactions, and South Africa is no exception in this regard, despite taxing explicit fees (DTC, 2015).

As mentioned above, the concept of value creation and its measurement raises many difficult questions in the financial services sector. For example: on the one hand, banks generate a significant portion of their revenue from fee-based income, while on the other, borrowers pay fees for using their money for (a) the ability to convert an illiquid asset, such as a promise to pay, at a later date into the liquid asset provided by the loan and (b) the ability to issue money in advance of depositors' income in return for forgoing liquidity and receive interest from deferring consumption. The assessment basis of a consumption-based VAT extends to all personal consumption expenditures and should be limited to these. Interest only contributes to consumption when it is spent. If the expenditure is intended for final consumption, it then becomes part of the VAT base (Report of the VAT Sub-Committee, 1995).

Several financial intermediation services are represented by the added value created by the financial institutions. Banks help borrowers avoid the expenses of taking out multiple small loans from different borrowers by enabling them to combine small deposits from various sources into a single large loan. Banks offer investors services for locating possible borrowers, evaluating creditworthiness, and expertly handling debts. In summary, banks offer a range of services to depositors and borrowers, including account management, fund transfers, brokerage, investment advice, and trustee services (Report of the VAT Sub-Committee, 1995).

Since a large portion of the added value is covered by the margin between the interest paid by borrowers and the interest paid to depositors, banks often do not charge fees for all the aforementioned services. Simply put, interest payments are viewed as a redistribution of income between lenders and borrowers.

Interest comprises the following:

- 'Pure' interest, which is defined as the price paid by borrowers for access to funds in advance of income (traditionally seen as unequal to output or value added and, as such, is inadequately taxed under the VAT Act).
- The fee charged by lenders for taking on the risk, which does not represent the value added. Therefore, such a fee should not be taxed.
- Fees for delivering financial intermediation services without a defined cost (this is the only component of interest that corresponds to the value being added and is, thus, acceptable for it to be taxed).

In principle, OECD National Accounts agreed that the interest margin should now be viewed as an 'indirect financial intermediation service charge'. Borrowers' interest payments referred to above as the 'pure' rate should be viewed as an implicit fee for intermediation services for which no explicit price exists, while depositors' interest payments below the reference rate should be seen as an implied levy for intermediation services. The interest margin will be distributed across economic sectors.

3.2.2 The historical treatment of financial services for VAT-related purposes

In its report, the Margo Commission recommended replacing the general sales tax with a broad-based sales and services tax. However, the government acknowledged that implementing a VAT system would pose challenges for specialised financial organisations such as insurers, banks and building societies. In 1988, the White Paper on the Margo Report was issued, and in 1990, a draft VAT law was released to implement an invoice value-added tax system. The draft bill included exemptions for certain listed financial services (DTC, 2018; The Margo Report, 1988).

After the draft bill was published, the Value-Added Tax Committee (VATCOM) was created to review feedback from interested parties. VATCOM made the following observations about financial services:

- Financial service vendors should be exempt from any taxation, and the institutions offering these services should be recognised as 'end users' regarding their inputs; otherwise, double taxation on these institutions' inputs will be risky, especially when they provide services to vendors.
- It seems reasonable to consider imposing VAT on financial services, as they are consumption expenses like any other service. It is only fair to tax them, especially since households with higher incomes tend to spend more on these services.
- It is challenging to justify exemptions due to the significant role played by South Africa's banks and insurance companies in providing financial services.

According to VATCOM, taxing financial services brings many problems and consequences. Therefore, VATCOM suggested exempting these services from VAT and focusing instead on taxing the value added by financial institutions. Alternatively, VATCOM recommended imposing other indirect taxes to ensure financial institutions pay the same tax as private investors and policyholders (DTC, 2018).

The VAT Act became effective on September 30, 1991. It followed the VATCOM recommendations and excluded the supply of financial services from VAT, as stated in Section 2 of the VAT Act, which is in line with Section 12(a) of the VAT Act (DTC, 2018).

In 1992, Section 12(a) of the VAT Act was changed to exempt the provision of any other goods or services necessary for financial services offered by the financial services provider. The purpose of the amendment was to expand the scope of the exemption to include those goods or services required for the provision of financial services offered by the provider, such as valuation fees charged to value a property to grant a mortgage loan or a cheque book that a current account holder receives from the bank (DTC, 2018).

In 1994, Section 12(a) of the VAT Act was amended to include the exemption of incidental supply of goods or services offered by financial service providers if they are necessary to provide financial services. The amendment was created to resolve issues when the supply of goods or services was considered an essential part of financial services. However, the amendment clarified that the exemption only applies to supplies of goods or services supplementary to financial services (DTC, 2018).

On 1 April 1995, amendments were made to Section 2 of the VAT Act, which included the removal of Section 2(1)(m), which previously classified the act of paying or collecting debts on behalf of another person concerning a financial transaction as a financial service. This exemption allowed debt collection and rent services to be exempt from VAT. However, this exemption was later removed based on the argument that there was no logical reason to treat these services differently from other administrative or professional services (DTC, 2018).

Furthermore, the elimination of the phrase 'arranging' from Section 2(1)(n) placed the operations of brokers, agents and other financial intermediaries into the standard-rated VAT net. According to the Explanatory Memorandum to the Taxation Laws Amendments Bill, 1994, the justification for exempting financial services does not apply to these services, and, hence, they should be subject to VAT in the same manner that other professional and administrative services are.

It should be emphasised that practical issues concerning the meaning of 'arranging' existed before the revision of Section 2(1)(n). It was not always obvious if the service was one of 'arranging' and therefore exempt or whether it constituted a distinct taxable administrative or consulting function.

The Privy Council of New Zealand addressed this issue in the Databank case (Commissioner of Inland Revenue v Data Systems Ltd), where it was determined that computer services provided by Databank to various banks constituted taxable administrative services because Databank merely recorded transactions rather than arranging them. This was no longer the situation in South Africa following the modifications to Sections 2(1)(n) and (m), which stretched the VAT net further than most other nations, including New Zealand.

The Katz Commission formed a subcommittee to examine the possibility of broadening the scope of financial services covered by the VAT system. The commission suggested several proposals, which are outlined below (DTC, 2018):

- To ensure that all fee-based financial services related to life insurance and superannuation funds are included in the VAT net, the provisions of Section 2(1) of the VAT Act should be reduced.
- The financial service levy introduced alongside VAT should be abolished to make up for the decline in revenue caused by exempting financial services.
- The Commissioner of Revenue's office should create a specialised team to investigate the possibility of using a more precise meaning for financial services.
- The Commissioner for Inland Revenue should urgently clarify the definition of a 'basis of apportionment'.
- It is recommended to neither have self-supply rules, which means institutions value their supplies and functions at market prices, nor implement VAT grouping provisions due to their complexity. This goes against the recommendations of the VAT Sub-Committee, which suggested implementing VAT grouping.

The VAT Act was modified as follows with effect from 1 October 1996 (DTC, 2018):

- The VAT Act's Section 2(1)(e) was removed. This provision covered financial services such as underwriting or sub-underwriting the issuing of debt, equity, or participatory securities. This was because it included the supply of a service that should have been subject to taxes since it involved accepting risk in exchange for payment.
- Sections 2(1)(g) and 2(1)(h) are no longer in effect. Section 2(1)(g) adds the renewal or modification of debt security, equity security, participatory security or credit agreement to the definition of 'financial services'. The provision, taking, modification or release of a financial guarantee, indemnity, security or bond, in connection with the performance of obligations under a cheque, credit agreement, debt security, equity security or participatory security, is listed as a financial service under Section 2(1)(h). The impact of the removal of Section 2(1)(g) made any fee paid for these services subject to tax and treated the transaction related to the services enumerated in Section 2(1)(h) in a similar manner as taxing short-term insurance.
- Section 2(1)(i), exempted the provision of a long-term insurance policy as a financial service, was narrowed down to exclude the administration of a pension fund by long-term insurers from the definition of 'financial service'.
- The applicability of Section 2(1)(j), which covered the provision or transfer of possession of an interest in a pension fund or the management of a pension fund as a financial service, was restricted by the exclusion of pension fund management. According to the recommendations of the Katz Commission, the service of administering a pension fund on behalf of an intermediary became a taxable service.
- The definition of financial service in Section 2(1)(n), which is described as giving permission to carry out any of the listed activities, was removed. This was in line with the Katz Commission's suggestion that value-added tax be applied to all fee-based financial services.

- Section 2(1) then read as follows: activities covered by Sections 2(1)(a)–2(1)(f) of the VAT Act are not deemed financial services if the consideration payable is a fee, commission, or comparable charge, discounting costs excluded.
- Section 12(a) of the VAT Act was amended to exclude the incidental supply of goods or services by the provider of financial services from exemption if the supply of such goods or services is required for the provision of financial services. Effective from 1 October 1996, any incidental supplies to financial services, such as the supply of a chequebook to a current account holder, became subject to VAT.

The scope of financial services was narrowed further to include merchant discounts in the proviso to Section 2(1), which became subject to VAT on 1 March 1999. According to Section 2(2)(vA), a 'merchant's discount is a fee charged to merchants for accepting credit or debit cards as a form of payment for the delivery of goods or services; or a similar fee imposed by a purchasing party. The definition of 'debt security' in Section 2(2) was broadened to include the transfer of an obligation or liability to pay money as an exempt financial service (DTC, 2018).

Originally, Section 2(4)(b) excluded the transfer of any interest in or right to be paid money owed by a person under a rental agreement from the definition of financial services and, therefore, from VAT exemption. On 1 October 2008, Section 2(4)(b) was repealed due to abuse by vendors who created bare dominium structures to claim input tax by misrepresenting financial services as rental payments. Since then, the transmission of a right to payment under a rental agreement has been exempt from VAT (DTC, 2018).

3.2.3 VAT cascading

The provision of financial services, as defined in Section 2 of the VAT Act, is exempt from VAT under Section 12(a). This exemption from VAT signifies that no VAT can be claimed as input tax on expenses incurred in the provision of financial services (DTC, 2018). Therefore, when a financial institution purchases goods or services for consumption, use or supply of financial services, the VAT incurred on such goods or services is not deductible as input tax (DTC, 2018).

Fee-based financial services were included in the VAT net since it was determined that they should not be treated any differently than other administrative or professional services (DTC, 2018). Financial services companies that charge for their services were then allowed to deduct a larger percentage of the VAT they pay on their taxable expenses as input tax due to the taxation of fee-based financial services (DTC, 2018). The input tax-eligible costs related to providing these services are usually small because most of the costs are related to staff. Furthermore, a financial services organisation's taxable expenses are usually linked to the company as a whole.

The following is a list of expenses that could result in non-recoverable VAT outsourced by a financial service organisation:

- The provision of support services such as human resources, information technology, treasury, finance and legal services;

- The employment of personnel by one company in a group and the assignment of such personnel to other companies within the group;
- Services for loan origination and evaluation;
- Handling and evaluating claims for long-term insurance policies;
- Binder agreements and underwriting management services for long-term insurance business;
- Centralised customer service and dispatch centres;
- Management and administration services; and
- Supply of infrastructure such as buildings and equipment.

The case of *ABC Trading v CSARS* (VAT 1908), 21 June 2021, found that the appellant who administered funeral policies on behalf of a long-term insurer was not conducting business that fell within the deeming provisions of a financial service for purposes of section 2(1)(i) of the VAT Act; therefore, they would have to account for VAT on the payment they received for rendering administrative services to the insurer. The appellant had relied on a Binding General Ruling issued by SARS, the purpose of which was to grant long-term insurers the permission to use a particular method of determining the consideration for the supply of management services to a pension fund where the consideration for the supply is not separately reflected but is embedded in the premium payable in terms of a long-term insurance policy. It was further argued that the appellant could not place reliance on the ruling, as the ruling was intended to cover long-term insurers who manage the administration of their schemes internally rather than the long-term insurers who outsource that particular function.

How financial services groups are structured can be affected by non-deductible VAT expenses. For example, a life insurance company may make direct property investments to avoid paying VAT on inter-organisational leases. Generally, life insurance companies that directly own their property investments receive a higher VAT allocation ratio than those that invest through property companies (DTC, 2018). Moreover, restrictions on borrowing also impact how life insurance companies invest in fixed assets. Companies that lack the financial resources to invest directly in property are forced to invest through property companies, which are funded with loan money. Rental income generated by property companies is not included in the VAT apportionment calculation for these life insurance companies, which results in a lower VAT apportionment ratio (DTC, 2018). Additionally, these companies must pay non-deductible VAT expenses on the rent they pay to the property owner.

The above listed expenses have the following impact on the financial service organisation:

- Cascading effect on financial services given to companies who are qualified to receive VAT reimbursement. When a financial supply acts as a middleman for a taxable supply and the financial institution is unable to deduct the VAT that a supplier has charged it, it is known as the cascading effect. The banking sector seems to be more affected by the cascading effect of VAT than the life insurance sector.
- There is a significant incentive for the financial services organisation to self-supply the services or infrastructure, a process also known as 'vertical integration', to avoid the additional VAT cost arising from outsourced services. However, vertical integration, in turn, creates several problems, including discrimination against third-party suppliers and smaller financial

institutions that are unable to integrate vertically. Moreover, it impedes the natural development of specialisation and creates inefficiencies in the production and delivery of financial services.

3.2.4 Issues regarding the taxation of financial services through the VAT/GST system

The EU's VAT system, which was created in the 1960s, serves as the paradigm for consumption tax systems around the globe. When it comes to the taxation of financial services, the standard practice is to exempt their supply to residents while taxing their supply to non-residents at 0% (Kerrigan, 2010).

Exempting financial services from VAT entails numerous disadvantages, not the least of which is that it compromises the neutrality of the tax. This can result in competitive distortions and, in some cases, tax revenue diversion. Owing to the technical difficulty of taxing financial intermediation services, an exemption has nevertheless been widely acknowledged as inevitable. Essentially, financial transactions are exchanges of money for money; therefore, it is difficult to separate the transaction from the income it generates. Even though exempting financial services is a pragmatic solution, this approach is widely regarded as one of the most significant unresolved issues in the design of a comprehensive VAT system (Kerrigan, 2010). Benedict (2011) discussed two primary challenges of taxing financial services under the VAT/GST system in their paper: valuation issues and theoretical concerns.

3.2.4.1 Valuation issues: How a transaction involving financial services should be valued to calculate the applicable VAT/GST

Plenty has been said about the valuation issues that arise when taxing financial services transactions under a VAT/GST system. This content is primarily focused on services with a margin-based markup. Typically, this margin is calculated based on an aggregate of transactions rather than 'the transaction' that is the subject of the 'financial supply' (Benedict, 2011). For instance, the value added by a bank that provides a deposit facility for the secure storage of funds and also lends money is typically determined by the disparity between the interest rate imposed on borrowings and the rate provided for deposits. This margin is compensation not only for the services rendered by the bank but also for the risk and pure interest payments for the time value of money (Benedict, 2011; Merrill 2011). This can be illustrated using Example 1.

Example 1: Margin compensation

Example:

Bank provides loan of \$100,000 to customer A at 8% p.a.

Bank provides a term deposit facility of \$100,000 to customer B at 6% p.a.

The Bank's interest rate spread is 2% p.a. However, this would need to be apportioned to customer A and customer B in order to determine the value attributable for the purposes of taxing the transactions as taxable supplies. What portion of the margin should be attributed to each customer?

In practice, this scenario is much more complex as this spread must be apportioned across a large customer base.

Note. Replicated from Benedict (2011)

There is also an additional concern to contend with. Even if it were possible to allocate margins between transactors, this valuation procedure would result in greater transparency for tax authorities and the general public concerning the margins under which financial institutions operate. This information is highly confidential, and, historically, financial institutions have been reluctant to perform this difficult task solely for the revenue authority. In any event, it would be questionable to treat financial institutions differently in a system that generally does not require vendors to disclose their transaction margins (Benedict, 2011).

As a result of these valuation issues, many VAT/GST jurisdictions opt to exempt margin-based financial services. Thus, these transactions are taxed based on their input as opposed to their output. Australia approaches these transactions similarly to other countries. As the Treasury's original consultation paper for financial services stated, the 'key guiding principle' for determining what constitutes a 'financial supply' is identifying services 'that are typically charged by way of a margin' (Benedict, 2011).

3.2.4.2 Theoretical concerns

When taxing financial services transactions under a VAT/GST system, the question of whether VAT/GST should be applied to financial services that are inherently savings-related arises. Some observers argue that it would be preferable to exclude financial transactions entirely from the VAT/GST and tax them under a distinct tax regime designed specifically for financial transactions.

VAT/GST is a levy on private consumption and not savings because savings are not consumed at the very time of saving but rather used for consumption later. This is because savings entail deferred consumption rather than actual consumption. According to one perspective, a substantial proportion of financial services involve savings-related transactions (whether through deposit savings or investment savings). Thus, financial services entail the postponement of consumption rather than consumption itself (Benedict, 2011).

A prevalent issue concerning financial services is their classification. If financial services are regarded as transactions associated with savings that cannot be consumed, then they are classified as transactions that should be excluded from VAT/GST (Benedict, 2011). This is essential because there will be double taxation if savings are taxed both at the time of the savings transaction and again when those savings are used to purchase goods and services (Benedict, 2011).

Nevertheless, a distinction must be made between the transaction involving the savings (whether it be a monetary deposit, loan, currency exchange or margin lending) and the services that facilitate that transaction. While the former should not be taxed under VAT/GST, the latter should be because they are customer-consumed services like any other services provided (Benedict, 2011).

3.2.5 Why are financial services exempt?

According to Kerrigan (2010), the difficulty in levying taxes on financial services does not lie in determining the added value created or the service provider's consideration but in valuing the implicit fees included in the margins. Further, it also poses administrative and interpretative difficulties for financial institutions. Therefore, it will be easier to impose VAT on financial services if explicit charges in the form of fees or commissions are evident. The issue with this, however, is that most of a financial institution's commercial activities are intermediation services, which generate revenue in the form of margins. The accounting and reporting requirements of the service provider already generate these data. Therefore, while it is not easy to quantify the consideration on a transaction basis, it is necessary to produce an invoice detailing the rendered services and permit the recipients to deduct the corresponding tax as input tax.

Any endeavour towards financial intermediation must consider the transaction as both an output for the provider and an input for the recipient. Even if a technical solution is found for taxing transactions between VAT-registered businesses, questions would persist regarding deposits made by non-VAT-registered individuals and the movements of funds excluded from VAT (Kerrigan, 2010).

The margin of a financial institution pertains to services rendered to depositors and creditors, including compensation for loss risk. The precise composition of the services will vary, and it is unlikely that the individual components will be explicitly observable. The periodic margin is the result of a complex combination of capital and interest transfers against a portfolio of deposits and other investments from savers (Kerrigan, 2010).

The procedure is made more complicated by the sensitive nature of margin disclosure, which jeopardises commercial confidentiality. The margin obtained on individual transactions is typically not required to be disclosed for purposes of VAT. Basing VAT rules on such an obligation would be a radical and unprecedented departure from neutrality principles, as the tax rules themselves would distort the market, and it would be nearly impossible to justify such interference (Kerrigan, 2010).

3.2.5.1 Measuring the financial activities for VAT

VAT is not predicated on the service provider's recurring accounting but rather on each transaction. The principle of neutrality necessitates that the application of a tax in each business sector be essentially consistent with its application in other business sectors. The tax should not impose excessive compliance costs and should have no negative impact on the competitive position of businesses (Kerrigan, 2010).

Despite some obstacles, it is possible to determine the value added of a financial institution by analysing its statutory account after considering the rules under which it was prepared and the several caveats regarding the presentation of the data. Similarly, the aggregate margin realised by institutions from financial intermediation can be determined. Some adjustments are necessary, but they are contingent on routinely accessible accounting data. However, the difficulty of applying the result to specific transactions will persist (Kerrigan, 2010).

3.2.5.2 Taxing deposits and loans

If the value of an institution's intermediation services on interest-generating activities can be measured by the difference between its loan and deposit interest, it is reasonable to classify loans as output and deposits as input, on both of which VAT could be levied. For VAT-related purposes, the VAT on the loan and deposit interest could then qualify as output tax and input tax, respectively. This would result in a disparity between the taxation of interest-generating activities and other intermediated services where the charge is less transparent, such as transactions related to the collateralisation of loans (Kerrigan, 2010).

It is technically feasible to tax loans on a transaction-by-transaction basis by adding VAT to each occasion on which interest is charged and paid, thereby conforming to the requirements of the invoice-credit VAT system. If the recipient of the service recovers at least a significant portion of the VAT, taxation would be desirable (Kerrigan, 2010).

As regards deposits, the circumstances are more complicated. Deposits from private individuals are fundamentally non-taxable supplies made by non-taxable individuals. Even if the deposited quantities are substantial, it is unreasonable to expect non-taxable persons to register and account for VAT on the supplies. Other depositors (i.e., businesses) and financial institutions are likely to view taxation favourably because it increases their aggregate tax recovery. When the depositor is a taxable entity that charges VAT on interest received and issues an appropriate invoice to the financial institution, the accounting for this VAT is as straightforward for both parties as it would be in any other business relationship (Kerrigan, 2010).

However, two negative outcomes render this approach undesirable, both of which are the result of a fundamental misunderstanding that leads to the use of excess interest as the tax base for output VAT, as opposed to the more correct but more challenging method of taxing the value of the intermediation service (Kerrigan, 2010).

3.2.5.3 Taxing foreign exchange transactions

No special regulations regarding the taxable base for financial services are mentioned in the VAT Directive. Member states that currently tax some of these services by allowing financial institutions to elect for taxation may continue to do so without excessive concern for uniformity. They will continue to act independently in the absence of community-level guidance on what constitutes the taxable base in these circumstances (Kerrigan, 2010).

The one notable, albeit limited, exception to this is the taxable base for foreign exchange transactions, concerning which the European Court of Justice (ECJ) has intervened to provide clarity, stating that in foreign exchange transactions where no fees or commissions are calculated in relation to specific transactions of the service provider over a given period – i.e., the periodic margin achieved – no fees or commissions are calculated (Kerrigan, 2010).

The calculation of the margin derived from foreign exchange transactions is straightforward. Over time, a foreign exchange institution will profit from the spread between the prices at which it acquires and sells currency. It receives compensation for its function as an intermediary, which is reflected in the value of this spread. The currencies received by the institution are not compensation. The ECJ acknowledged that for the turnover-based method of deducting input VAT, a financial institution's turnover is the net result of all transactions over a period that it could retain for itself. The ECJ did not specify how the service's value must be determined on a transaction-by-transaction basis (Kerrigan, 2010).

3.2.5.4 Other complex margin activities

In the ordinary course of their intermediation business, financial institutions maintain inventories of equities and debt that are purchased and sold. The resulting income is reflected in the published accounts, but adjustments must be made to calculate the value added for VAT (Kerrigan, 2010).

Certain accounting elements, such as unrealised gains and losses reflecting changes in the market value of the securities (fair value), must be disregarded for VAT-related purposes. Aside from these modifications, the ECJ's reasoning in *First National Bank of Chicago v Customs and Excise Commissioners* is readily applicable to these more complex margin services. All that is lacking is a mechanism or proxy for attributing the outcome to specific transactions (Kerrigan, 2010).

Combining margins and fees, financial institutions generate income from complex transactions such as the issuance of shares. Some of these transactions may be conducted without a distinct counterparty, and the tax system would have to account for this circumstance. In general, the impossibility of identifying the counterparty for a particular transaction may leave little choice but to regard these as bearer transactions (Kerrigan, 2010).

3.2.5.5 'Value-Added' as identified in statutory accounts

Cross-subsidisation cannot be excluded owing to the complexity of the relationship between a financial institution and its clients. When the price for administrative service is coupled with the apparent margin, there is also a lack of transparency. If VAT is to be charged, the implicit pricing of these other services must be observed and imputed to customers (Kerrigan, 2010).

It is, however, a standard auditing procedure to reconcile the revenue reported in the income statement with the taxable amount declared for VAT for the same period. Cross-checking would typically be regarded as the best practice, if not mandatory. If the decision were made to tax financial services, reconciliations of this nature would play a crucial role (Kerrigan, 2010).

As regards the question of whether the total taxable base for VAT can be derived from the sources employed in a financial institution's statutory income statement, the answer must be affirmative despite the challenges involved. It is a matter of making the necessary adjustments to get from one single set of figures to the other. Common standards across the union would be a prerequisite for calculating the taxable margin for VAT-related purposes, and these should be established at the union level to discourage the emergence of regional interpretations (Kerrigan, 2010).

This strategy necessitates a method that allocates the taxable margin at the level of individual transactions so that, for B2B transactions, an invoice can be generated, and VAT can be accurately applied to the cost of financial services.

3.3 Exemption of financial services in South Africa

In their study, Moodley (2016) discussed the practical challenges that come with taxing financial services at the standard rate, as a result of which financial services are exempt. These challenges consist of the following:

1. The full VAT will increase the cost of private borrowing for housing, durable consumer goods and other purposes. However, it could be argued that the prices of a variety of other goods and services also increase by a comparable amount, and there is no reason to regard financial services differently. Exempting financial services from VAT reduces after-tax costs for consumers and other non-registered purchasers of exempt services because the value added by the exempt service provider is not taxed. Alternatively, a VAT-registered purchaser of tax-exempt financial services pays a higher price after tax than if the services were taxable.
2. The comprehensive taxation method will generate a powerful incentive for disintermediation, especially for household borrowers. Buyers will bypass financial institutions and approach private investors directly for funding, while financial institutions will be encouraged to function as matchmakers between non-vendor investors and private borrowers, as opposed to their current role as market principals.
3. The taxation of interest will also increase the number of vendors who must register for VAT when the VAT registration requirements are met. Depositors or investors, who are frequently non-business persons such as widows or retirees will now be required to register for VAT in

South Africa and submit VAT returns to SARS. This will impose a substantial administrative burden on both the depositor and SARS in managing the process.

4. To verify the status of the depositors, additional administrative burdens will be imposed on financial institutions. Moreover, because the VAT status of a vendor may change over time, it would be in the financial institution's best interest to monitor the status regularly if the depositor is active.
5. Financial institutions will be required to procure tax invoices from vendors to claim an input tax deduction. This will increase the financial institution's compliance documentation burden.
6. Banks will also need to determine if their systems can store large amounts of data and transactions. The taxation of interest will also increase the number of vendors who must register for VAT when the VAT registration threshold is reached.
7. The situation described above may also encourage investors who are not VAT-registered vendors to falsely classify themselves as such. Consequently, the investor would receive VAT on top of the interest rate. On the other hand, the bank would claim an input tax deduction based on the receipt of a fictional tax invoice. The financial institution's VAT payment would not be remitted to SARS, resulting in a loss to the fiscus.
8. In accordance with Section 102 of the Tax Administration Act, SARS places the burden of proof on the taxpayer to demonstrate that a particular amount or item is tax deductible. Consequently, the bank may be liable for penalties and interest imposed by SARS if the asserted input tax was based on the receipt of an invalid/false tax invoice.
9. Existing loans will also be subject to the tax, as institutions would otherwise incur losses. Consequently, transitional arrangements will need to be established, resulting in added complexities.

3.4 Conclusion

The neutrality of the application of VAT to financial services necessitates that they be included in the tax base to the maximum extent possible. Historically, most financial services were exempt from VAT due to the impracticality of valuing implicit financial fees. However, theoretical and technological advancements have rendered exemptions obsolete.

As a starting point for the development of a value-added tax in the United States, it appears that there are few obstacles to including all explicit fees for financial services in the tax base, as is the case in South Africa. Experience has also demonstrated that it is relatively straightforward to incorporate general insurance into the VAT system. Although limited experience exists, it does not appear to be overly difficult to impose value-added tax on market makers based on the bid-ask margin for regularly traded currency and securities.

The key to simplifying this issue is to consider implicit financial fees charged to VAT-registered customers as zero-rated and measure and tax them accordingly. Naturally, zero-rating supplies to VAT-registered customers would be contrary to the typical operation of VAT regulations. However, it is economically equivalent to complete taxation for customers eligible for a full input VAT refund. For partially exempt customers, special rules would be required. Moreover, portfolio approaches to

taxation life insurance appear promising, although implementation would necessitate additional research and testing.

Chapter 4: Value-Added Tax in other countries

Although over 100 countries have adopted VAT, most have not included financial services such as bank charges and other services without explicit fees (Zee, 2004). These charges can be fixed amounts or a percentage of a specific figure, such as fees for ATM withdrawals, safety deposit boxes, annual credit card fees and service fees for savings accounts (Inland Revenue, 2015). Although the VAT base has broadened in many countries, financial services are still not typically included in it. Most value-added tax systems in use today are credit invoice and European-style systems. When a taxable enterprise submits a VAT return, the difference between output tax and input tax credit is used to determine net tax liability. Multiplying taxable sales by the relevant VAT rate results in output tax. The VAT paid on taxable business purchases of inputs used to produce taxable sales is known as input tax. A VAT credit invoice would then account for explicit charges for sales to determine the output tax and the associated purchases to determine the input tax (Zee, 2004).

Financial intermediaries, such as banks, frequently conceal the costs of their intermediary services within the interest rate margins between deposits and loans. Similarly, they charge for other services within interest rate margins, such as the margins of buy and sell rates of different currencies for currency conversion commissions. It presents significant conceptual and administrative challenges to measure such implicit costs in packaged financial services for the application of a VAT credit invoice (Zee, 2004).

The various methods used by various nations to address financial services under VAT are reviewed and evaluated in this chapter.

In 2021, Deloitte reported that the OECD had identified the following five tax policy principles that legislators should consider when drafting VAT legislation:

- **Neutrality:** It aims for equal treatment of traditional and online commerce in tax policy. Corporate decisions should be based on economic considerations rather than tax considerations, and similar tax rates should apply to taxpayers in comparable situations and activities.
- **Efficiency:** It is crucial to minimise business compliance expenses and administrative costs for tax authorities as much as possible.
- **Certainty and simplicity:** Taxpayers have the right to know the tax implications of a transaction, such as when and where it occurred and how the tax was calculated. For this reason, tax regulations need to be easily understood and transparent.
- **Effectiveness and fairness:** Taxes should be collected accurately and on time to prevent tax avoidance and evasion. Any responses to such behaviour should be proportional to the level of risk involved.
- **Flexibility:** Tax systems must be adaptable and dynamic to keep up with technological and commercial advances.

Several suggestions have been made to modify the exemption for financial services, including various alternatives. The Deloitte report has classified these alternatives into three groups: preserving, eliminating and partially maintaining the exemption. These alternatives have been compared to the current exemption while considering the OECD policy guidelines (Deloitte, 2021).

4.1 VAT system in use in Europe

4.1.1 Option 1: To maintain exemption with a similar scope, draft guidelines that clearly define exempt financial services are required.

One possible solution to maintain the current broad exemption while providing more formal advice is establishing consistent legal definitions of financial services that qualify for the VAT exemption. Additionally, targeted relief can be provided to make this alternative less intrusive than the current system, as suggested by Deloitte (2021).

This approach offers several potential advantages, the most significant of them being the elimination of economic distortions caused by conflicting national interpretations when companies compete internationally. It also addresses issues related to legal certainty. However, it does not fully solve several fundamental problems with the current exception (Deloitte, 2021). A notable point is that legal definitions will always become outdated as new technologies emerge. Another concern is that the proposal does not address the additional VAT expense of outsourcing (Deloitte, 2021). This can be partially alleviated by implementing a cost-sharing exemption (CSE) and VAT grouping, which must be internationally relevant and broad to be effective. Despite the potential benefits, outsourcing activities by financial service providers may increase their cost base without increasing the consumption of financial services, putting them at a disadvantage compared to other businesses. This could impact the principles of neutrality and efficiency (Deloitte, 2021).

Further, it may hinder the flexibility of financial service providers from outsourcing to keep up with digital innovations. As a result, this can create obstacles to cross-border expansion and collaboration within the internal market, which goes against the intended goal. Extending operations across multiple member states can also result in higher costs due to non-recoverable VAT charges, thereby increasing the cost of services for multinational corporations compared to local operators. To mitigate this issue, the EU could implement cross-border VAT grouping, as suggested by Deloitte (2021).

4.1.2 Option 2: Abolish the exemption

Applying standard VAT to deliveries for final customers could increase the burden on financial services, leading to higher costs and potentially excluding low- and middle-income consumers from accessing these services. Removing this exemption may also harm the competitiveness of the EU's financial services industry, especially considering potential overlaps with other national taxes (Deloitte, 2021). To effectively analyse the impact of eliminating this exemption, we should consider factors such as the place of supply, taxable amount and VAT rate. Additionally, examining the taxation of value-added

financial services at the location of use is essential, which is consistent with the OECD policy principles on effectiveness and equity (Deloitte, 2021).

As regards business-to-consumer (B2C) services, it is possible to explore changes to the rules about the place of supply. At present, the primary rule is that the supplier's place of establishment determines the location of supply; however, aligning with the destination principle may be more appropriate by using the customer's residence location to determine the consumption taxes. This change could also address potential competition distortions among EU member states and ensure that financial services both provided by non-EU suppliers and used by EU customers are subject to taxation in the EU (Deloitte, 2021).

4.1.3 Option 3: To preserve partial exemptions, consider increasing taxes on certain services.

One option to address the taxation of financial services involves maintaining a partial exemption while taxing additional services. This approach considers the taxation of financial services in other regions and countries, such as the Gulf Cooperation Council States, New Zealand and South Africa. The third option involves taxing fee-based financial and insurance services while exempting margin-based financial services, which offer a spread as a return on investment or interest income. This is in recognition of the complexity of financial services and provides an exception for margin-based services to mitigate the downsides of VAT exemptions (Deloitte, 2021).

In VAT systems without exemptions, general insurance goods and brokerage are taxed, while life insurance premiums are exempt. Implementing a partial exemption of financial and insurance services has similar effects and implications as option 2, which involves the complete elimination of exemptions. The two most significant considerations for this option constitute the distinction between margin-based and fee-based suppliers and the tax rate for taxable services (Deloitte, 2021).

4.1.3.1 Margin-based vs. fee-based

Although the difference between margin-based and fee-based services may seem straightforward, it can cause problems with efficiency, certainty and simplicity (Deloitte, 2021). Moreover, services that are equally useful to customers may be taxed differently based solely on how the payment is calculated or made; consequently, this can be unfair and violate the principle of efficacy and fairness of taxes. Therefore, this could lead to customers rearranging their goods to receive the desired VAT treatment (Deloitte, 2021).

Moreover, financial service providers may face an issue with proportional VAT recovery. While applying exemptions can alleviate the problem of calculating the taxable amount for VAT due, it may still be necessary to calculate partial exemptions. Therefore, further guidance may be necessary to ensure this method is uniformly used.

4.1.3.2 Tax rate

A high VAT rate may be necessary for taxable financial services to maintain the exemption for margin-based financial services, including life insurance premiums. However, this may contradict the policy goal of providing financial services to all clients and supporting EU initiatives to improve capital markets (Deloitte, 2021).

4.2 VAT system in use outside the EU

In the above section, the alternative methods for the VAT treatment of financial services (i.e. maintaining exemptions, abolishing exemptions, and preserving partial exemptions) were examined as it became clear in Chapter 3 that the exemption approach was chosen because it was difficult to quantify the implicit financial costs, not because it was believed to be the technically correct manner of taxing.

Below are some of the prominent VAT jurisdictions that South Africa studied intending to minimise the VAT cascading effect as discussed in Chapter 3 (3.2.3) such as Australia, through its unique reduced input tax credit. Singapore's VAT system is similar to that of South Africa as they are both based on the New Zealand VAT legislation, although the VAT base in financial services is larger compared to that of South Africa. Canada's Quebec state used to apply zero-rating to its financial services as is done by New Zealand and Singapore.

4.2.1 New Zealand

Except for the revisions of Section 2, which abolished the exemption for organising services and debt collection with effect from 1 April 1995, the VAT legislation in New Zealand (on which the South African system is based) is essentially the same as the South African VAT. In New Zealand, the services are still excluded. Short-term insurance, on the other hand, is subject to VAT at the regular rate, just as it is in South Africa.

New Zealand has implemented a zero-rating policy for selling financial services to clients since January 2005. This policy helps to minimise the cascading effect of non-recoverable VAT on financial services. For zero-rating, customers must be registered for VAT/GST, and their taxable supplies made in 12 months must equal or exceed 75% of their total supplies for the period. Customers who do not meet this threshold but are part of a group that meets the threshold in 12 months, such as the treasury or finance function of a group of companies that receive financial services, also qualify (DTC 2018).

According to the New Zealand GST Act, financial service providers can get an additional tax deduction for supplying their services to other providers who supply zero-rated financial services to eligible businesses. The deduction amount depends on the proportion of taxable and non-taxable services the recipient provides, as indicated by DTC (2018).

4.2.2 Singapore

Singapore's VAT system is based on the United Kingdom's VAT legislation and New Zealand's GST legislation. There are, however, some significant variances in the VAT handling of financial services. While most financial services are exempt and zero-rated on export, most brokerage services and securities transactions other than a primary are subject to VAT at the standard rate. As a result, agency commissions from the sale of securities are liable to VAT at the standard rate. Furthermore, a variety of fee-based services, such as credit card replacement costs, are standard-rated, although the VAT base in Singapore is significantly larger in terms of financial services,

When a financial institution spends money on expenses and acquisitions that cannot be entirely attributed to taxable or exempt supplies, it must allocate it accordingly. They can recover this expenditure based on the taxable-to-total-supply ratio. However, a unique allocation mechanism can be authorised by the controller, which allows financial service providers to claim input tax incurred while providing specific financial services (DTC, 2018).

Singapore regards exempt supplies supplied to taxable persons as taxable supplies to prevent a cascading effect of VAT on financial services provided to taxable firms. By doing this, these suppliers are essentially zero-rated, allowing the financial institution to claim input tax on them. As an alternative, a financial institution may use a special allocation system designed for financial organisations to claim input tax for a predetermined percentage of the overall input tax (DTC, 2018).

Let us take the example of a bank with 20 million in taxable supplies, 50 million in specified exempted financial services and 30 million in other exempt supplies. The input tax not attributable directly to taxable or exempt supplies is \$700,000. For the allocation of input tax, the number of taxable supplies is considered to be 70 million (including the 20 million taxable supplies and the 50 million defined exempt financial services). The allowable credit is 700,000 times 70 million divided by one hundred million, or 490,000. The current standard GST rate in Singapore is 7% (DTC, 2018).

4.2.3 Australia

4.2.3.1 Reduced input tax credit

Australia's GST Act has a unique reduced input tax credit (RITC) mechanism that aims to make outsourcing more cost-effective by eliminating vertical integration preference. Further, it enables the providers of financial services to recover 75% of the tax paid on specific inputs mentioned in the GST regulations. However, as of 1 July 2012, the RITC rate for some services obtained by investment trusts, including superannuation funds, decreased from 75% to 55%. Moreover, the RITC was also broadened to cover audit and legal expenditures spent by these companies (DTC, 2018).

The de minimis provisions in the Australian GST Act were created to allow taxpayers who make financial supplies below a certain threshold to recover all their input costs. To qualify, the acquisition must be treated as exempt supplies only for making financial supplies. Additionally, the taxpayers' enterprise must not exceed the financial acquisition requirement (DTC, 2018).

The financial acquisition threshold is determined by the level of an organisation's input tax credits. If the total amount of credits that would otherwise be denied does not exceed \$30,000 or \$60,000 (whichever is lower), an organisation may obtain input tax credits for acquisitions relating to the production of financial supplies under the de minimis test. However, if these thresholds are surpassed, it means that the organisation has exceeded the financial acquisition threshold; consequently, it is denied input tax credits because its acquisitions were not made for a creditable purpose. In such cases, the RITC may be claimed on the expenses outlined in the rule (DTC, 2018).

4.2.4 Canada

In Canada, most financial services are exempt from VAT, but some exceptions do exist, such as management and advisory services, administrative services and investment advisory services. The Canadian state of Quebec used to have a zero-rating system for financial services under the Quebec Sales Tax (QST), but they were changed to exemptions in 2013 to align with the federal harmonisation efforts. In the past, Quebec's zero-rating policy was intended to keep its financial institutions competitive and prevent foreign financial services from being imported. However, financial organisations had some drawbacks, such as limited input tax deductions and compensating tax. Canada's standard Harmonized Sales Tax (HST) rate varies by province, with the rates being 5%, 9.975%, 13% or 15% depending on the location. While potentially taxing financial services has been a topic of discussion, such a system has not yet been successfully implemented due to the difficulty in finding a suitable basis for taxation and uncertainty about generating additional VAT income (DTC, 2018).

The South African government has studied specific ideas to reduce the incentive for financial institutions to engage in vertical integration and eliminate or reduce the cascading effect of VAT under the current VAT exemption provisions. These ideas were proposed by the DTC (2018) as follows:

- A new taxation method has been introduced where self-supplied goods or services are subject to VAT. This mechanism assigns a specific value to these items and requires financial institutions to account for output tax on their value.
- New Zealand and Singapore, as well as Quebec in Canada, have implemented a zero-percent VAT rate for financial services. This could be a beneficial approach to consider.
- The Australian RITC model allows financial institutions to claim input tax deductions or reduced input tax deductions on the products and services they purchase from suppliers for providing financial services.
- Financial institutions can offer taxable individuals the option to be taxed on the financial services provided, allowing them to claim VAT as input tax.
- Group companies can implement group VAT registrations for better efficiency.
- The exemption for financial institution intermediary service reinstatement.

4.3 Non-insurance financial services

4.3.1 Financial services (explicit fees)

Banks and other financial institutions may have to pay fees for their services, which can be included in a credit-invoice VAT without additional costs for businesses or tax authorities. If these fees are subject to VAT, businesses can claim input tax credits for the VAT paid on services used to generate taxable sales. For example, a bank may charge a fee for ATM cash withdrawals subject to VAT. The bank can then claim a credit for the VAT paid on the necessary items because it provides a taxable service. If consumers purchase the ATM service, they are responsible for paying the applicable VAT. When a business purchases a service for use in taxable sales, it can recover the tax by claiming an input tax credit on its VAT return; therefore, financial services with explicit fees can be taxed similarly to all other taxable goods and services (Zee, 2004).

4.3.2 Financial services (implicit fees)

Taxing financial services with hidden fees resulting in higher prices for acquired securities is like taxing intermediation services. If these hidden fees are not included, it can lead to a cascading effect, as in the case of exempting intermediation services. Consider a situation where a business offers financial services with hidden fees that are exempt from taxes and chargeable services such as domestic services with explicit fees or zero-rated exports. This can result in additional business and tax authorities expenses. These expenses arise because the service provider must calculate the portion of input tax that is not creditable – that is, the tax on purchases used for exempt services. The tax authorities also must verify this allocation. In several countries, financial institutions and tax authorities often disagree over calculating creditable input tax (Zee, 2004).

4.4 Alternative VAT treatments of non-insurance financial services

Zee (2004) identified different ways of taxing financial services under the VAT, each with its advantages and disadvantages concerning revenue, compliance costs and economic inefficiencies. Some countries exempt most financial services, while others apply a zero-rating to financial services provided by financial institutions. What follows is a brief analysis of these approaches and methods.

4.4.1 Basic exemption

Many countries with VAT have chosen to exempt financial services due to the difficulty in determining the value of intermediation services and implicit fees. The EU and several other countries have adopted this strategy, exempting most financial services from VAT, except for certain fee-based services that financial institutions charge. Financial services exported from the country are zero-rated. EU member states must unify their VAT and exempt various financial services, including insurance. Belgium, France and Germany have only used this option to a limited extent (Zee, 2004). Most EU member states exempt 'core' financial services such as lending, bank accounts and money, stock and bond transactions but tax certain fee-based services (known as 'secondary' services) such as financial counselling and safe deposit boxes. Financial institutions can claim input tax credits for

taxes paid on goods used to export financial services. Most OECD members follow the EU model (Zee, 2004).

4.4.1.2 Merits and limitations

Exempting financial services from VAT benefits tax authorities and businesses as it reduces administrative and compliance costs. However, this exemption breaks the VAT credit chain for financial institutions, resulting in a cascading effect when taxable businesses purchase these exempt services (Zee, 2004). Additionally, this exemption causes pricing distortions, where individuals are undertaxed, and businesses are overtaxed. Moreover, exempting certain fee-based services narrows the tax base and reduces revenue. Conversely, financial institutions providing both taxable and exempt services face increased costs as they must calculate the portion of input tax that can be allocated to the taxable services, which is complicated due to the complexity of their product lines and activities (Zee, 2004).

4.4.2 Decrease in exemption

While exempting essential financial services, South Africa went one step further and taxed nearly all explicit fee-based domestic financial services as of October 1996, including non-life insurance (note, exported financial services are still zero-rated). South Africa follows the EU in this regard. To achieve this, the Value-Added Tax Act of South Africa classifies the bulk of financial services as those provided for free, (Section 2(1)) but exempts the provision of all financial services (Section 12(a)), unless they are zero-rated (Section 11).

The limited exemption technique restricts exemptions to intermediation services and other financial services with implicit costs, taxing almost all explicit fee-based financial services. Compared to the EU's basic exemption structure, this technique results in less distortion and cascade for services rendered to companies with taxable sales. However, to take advantage of the exemption of implicit fees, financial businesses would be motivated to combine explicit fee-based customer services with other exempt services. However, if the VAT rate is low, this incentive is probably only going to be minimal. It is possible to identify comparable distortions amongst different categories of financial organisations that offer comparable services, most of which are usually more obviously fee-based than others.

In countries where interest rates are unregulated, banks will continue to charge explicit fees for many of the services they offer to maintain their ability to offer competitive loan and deposit rates (Zee, 2004).

In addressing the difficulty of dividing permissible input tax credits between residual exempt services and taxable explicit fee-based services, South Africa's approach does not eliminate the administrative and compliance costs suffered by the EU's approach.

4.4.3 Exemption with input credits

Like the EU, Singapore also exempts a vast array of essential financial services from VAT when they are delivered domestically (and zero-rates them if exported). None the less, such services are taxable when they are planned, underwritten or supplied with advice for a commission, fee or other comparable pay. Singapore allows financial institutions to claim input tax credits using either a 'special approach' or a 'fixed input tax recovery method' to prevent the cascading effect of exempting financial services used as business inputs and preserve the competitiveness of the financial sector. The regulations consider exempt supplies delivered to taxable individuals as taxable supplies under the special technique. This method mandates that financial institutions separate exempt supplies delivered to taxable persons, although these supplies are not taxed in practice. In contrast, a financial institution may claim a credit for specified percentages of total input taxes, which vary based on industry standards and the kind of financial institution. Administratively, the fixed input recovery technique is considerably simpler than the special approach, as the fixed VAT recovery ratios apply to all VAT paid on inputs, thus removing the need to compute eligible input tax credits depending on taxed services, exempt services and exported services (Zee, 2004).

Like Singapore, Australia follows the EU model and exempts core financial services, but it also offers partial input tax credits for these services. Nevertheless, as previously said, Singapore's input tax rebate policy (which aims to prevent cascading generally) and Australia's, which restricts vertical integration, are essentially different. Providers of exempt financial services in Australia are entitled to reimbursement for up to 75% of the input tax paid on purchases (sometimes referred to as "reduced credit acquisitions") while providing exempt financial services. For instance, a bank may be eligible to receive an input tax credit for up to \$375,000, or 75% of the input tax, if the VAT on the inputs used to offer exempt financial services is \$500,000.

4.4.3.1 Merits and limitations

Australia and Singapore have achieved a good balance between administrative ease of use and effective policy. Cascade and the administrative challenge of allocating input credits between taxable and exempt sales of financial institutions are handled by a single statute. Because financial institutions do not always recover all the input VAT they pay, this technique leaves residual cascading in the system. Financial services would need to be rated zero to stop all cascades, which would have distortionary effects in addition to increasing the cost of government revenue (Zee, 2004).

Given that different financial institutions typically have different proportions of taxable and exempt sales, Singapore's differentiated (by type of financial institution) fixed input tax credit recovery method seems conceptually preferable to Australia's method of applying the same fixed recovery ratio to all financial institutions (Zee, 2004).

Table 2: The below table illustrates the advantages and disadvantages of each method as discussed above

Method	Advantage	Disadvantage
Exemption	Reduce administration and compliance cost	- Results in VAT cascading when businesses purchase exempt services - Pricing distortion as individuals are undertaxed and business overtaxed - Narrows the tax base and reduce revenue - Increase in cost for financial institutions offering both taxable and exempt supplies - Possible VAT expense of outsourcing to deal with emerging technologies
Exemption with input credit	-Restrict vertical integration -Enables the financial service providers to recover 55% of tax paid -Outsourcing more cost-effective -It provides a certain amount of impartiality between smaller and bigger financial institutions	- Residual cascading remains in the system and requires zero rating to stop all cascading - Distortionary effect
Standard-rated (15%)	-Tax cascading and vertical integration eliminated	-High administrative burden and costs -Low revenue collection for the government
Zero-rated (0%)	-Tax cascading and vertical integration eliminated -Increased apportionment rate and reduced VAT cost -Suppliers overall right to deduct input not compromised	-The status of each vendor will need to be determined and their value of taxable supplies -VAT avoidance will need to be coupled with anti-avoidance rules which will result in administration burden -Loss of revenue to the fiscus

In conclusion, it is difficult to distinguish the added value of financial services from other economic activities. This is because assessing the worth of financial services transaction-by-transaction is impossible when combined with additional costs, which require making concessions. Policymakers must consider the revenue consequences against economic distortions as well as administrative and compliance expenses before deciding on a method, such as the EU's basic exemption, South Africa's limited exemption, or Australia's and Singapore's exemption with input credits. The exemption with input credits strategy, which reduces cascade more effectively than other options in an administratively straightforward manner, is employed by Australia and Singapore. It is a combination of the basic exemption and zero-rating approaches.

New Zealand's plan to zero-rate business-to-business sales of financial services is intriguing and has potential, but its administrative repercussions have not yet been analysed. Therefore, policymakers need to consider these factors before deciding on a strategy.

Chapter 5: VAT/GST and cryptocurrency

Bitcoin's growing global popularity as a stateless digital currency outside of the confines of traditional commerce and finance has raised concerns about taxation. To ensure clarity regarding VAT regulation of Bitcoin and other digital currencies, the EU has taken a unified position (OECD, 2020).

The way Bitcoin and its related activities are taxed under VAT depends on the legal status of the digital currency. As there is no transparent approach to this status, the Commission services proposed different options to be considered in a previous working paper by the Value-Added Tax Committee. The focus of these options is on identifying the potential challenges depending on how Bitcoin is treated (Greeff, 2019).

To ascertain the effects of the VAT treatment of Bitcoin, it is necessary to examine not only the payments in this digital currency but also the activities that surround them. Thus, this chapter focuses on (i) the supplies of goods and services subject to VAT that are paid for with Bitcoin; (ii) the services relating to the arrangement of Bitcoin transactions; (iii) the services relating to the verification of Bitcoin transactions (i.e., mining activities); and (iv) the services relating to the exchange of Bitcoin.

This chapter also takes into consideration the characteristics and nature of the cryptocurrency as discussed in Chapter 2 to explore the implications of VAT/GST/HST based on a particular country.

The countries discussed in this chapter were selected based on the historical developments of VAT systems after looking into the EU member states for perspective and a group of what could be considered a second group of countries in the development of VAT/GST/HST, namely, New Zealand, Singapore, Australia and Canada.

5.1 European member states

The current VAT Committee Working Paper No. 1037 concentrates on payment tokens, also known as virtual currencies. This type of token is also subject to a more in-depth analysis by the OECD and tax guidance issued by the member states' tax authorities. However, it should be remembered that the issue at hand is indeed complex and that a single token may have characteristics and functions distinct from those described above (VAT committee, 2022).

The constant and rapid evolution of the tokens and their functions further complicates the VAT appraisal of transactions involving crypto assets. The OECD report identified the following as some of the emerging trends associated with virtual currencies:

- Stablecoins are digital currencies the value of which is pegged to that of a particular asset or a portfolio of assets.

- Central bank digital currencies, even if they do not necessarily constitute crypto assets (such digital currencies would be issued and backed by a centralised public authority and would, therefore, provide a stable digital form of currency), could provide a stable digital form of currency.
- Decentralised finance is an alternative financial system based on blockchain technology and virtual currencies that employs applications providing financial services.
- Changes to the common consensus process and the use of tokens as collateral for loans and borrowing are examples of how the nature and technologies of virtual currencies have changed noticeably. These changes point to a rise in the usage of proof-of-stake rather than proof-of-work.

5.1.1 Supplies at stake and their VAT implications

The key supplies linked to crypto assets, whose VAT treatment should be considered, are as follows:

- Supplies of crypto assets themselves, after being created
- Storage and transfer
- Exchange, including payments
- Modification of a token

The analysis of the implications of VAT on the supplies involved the following steps:

1. Qualification as a taxable supply: assessment as to whether the supply falls within the scope of the VAT, i.e., whether it is:
 - a supply of goods or services for consideration; or
 - made by a taxable person acting as such.
2. If within the scope, identification of the type of the supply should help conclude whether it is to be taxed or exempt.

5.1.2 Supplies of crypto assets following creation: mining and forging

After new crypto assets are created, they must be made accessible to prospective users and distributed to them. This can occur using a variety of methods, including mining, forging and ITO (VAT committee, 2022).

Already at the outset of the analysis, free (i.e., uncompensated) supplies can be disregarded as being outside the scope of VAT. An example of this is an airdrop, which is the uncompensated distribution of tokens to raise awareness of a new token and increase liquidity in the early phases of a new token project. Another example would be mining, which involves no transaction fees (VAT Committee, 2022).

It should be noted, however, that if a miner (or a digital wallet provider) provides free services for their private use; the use of their staff; or, more generally, purposes other than those of their business, the transaction may be treated as a supply of services for consideration under Article 26(1)(b) of the

VAT Directive. This is the case if the miner (or digital wallet provider) initially qualifies as a taxable person (VAT Committee, 2022).

Mining refers to the process by which crypto asset transactions are verified and added to the blockchain-based distributed ledger, which is the record of transactions. The miner performs the essential computer operations by being the first to solve complex equations, typically following the proof-of-work protocol.

The crypto assets are supplied for payment if, as mentioned previously, there is a direct link between the supply and the payment received and there is a reciprocal performance between the service provider and the recipient.

Even though transaction fees for mining are not required, they are frequently paid as an incentive to ensure that a particular transaction is verified by the miner more swiftly. The miner may be entitled to a mining reward paid in the form of new tokens or a protocol transaction fee, which constitutes a percentage of the transaction's value and is deducted from that transaction (VAT Committee, 2022).

In Working Paper No. 892, the VAT-related implications of mining were analysed in detail. The paper examined the issues associated with assessing mining as a taxable transaction to argue that it is not always obvious that a direct link exists in the case of mining, particularly when the miner is rewarded with crypto assets automatically generated by the system and receives no payment from the other party. However, as transaction fees gradually replace automatic rewards, mining is increasingly likely to qualify as a taxable activity. In addition, the maximum number of tokens that can be mined is predetermined for virtual currencies. When the creation of virtual currency ceases, transaction fees will likely be the only source of revenue for miners. This will facilitate the identification of the direct connection between supply and compensation (VAT Committee, 2022).

The qualification of miners as taxable persons is less controversial, particularly because mining requires the use of sophisticated hardware capable of solving complex mathematical equations. This would enable the mining industry to qualify as an economic activity (VAT Committee, 2022).

- Article 135(1)(d) of the VAT Directive as a transaction concerning payments or transfers.
- Article 135(1)(e) of the VAT Directive, which covers transactions concerning currency.

The working paper concluded that the exemption under Article 135(1)(e) of the VAT Directive, encompassing services relating to means of payment, could be justified. Further, the report concluded that taxable services provided by miners in exchange for compensation may qualify for exemption under Article 135(1)(d) of the VAT Directive. The paper emphasised that miners are not merely information transmitters but also perform an activity that is crucial for the sustainability of the crypto asset system, the accuracy of transaction content and the avoidance of double spending. In fact, the miner verifies that the information contained in a transaction request is legitimate and consistent with the information about previous transactions that are recorded in the blockchain. According to the

paper, it is possible to contend that mining activities are the actual transfer of funds. (VAT Committee, 2022)

Forging, also known as staking, is a second method for producing crypto assets, resulting from the transition from the proof-of-work consensus mechanism to the proof-of-stake consensus mechanism. Under a proof-of-stake mechanism, validation rights are distributed to users proportionate to their blockchain holdings. Validators are referred to as ‘forgers’ or ‘stakers’ in this system. To participate in the verification process, forgers are required to have a minimum stake in the blockchain. They stake their tokens in exchange for the right to verify a transaction, for which they receive either a transaction fee or new tokens (VAT Committee, 2022).

The connection of the miner/forgery with the network appears to be the primary distinction between the proof-of-work and the proof-of-stake mechanisms. Under the proof-of-work mechanism, the miner is not required to possess the tokens they are mining. The automatic system generates new tokens as a reward for processing transactions, and the other party to the transaction will occasionally pay transaction fees to encourage quicker processing. Conversely, under the proof-of-stake mechanism, forgers can only receive tokens or transaction fees based on their prior holdings of a given type of crypto assets and in proportion to their share of the crypto assets in question, but they must take affirmative action to receive these tokens or fees (VAT Committee, 2022).

This distinction is significant from a direct tax perspective because it enables the forger to be treated as generating a return on existing assets and, thus, having a capital income. This appears to be the situation in certain jurisdictions. However, the difference is not inherently significant from a VAT-related standpoint. What matters for VAT-related purposes is the essence of the services. The services provided by miners and forgers consist of the validation and verification of transactions. The principles regulating the VAT assessment of the supplies of mining services, as outlined in Working Paper No. 892, apply to the forging/staking services (VAT Committee, 2022).

Furthermore, the OECD report also mentioned ITO as a method for creating crypto assets. ITO typically entails the issuance of a new token in exchange for virtual or fiat currency. Given that the ITO is primarily used to create utility tokens rather than payment or security tokens, it will not be analysed further in this paper; instead, the ITO assessment should be conducted considering the VAT principles applicable to the platform economy.

5.1.3 Storage and transfer: digital wallets

Users need digital wallets to hold crypto asset accounts, keep records of balance and carry out transactions linked to these assets. The OECD report identified four main types of digital wallets: hot custodial wallets, hot non-custodial wallets, cold hardware wallets and cold paper wallets (refer to Chapter 2 for more details).

From the standpoint of VAT, whether wallets are 'hot' or 'cold' (i.e., whether they are connected to the internet or not) appears irrelevant. What matters is whether they are provided for a fee or for free.

Working Paper No. 892 analysed both situations:

- In a situation where digital wallet providers operate free of charge, there is no consideration, and the transaction falls outside the scope of VAT.
- In a situation where digital wallet providers perceive a consideration and there is a direct link between that consideration and the services provided, they can, in principle, be considered taxable persons, and their services fall within the scope of VAT.

The working paper examined the applicability of the exemptions specified in Articles 135(1)(e) and (d) of the VAT Directive in greater detail, concluding that the services provided by digital wallet providers explicitly involve means of payment within the meaning of Article 135(1)(e) of the VAT Directive – specifically, the making of crypto assets available to users and create rights and obligations concerning the means of payment. Therefore, the application of the exemption under Article 135(1)(e) of the VAT Directive could be justified.

The paper then examined whether the services provided by the purveyors of digital wallets could be exempt as regards payments or transfers under Article 135(1)(d) of the VAT Directive. It recalled the CJEU case law, particularly the judgments in cases C-2/95 SDC28 and C-350/10 (Nordea) while emphasising that it is not sufficient for a service to be exempt merely because it is an input to another exempt service. The service itself must qualify as an exempt service. For the exemption to apply, the supplier's responsibility cannot be limited to merely technical considerations and must extend to specific, essential aspects of the financial transactions at issue. It is noted that digital wallet platforms connect crypto asset users with miners whose job is to verify transactions between users, but providing this service does not alter the ownership of the funds, regardless of how essential the service may be for crypto asset transactions to occur. Therefore, the paper concludes that taxable services provided by digital wallet providers for a fee could not qualify for exemption under Article 135(1)(d) of the VAT Directive.

According to the Commission services, this assessment still applies to digital wallets used to store crypto asset accounts and conduct transactions related to these assets, where the wallet's primary function is to connect users and processors. Then, the services provided by providers of digital wallets should constitute input services, although not as exempt services.

This evaluation is without prejudice to the evaluation of the various e-money wallet varieties outlined in Working Paper No. 1038.

5.1.4 Exchange

The exchange of crypto assets may occur online or offline, through a peer-to-peer network as discussed in Chapter 2 (2.2.3).

In *Skatteverket v Hedqvist*, the CJEU ruled that the exchange of bitcoins for fiat currency is a taxable provision of VAT-exempt services under Article 135(1)(e) of the VAT Directive. Therefore, the CJEU treated crypto assets identically to traditional currencies for the objectives of the VAT Directive and its implementation pertaining to exchange services.

The Commission services believe that this treatment should be extended to include crypto asset exchanges for other crypto asset exchanges. Moreover, under Article 135(1)(e) of the VAT Directive, these transactions should be considered taxable but exempt from VAT.

5.1.5 Supplies of goods and services remunerated in cryptocurrencies

According to the Commission services, any supply of goods or services subject to VAT for which the consideration is paid in crypto assets should be treated similarly to any other supply for VAT-related purposes. The *Hedqvist* decision of the CJEU makes it plain that in the case of such supplies, crypto assets function as a means of payment and that no VAT should be imposed on the crypto assets themselves.

According to Article 73 of the VAT Directive, the taxable amount for these transactions is all the consideration obtained or to be obtained by the supplier in exchange for the supply from the consumer or a third party. Therefore, to determine the taxable amount, it is necessary to convert crypto assets into conventional fiat currency. Working Paper No. 892 provided guidance on how such a conversion should be performed, which is still valid today.

5.1.6 Modifications of a token

Most modifications to the token's operation necessitate alterations to the underlying protocol. The users' protocol software needs to be updated because of these modifications, which are referred to as forks in the chain. For a fork to take effect, the consent of the majority of protocol users is needed. As already mentioned in Chapter 2, the OECD report made a distinction between a hard fork and a soft fork.

The way cryptocurrencies are handled varies significantly across the EU. The same transactions, such as mining, are considered exempt in some member states, out of scope in others and unregulated in the rest. Further, in several member states, no policy is in place (VAT Committee, 2022).

The following summary compares the treatment of cryptocurrencies and related services in EU member states and the United Kingdom. It was supplied by the contractor who prepared the review of the VAT rules for financial and insurance services for the Commission considering the existing regulatory and other indirect taxation rules. This was updated by the Commission services based on information provided by the member states (VAT Committee, 2022).

Figure 1: Treatment of cryptocurrencies and related services

Treatment of cryptocurrencies	Exchange of cryptocurrencies	Digital Wallet	Mining
As a currency. Austria, Belgium, Bulgaria*, Czech Republic, Germany, Denmark, Estonia, Spain, Finland, France, Croatia*, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, the Netherlands, Poland, Portugal, Sweden, Slovenia, United Kingdom.	Exempt. Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Germany, Hungary, Denmark, Estonia, Spain, Finland, France, Croatia, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, the Netherlands, Poland, Portugal, Sweden, Slovenia, Slovakia, United Kingdom.	Exempt. Bulgaria, Finland, Malta, Portugal, Slovenia.	Exempt. Austria, Estonia, Ireland**, Latvia, Netherlands, Portugal, Sweden**.
As a negotiable instrument. Bulgaria*, Croatia*.		Not exempt. Germany, Denmark.	Out of scope. Finland, France, Germany, Hungary, Denmark, Ireland, Lithuania, Malta, Sweden, Slovenia.
No policy established. Cyprus, Greece, Hungary, Romania, and Slovakia.	No policy established. Greece, and Romania.	No policy established. Austria, Belgium, Czech Republic, Cyprus, Estonia, Greece, Ireland, Spain, Finland, France, Croatia, Hungary, Italy****, Lithuania, Luxembourg, Latvia, the Netherlands, Poland, Romania, Sweden, Slovakia, United Kingdom.	No policy established. Belgium, Czech Republic, Cyprus, Estonia, Greece, Spain, Finland, Croatia, Italy, Luxembourg, Poland, Romania, Slovakia, United Kingdom.

Note. Replicated from Working Paper No. 1037; VAT Committee – Questions

5.2 Australia

According to the Australian Taxation Office (ATO), sales and acquisitions of digital currency are exempt from GST since 1 July 2017, which means that you are not required to collect GST on sales of digital currency, nor are you eligible for GST credits on purchases of digital currency.

If you are not conducting business, there are no GST-related implications for purchasing or selling digital currency or using it as payment. If you operate a business with digital currency, use it as part of your existing business or if you accept digital currency as payment in your business, you must consider any potential GST implications (ATO, 2018).

Before 1 July 2017, the sales and purchases of digital currency (such as Bitcoin) were subject to GST. This means that if you were registered for GST, you were required to pay GST and were eligible for GST credits on all digital currency transactions. In addition, for GST-related purposes, the exchange of digital currency for goods or services was treated as a barter transaction. Table 2 presents guidance for distinguishing between digital and non-digital currencies.

Table 2: The difference between digital and non-digital currencies

Digital currency	Non-digital currency
Fully interchangeable with another unit of the same digital currency for payment purposes	Retailer-issued loyalty points that can only be redeemed for the goods and services specified by the loyalty scheme
Acceptable as payment for all forms of transactions	The 'currency' used in online multiplayer games that cannot be used outside of the game in which it is issued
Accessible to the public without significant restrictions	'Digital currency' that derives its value from something else or that confers rights or privileges on something else; for instance, a token that corresponds to an Australian or foreign currency or grants access to software application services
Not denominated in the currency of any country	
The value does not depend on or derive from anything else	
Does not confer the right or privilege to obtain something else	

5.3 Singapore

The transfer (including exchange) of bitcoins in exchange for a monetary or non-monetary consideration constitutes taxable services under the GST. If the seller is registered for GST, they must account for output tax on cryptocurrencies sold for business purposes. When bitcoins are accepted as payment for tangible goods or services (or digital goods such as online music), the transaction is considered a barter. If the parties involved are registered for GST, then GST must be accounted for on the individual supplies (i.e., the supply of bitcoins and the supply of actual goods or services) (Moore Rowland, 2023).

As a concession, the supply of bitcoins will not be taxed if they are used to purchase virtual goods or services within a virtual gaming world until they are exchanged for real money, goods or services. As Bitcoin does not meet the definition of 'money' or 'currency' under the GST Act, a Bitcoin supply would not be deemed a supply of money for the purposes of GST. However, the provision of Bitcoins would be considered a service since it entails the transfer of a Bitcoin-related right or interest. Depending on whether the company is the principal or agent in the transaction, the GST treatment of the supply of

Bitcoins will vary. Only commission fees are subject to GST if the company solely facilitates and functions as an agent in the Bitcoin trade (e.g., a Bitcoin exchange transfers bitcoins directly to a customer's wallet). However, if the company operates as a principal in the Bitcoin transaction (e.g., if it purchases bitcoins and resells them to the customer), GST is charged on the total amount received, which includes the sale of bitcoins and commission fees (Moores Rowland, 2023).

According to Section 10(2)(b) of the Commodities and Services Tax Act (Cap. 117A) (the GSTA), anything that is not a supply of commodities but is performed for compensation (including the granting, assignment or surrender of any right) is deemed a supply of services. The law does not classify utility tokens as stocks, bonds or other financial instruments; consequently, the distribution of these tokens to participants in an ICO is not exempt from GST (Moores Rowland, 2023).

On its website, the IRAS affirms unequivocally that the issuance or sale of cryptocurrencies constitutes a taxable service supply, and the exchange of one cryptocurrency for another is considered a barter transaction. Both parties are presumed to have made a taxable supply if they are GST-registered or required to register for GST. Moreover, if both parties have a substantial connection to Singapore, a cryptocurrency transaction is subject to GST. The supplies made by a token-issuing entity with a foreign incorporation may be subject to GST in Singapore if, according to the definition of this term, the entity 'belongs' in Singapore. If the entity issuing the token has a business or permanent establishment in Singapore, this is likely to be the case. These are two separate concepts. If an entity conducts business in Singapore through an agent or branch, it will be considered to have a business establishment there (Moores Rowland, 2023).

According to IRAS guidance, a company has a business establishment in Singapore if its 'main place of economic activity' is located there. A company may be considered to have its 'main seat of economic activity' in Singapore if its senior officers hold meetings, make decisions or conduct business in Singapore. A fixed establishment, on the other hand, has the requisite human and technical resources to provide the services in question permanently (Moores Rowland, 2023)

If a company issuing tokens is incorporated in Singapore, it is likely to be considered a Singaporean entity. When a foreign-issuing SPV is used, a comprehensive analysis must be performed to determine whether it has a business or fixed establishment in Singapore. The likelihood of the GST applying to token sales to Singapore residents is likely to be minimal. Under Section 21(3) of the GST Act, the supply of tokens to non-residents with no nexus to Singapore may qualify as a zero-rated supply of international services.

5.4 New Zealand

In New Zealand, cryptocurrencies are exempt from GST, and, by extension, so is the purchase and sale of crypto assets. Moreover, registration for GST is not required. However, businesses that raise capital through the issuance of security token crypto assets, which are characteristically similar to debt or equity securities, may claim input tax credits on their capital-raising expenses. These include legal fees, exchange listing fees and product disclosure statements (or white paper in the context of crypto assets) (Irish Revenue, 2022).

You must still charge GST if you take crypto assets as payment for the goods and services you offer. Moreover, you are required to report GST on the New Zealand dollar value of the crypto assets you receive as payment, after which normal GST regulations apply. You are, however, not required to account for GST on the sale of crypto assets received as payment for goods or services (Irish Revenue, 2022).

5.4.1 GST and mining

Providing a mining service constitutes a supply of a service; therefore, GST is applicable. However, the provision of mining services for a blockchain that exists outside of New Zealand is zero-rated (Ireland Revenue, 2022).

5.5 Canada

Beginning in 2019, Canada has been progressively implementing new GST/HST regulations for cryptocurrencies. For example, in May of 2019, the Canadian Department of Finance published a draught bill that would exempt cryptocurrency trading as a financial service. These proposals received royal approval on 29 June 2021, and, thus, became law. Officially, the Excise Tax Act of Canada now classifies the vast majority of cryptocurrencies as ‘virtual payment instruments’, the purchase, sale and transfer of which are GST/HST exempt (Rotfleisch, 2022).

The Canadian Department of Finance issued a legislative proposition regarding the GST/HST treatment of cryptocurrency mining in February 2022. These recommendations have not yet been implemented. If the legislation is enacted, these tax rules will become retroactively effective on 5 February 2022, if it is approved (Rotfleisch, 2022).

5.5.1 Canada’s GST/HST regime: An explanation

Subsections 165(1) and (2) of the Canadian Excise Tax Act impose GST/HST on ‘every recipient of a taxable supply made in Canada’. A ‘taxable supply’ includes most business transactions; specifically, it refers to the sale, transfer, barter, exchange, rental or donation of a property or service if the transaction occurs in the course of conducting business (Rotfleisch, 2022).

Even though the recipient of the property or service (i.e., the purchaser) is charged GST/HST, the seller is responsible for collecting and remitting the tax (Section 221(1)). To this end, the Excise Tax Act requires a person to register for and collect GST/HST if they sell, transfer, barter, exchange, rent or donate a property or service in Canada for business purposes (Rotfleisch, 2022).

Another example of a business that is exempt from charging or gathering GST/HST is a business that provides financial services. As per the Excise Tax Act, the definition of 'financial service' includes various transactions involving a 'financial instrument', such as follows:

- The purchase or sale of a financial instrument as a method of payment
- The issuance, adoption or transfer of a financial instrument
- The act of issuing a financial instrument
- In relation to a financial instrument, the payment or receipt of currency in the form of dividends, interest, principal or other similar payments or receipts.

In June 2021, the term 'virtual payment instrument' was added to the definition of a financial instrument. A virtual payment instrument refers to a property that is a digital representation of value, functions as a medium of exchange and only exists at a digital address on a publicly distributed ledger. Thus, fungible cryptocurrencies such as Bitcoin, Ethereum, and Chainlink qualify as virtual payment instruments. Consequently, cryptocurrency trading and the use of cryptocurrency as a payment mechanism are exempt from GST/HST because they are classified as financial services under the Excise Tax Act (Rotfleisch, 2022).

5.5.2 Tax rules for cryptocurrency mining under the Excise Tax Act, Section 188.2, relating to GST/HST in Canada

In February 2022, the Canadian Ministry of Finance proposed the addition of Section 188.2 to address the GST/HST treatment of cryptocurrency processing, although these recommendations have not yet been implemented. If the legislation is enacted, these tax rules will take effect retroactively beginning 5 February 2022 if approved (Rotfleisch, 2022).

The provision of mining activity as defined above in Section 5.1.2 is not deemed a supply by Section 188.2 of the Act. Consequently, miners of cryptocurrencies are exempt from paying GST/HST on the mining rewards or other compensation they receive as a result of their mining activities.

In addition, if a cryptocurrency miner acquires, consumes or uses any property or service in connection with cryptocurrency mining, Section 188.2 determines that the miner did not do so in the course of a commercial activity. This prevents miners from claiming input tax credits for their mining operations (Rotfleisch, 2022). Thus, Section 188.2 treats cryptocurrency mining as an exempt supply and the cryptocurrency miner is not required to collect and remit GST/HST on the miner's compensation from mining; however, the miner cannot claim input tax credits in Canada for the GST/HST incurred when operating the mining operation.

Nevertheless, the proposed crypto mining tax rules contain an exception: they do not apply when a person mines cryptocurrency for another person whose identity is known to the first person and who does not qualify as a 'mining group operator', which generally refers to the individual who coordinates the cryptocurrency-mining activity of a group (i.e., the coordinator of a mining pool). When mining cryptocurrency for a known individual who does not coordinate a mining pool, the miner may be required to collect GST/HST and may be eligible for a tax credit (Rotfleisch, 2021).

Chapter 6: Discussion and synthesis

How crypto assets transactions are treated for VAT depends on how the jurisdiction defines them, that is, whether they are defined as cash/legal tender, a financial/negotiable instrument or simply an intangible good. This classification helps determine how supplies are categorised based on crypto assets (Deloitte, 2021; African Tax Administration Forum, 2020).

In most cases, VAT applies to nearly all transactions involving goods and services unless they are exempt. Whether crypto asset transactions should be exempt from VAT is a contentious topic, given that crypto assets are intended to function as currency. However, tax authorities have differing opinions on this matter.

Some countries do not allow the exemption of VAT on crypto asset transactions. For instance, according to the Norwegian Directorate of Taxes and the Estonian Revenue and Customs Board, crypto assets are not considered legal tender and, therefore, do not qualify for the exemption for financial services (Bal, 2015). Even in Singapore and Australia, crypto asset transactions were not exempt from indirect taxation such as GST. The Australian Taxation Office had also stated that the supply of crypto assets is not considered a financial supply for GST-related purposes (Bal, 2015) up until the law changed in 2019.

Moreover, crypto asset transactions are considered exempt financial services in some countries. For instance, in the United Kingdom, the HM Revenue and Customs exempt income miners receive for their mining activities and charges for arranging or carrying out any crypto asset transactions (Bal, 2015). Similarly, the Belgian tax authorities consider trading crypto assets and other virtual currencies comparable to an intermediary's activity in securities and other negotiable instruments and, therefore, exempt from VAT (Bal, 2015). The Finnish Central Tax Board also categorises transactions involving virtual currency as exempt financial services, despite previous instructions from the Finnish Revenue Authority that denied virtual money the status of a currency, security or financial asset (Bal, 2015).

In South Africa, according to a 2018 guidance document from the South African Reserve Bank and a 2019 Parliamentary response, crypto assets fall under the financial services exemption. This means that the issue, acquisition, collection, buying, selling, or transfer of ownership is exempt from VAT.

6.1 The relationship between traditional assets and cryptocurrencies

From the beginning, cryptocurrencies have captured the interest of the financial community, gaining prominence and appreciating in value over time. Investor interest in their link with traditional assets is growing as they gain prominence. Because they are not governed by governments and are decentralised, these digital assets have become increasingly popular as an alternative to conventional fiat currencies (Robertson, 2023).

Traditional assets include conventional investments such as stocks, bonds, and commodities. These assets, in contrast to cryptocurrencies, are recognised for their stability and predictability and have a proven track record in the financial arena. None the less, in recent times, there has been a lot of speculation regarding the relationship between digital currencies and traditional assets (Robertson, 2023).

The link between cryptocurrencies and traditional assets is primarily determined by market sentiment. An increase in risk-taking and the allocation of investments towards cryptocurrencies are common among investors who demonstrate a positive outlook on the economy (Robertson, 2023).

On the other hand, in times of market turbulence or uncertainty, investors might look to traditional assets as a safer option. The growing interest of corporations and traditional financial institutions in cryptocurrencies is another important factor that can increase the link between the two asset classes. Because these institutions have a substantial market impact and can affect both traditional assets and cryptocurrencies, this is mostly because of their activities (Robertson, 2023).

There has been a moderately unfavourable association in the past between cryptocurrency and traditional assets. It seems that when traditional assets do well, cryptocurrencies tend to underperform, and vice versa. Since more investors now see cryptocurrency as a credible investment choice, this negative connection has, however, reversed (Robertson, 2023).

During recessions or other economic downturns, there is usually a negative association between traditional assets and cryptocurrencies. This is due to the fact that during these periods, investors typically retreat from risky assets like cryptocurrencies and seek out safer options (Robertson, 2023).

Investment methods are significantly impacted by the relationship between cryptocurrencies and traditional assets. To attain a well-rounded return, investors aiming to diversify their portfolio can allocate their investments between conventional assets and cryptocurrencies, taking advantage of their negative correlation. On the other hand, some investors allocate money to cryptocurrencies as a hedge against traditional assets to reduce losses during market downturns (Robertson, 2023).

Below is a summary of the characteristics of a traditional financial instrument in relation to the characteristics of Bitcoin as discussed in Chapter 2.

Table 3: Financial instrument versus Bitcoin

Financial instrument	Bitcoin
Strongly protected by laws that are enforced by the government	Bitcoin resides outside the conventional regulatory environment for currencies with legal tender status
Affected by economic factors	Not dependent on a single currency, allowing you to own an asset immune to fluctuations in the economy (like hyperinflation)

Values are derived from quantifiable profit margins.	It takes some decoding to measure Bitcoin and it trades at different values on various exchanges
Most of the time, investing in gold, property, and stocks is a steady and long-term strategy to grow one's wealth.	The highest number of bitcoins that can ever be in circulation is capped at 21 million. Bitcoin is utilised for investing objectives, due to its poor correlation with other asset classes (such as bonds and stocks)

As it can be seen above, the characteristics of Bitcoin do not match those of a financial instrument. This is proof that Bitcoin cannot be classified as a financial instrument as it does not meet the requirements of a financial instrument.

6.2 The current VAT treatment of Bitcoin in the South African landscape

In South Africa, according to a 2018 guidance document from the South African Reserve Bank and a 2019 Parliamentary response, crypto assets fall under the financial services exemption. This means that the issue, acquisition, collection, buying, selling, or transfer of ownership is exempt from VAT.

If a South African VAT vendor exchanges crypto assets for South African rand, it is considered a supply of 'services' and subject to a 15% output tax (all conditions would be met as discussed in Chapter 3). While crypto assets are not classified as 'goods' under the Act, they automatically qualify as 'services' if payment is in South African rand. This exchange does not qualify as an exempt supply, as it does not meet the criteria for a 'financial service' outlined in Section 2 of the Act. In the given example, Entity A, a South African VAT seller, must account for an output tax of R33,318 ($R255,438 \times 15/115$) (Greeff, 2019).

In the case of *Commissioner for the South Africa Revenue Services v Tourvest Financial Services (Pty) Ltd* Case no 435/2020) [2021] ZASCA, the court was tasked to determine whether Tourvest, in the exchange of currency through its network branch, only made taxable supplies or, as SARS held, made taxable and exempt supplies.

According to the VAT Act's Section 2(1) proviso, a fee-based financial service that would have been exempt is partially taxable due to the inclusion of VAT, and this created a mixed supply from the identified activity rather than completely removing its exempt status. This decision was upheld on appeal.

The SCA further held that the effect of the proviso in the present context was just to add a taxable element to what was and at its core remained an exempt financial service (i.e., exchange of currency). It turned the activity into a partly taxable supply.

An analysis by Greeff (2019) investigated whether transactions involving the exchange of Bitcoin for the South African rand could be considered a supply exempt under financial services. The analysis concluded that under Section 2 of the Act, such exchanges may not be classified as financial services.

Table 4: Application of the law

Financial services	Application
The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise (s 2(1)(a))	The National Treasury and SARB (2014) regard Bitcoin as neither a real currency as it has no legal tender status nor as electronic money (Greeff, 2019)
The issue, payment, collection or transfer of ownership of a cheque or letter of credit (s 2(1)(b))	Not applicable, as Bitcoin is not a cheque or a letter of credit (Greeff, 2019).
The issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security (s 2(1)(c))	Not applicable, as Bitcoin is not a debt security (Greeff, 2019)
The issue, allotment or transfer of ownership of an equity security or participatory security (s 2(1)(d))	Not applicable, as Bitcoin is not a share in a company or a member's interest in a close corporation (Greeff, 2019)
The provision of a loan as well as the paying of interest (s 2(1)(f))	Not applicable, as Bitcoin does not constitute a loan or interest (Greeff, 2019)
The provision or transfer of ownership of a long-term insurance policy (s 2(1)(i))	Not applicable, as Bitcoin is not a form of an insurance policy (Greeff, 2019)
The provision or transfer of ownership in a pension fund, such as pension (s 2(1)(j))	Not applicable, as Bitcoin is not a form of pension fund (Greeff, 2019)
The buying or selling of a derivative or granting of an option (s 2(1)(k))	Not applicable, as Bitcoin is not a derivative or an option (Greeff, 2019)

Note. Replicated from Greeff (2019)

6.3 VAT Treatment of Bitcoin in other jurisdictions

On 2 June 2014, it came as no surprise that the Court of Justice of the European Union (CJEU) was asked to clarify the VAT treatment of Bitcoin transactions considering varying viewpoints on the subject. In the case of *Skatteverket v David Hedqvist* Case C-264/14, the court was asked to evaluate how a Bitcoin traditional currency exchange might be taxed. Before the court was Mr Hedqvist, who intended to establish a Bitcoin exchange. Before taking this action, he desired clarity regarding the VAT status of his new business. This prompted the Swedish courts to seek clarification from the European court. The numerous contributions made towards Mr Hedqvist's legal fees demonstrate the significance of this ruling to the Bitcoin community (Norton Rose Fulbright, 2015).

As expected, this judgment affirms that the exchange of Bitcoin for cash is a service. The court determined that an exchange of crypto assets was exempt under Article 135(1)(e) of the VAT Directive, thus exempting VAT transactions ‘involving legal tender cash, bank notes, and coins’ (Norton Rose Fulbright, 2015).

Although this judgment was limited to the activities of a Bitcoin exchange, there appears to be no reason why it would not also apply to other virtual currencies that serve no other purpose than as a payment method (Norton Rose Fulbright, 2015).

It was argued before the court that the ‘currency’ exemption should only apply where both currencies involved in a trade are legal tender. There are variations in the appropriate terminology across the various language versions of the VAT Directive. Because of this linguistic ambiguity, the court attempted to interpret the phrases in the context in which they are employed and considering the VAT Directive’s objectives. Ultimately, the court determined that the ‘currency’ exemption should apply because Bitcoin’s sole function is as a payment method (Norton Rose Fulbright, 2015). It is important to note that the definition of legal tender is rather narrow. Scottish cash, for example, is not legal tender.

The ruling in the Hedqvist case closely guides how virtual currencies are treated by non-EU European nations regarding VAT. Almost all countries outside of Europe take a similar stance when it comes to excluding virtual currency exchanges from VAT and classifying the acquisition of goods and services using virtual currencies as a taxable sale rather than a barter transaction (OECD, 2020). As an example:

Australia:

It used to be considered a taxable barter event in Australia when people used virtual currency. Beginning on July 1, 2017, the law was changed to classify the exchange of virtual currency and/or fiat currency for the purpose of purchasing goods and services using virtual currency as financial services, and to treat such transactions as non-barter events (OECD, 2020).

Singapore:

Prior to January 1, 2020, in Singapore, the exchange of virtual currencies was considered a taxable supply of services for Goods and Services Tax (GST) purposes, unless it satisfied the criteria for exempt financial services. Consequently, the issue of ICOs for consideration along with the exchange of virtual currencies for fiat currencies or other virtual currencies resulted in a GST liability. Additionally, the barter trade was born out of their use as payment for products and services. This treatment implied, among other things, that any local trader over the applicable threshold might have had to register for GST purposes (OECD, 2020).

Virtual currencies are now regarded as exempt supply if they are traded for fiat currencies or other virtual currencies, and they are an excluded transaction if they are used to pay for goods and services. This treatment was modified, though, beginning of January 1, 2020. GST applies to supplies of goods

and services that are made in return for virtual currencies. Intermediaries' service supply is still taxable, as are mining services provided to identifiable parties in exchange for payment (IRAS, 2020).

New Zealand:

The current position is that crypto assets will likely fall within the scope of existing GST rules (although this position is unclear). Although GST does not apply to money or financial services, crypto assets are not money for the purposes of the GST Act. Under current law, the application of GST to crypto assets would vary depending on the facts, the features of the crypto asset and the residency of the parties to the transaction. The supply of a crypto asset could either be subject to GST at 15%, an exempt financial service, or a zero-rated supply to a non-resident (New Zealand Inland Revenue, 2021).

Should GST be applied to crypto assets, this could lead to incentives to sell to non-residents (zero-rated) and in certain situations, double taxation (for example, if a car dealer accepted bitcoin payment for a sale and then had to account for GST twice when transferring the bitcoin into New Zealand dollars). The current GST regulations offer a confusing and inconsistent GST approach in this regard. Because of this, utilising or investing in crypto assets may not be as appealing as using cash or making investments in traditional financial instruments. Similarly, taxing significant unrealised gains and losses under the FA rules would result in accrual-based taxation, which would skew investment decisions (New Zealand Inland Revenue, 2021).

Canada:

In June 2021, the term 'virtual payment instrument' was added to the definition of a financial instrument. A virtual payment instrument refers to a property that is a digital representation of value, functions as a medium of exchange and only exists at a digital address on a publicly distributed ledger. Thus, fungible cryptocurrencies such as Bitcoin, Ethereum, and Chainlink qualify as virtual payment instruments. Consequently, cryptocurrency trading and the use of cryptocurrency as a payment mechanism are exempt from GST/HST because they are classified as financial services under the Excise Tax Act (Rotfleisch, 2022).

The EU Value- Added Tax Committee re-evaluated its strategy in the wake of the Hedqvist ruling (European Commission Value-Added Tax Committee, 2016). Hedqvist had already established the exchange rate between virtual and fiat currencies, so the study looked at four more scenarios: (i) VAT-liable supplies of goods and services paid for in virtual currency; (ii) services related to digital wallets and the organisation of transactions in virtual currency; (iii) services related to mining and transaction verification in virtual currency; and (iv) services related to intermediation offered by exchange platforms for consideration (OECD, 2020).

Figure 2: The treatment of virtual currencies within the EU, as determined by the Hedqvist ruling

Activity	Subject to VAT?	If so, exempt?
Use of Bitcoins for acquiring goods or services	<i>Out of scope:</i> No VAT should be levied on the value of the Bitcoins themselves.	
Supplies of goods or services, subject to VAT, remunerated in Bitcoins	<i>Taxable:</i> The supply of goods and services, subject to VAT and remunerated by way of Bitcoin, would for VAT purposes be treated in the same way as any other supply. VAT should therefore be levied on the goods or services provided.	
Services supplied by digital wallets	<i>Out of scope</i> ¹ : A large majority of the services supplied by digital wallet providers are free of charge, which sees these transactions falling outside the scope of VAT.	
	<i>Taxable:</i> If, however, some digital wallet providers ask for payment of fees in exchange for their services, it seems that the transaction would be taxable.	<i>Exempt:</i> Such services could however be seen as exempt pursuant to Article 135(1)(e) of the VAT Directive, on the grounds of them being transactions directly concerning currency. <i>Not exempt:</i> It seems that services supplied by digital wallet providers could not be exempt pursuant to Article 135(1)(d) of the VAT Directive.
Mining activities	<i>Out of scope</i> ¹ : The fact that the payment of a transaction fee by a Bitcoin user is not a necessary condition for successfully sending Bitcoins (and thus for receiving a verification service supplied by the miner) may be indicative of there not being a direct link between the consideration and the service. Besides, the provision of a mining service does not create for the miner the right to receive a consideration in exchange, which could imply the non-existence of a legal synallagmatic relationship between him and the recipient of the verification services (the user whose transaction request the miner has validated).	
	<i>Taxable:</i> New bitcoins received automatically by the miner from the Bitcoin system every time that a verification service is supplied could possibly be seen as constituting a consideration for a taxable service. Despite the fact that Bitcoin transactions carried out for free are in theory possible, in practice Bitcoin users pay fees (used as a default by most digital wallets); and it seems almost impossible to imagine users would be willing to wait days or weeks, before a transaction is verified (which could be the case if no fee is paid).	<i>Exempt:</i> Mining activities could be seen as exempt pursuant to Article 135(1)(e) of the VAT Directive, on the grounds of them being services directly concerning currency. <i>Exempt:</i> Mining activities could be treated as exempt pursuant to Article 135(1)(d) of the VAT Directive on the basis of them fulfilling in effect the specific, essential functions of an exempt supply (the transfer of bitcoins itself).
Services related to intermediation supplied by exchange plat-forms	<i>Taxable:</i> Services for consideration supplied by exchange platforms acting as intermediaries would be taxable.	<i>Not exempt:</i> Exchange services could not be seen as exempt pursuant to Article 135(1)(e) of the VAT Directive.

Note. *Replicated from OECD (2020)*

Member states are not legally required to abide by the recommendations of the EU's Value-Added Tax Committee, in contrast to rulings from the ECJ. As a result, in their policies and laws, member states are free to deviate from the analysis supplied by the EU's Value-Added Tax Committee. The minutes of the September 2016 VAT Committee meeting, however, appear to indicate that member states follow this approach (European Commission Value-Added Tax Committee, 2016).

Virtual currencies in EU member states would be subject to the VAT treatment shown in Figure 3 as a result of the Hedqvist ruling and the discussion that followed in the EU's VAT Committee.

Figure 3: VAT Treatment as a result of the Hedqvist ruling

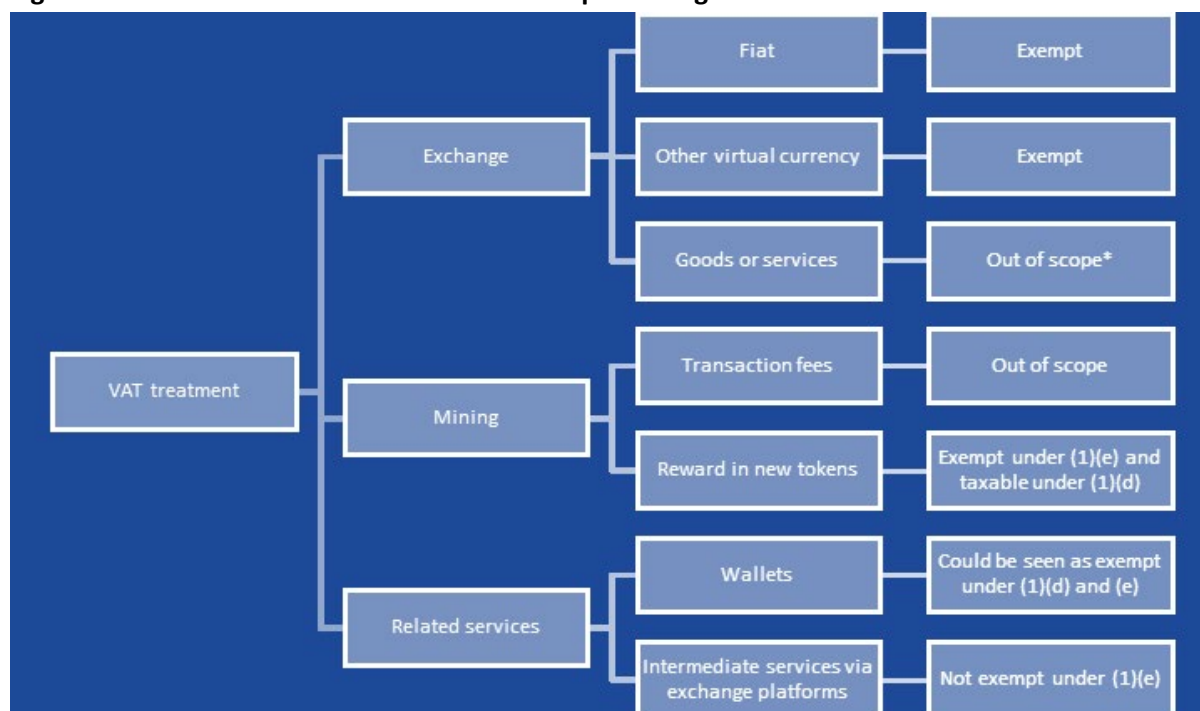


Table 5: Table of comparison on the classification of crypto asset and VAT treatment in other jurisdictions compared to South Africa

Country	Crypto asset classification	VAT/GST/HST
Australia	Financial service	Exempt from GST
Singapore	Financial service	Exempt from GST
New Zealand	Financial service	Exempt from GST
Canada	Virtual payment Instrument	Exempt from GST/HST

Virtual currency transactions are exempt from VAT in practically all countries. This is true whether fiat money or other virtual currencies are being exchanged. It is also not within the purview of VAT to levy VAT on the value of virtual currencies as utilising them to purchase goods or services is an independent activity. The transaction is not a barter; virtual currencies are merely a method of payment. None the less, VAT is still applicable where appropriate to the supply of taxable goods and services paid for with virtual currency (OECD, 2020).

Avoiding the practical challenges of treating these transactions as taxable under VAT regulations, such as the intricate record-keeping required to determine values and deductions and the possible inclusion of individuals or small dealers under VAT registration rules, is another benefit of this treatment. The current tax position for virtual currencies in EU countries is also a result of the Hedqvist ruling, which treated them as currencies for the purposes of the VAT Directive (OECD, 2020).

Different countries consider services differently that are associated with virtual currency exchanges but are not essential to them. The great majority of countries do not impose charges on VAT, usually on the grounds that it is free from duty or covered by laws pertaining to financial services. The standard VAT regulations apply to services pertaining to virtual currency exchange as a supply of taxable services in other countries, especially those outside the European Union. Consistency with how various nations handle financial services and traditional payment methods is crucial when it comes to these services. It is also important to take into account the real-world effects of differing approaches for taxpayers in terms of virtual currency valuation, record-keeping, and registration.

South Africa with an observer status of the OECD has also followed suit in the treatment of crypto assets as a financial service and exempt for the purposes of VAT. Cryptocurrency is still not defined in the VAT Act, more consideration will need to be given to different treatments of different cryptocurrencies as they all have different features.

As summarised in Table 3 and Table 4, it can be concluded that South Africa took a rather stringent approach is categorising crypto assets as a financial instrument. It is quite clear in the tables above that there is no relation between the characteristics of Bitcoin to that of a financial instrument.

Determining the nature of supply involving cryptocurrencies will be made easier through characterisation, which will allow for the classification of cryptocurrencies as either out of scope or outside of the jurisdiction's definition of goods, services, or exempt items. As a result, the VAT consequences will vary based on the specifics of the transaction. The origins and applications of cryptocurrencies offer them a variety of characteristics.

The below are some suggestions made by the African Tax Administration Forum, (2020) for classifying cryptocurrency transactions for VAT purposes when it comes to block rewards and tokens.

Block rewards

Depending on the jurisdiction, miners' block rewards may be considered exempt from VAT or beyond its purview for the following reasons:

- Because there is a clear contract that establishes rights and obligations for the parties, some states view it as a voluntary activity; as a result, the block reward is not regarded as payment for the provision of services.
- Because of the nature of the transactions and participants—such as miners' rapid access and departure due to their digital mobility—enforcing VAT compliance presents an administrative problem.

The VAT regulations pertaining to negotiable instruments and transactions involving the acquisition of fiat money will determine how cryptocurrency exchanges are treated. Consideration should be given to the following suggestions:

- Peer-to-peer exchanges, or barter trades, are instances of bitcoin transactions between entities that don't require an intermediary to be paid a commission. VAT will be applied to each of the two exchanged supplies as if they were independent supplies.

- Exchange of tokens between entities through an intermediary for a fee is known as peer-to-peer exchange. In this case, VAT should be applied to the commission and the parties involved should be regarded as in the point above.
- VAT will be charged on the amount paid if one party in the trade pays cash to obtain the cryptocurrency.
- When a cryptocurrency is acquired by an exchange platform—that is, when it buys the cryptocurrency from one party and sells it to another—VAT should be applied to both the amount in fiat money that the exchange platform paid to acquire the cryptocurrency and the amount that the customer who purchased the token from the platform paid.
- VAT ought to be charged in cases where the exchange platform sells the token that it owns.
- When there is no taxable transaction or supply of goods or services, the movement of cryptocurrencies into and out of wallets shouldn't be subject to VAT fees. However, VAT should be levied on fees for using e-wallets.

Tokens in an initial coin offering (ICO) or initial token offering (ITO)

- The transaction shall be handled in accordance with the VAT regulations on transactions involving securities if it contains elements of a security instrument. The transaction should be handled as a debt instrument or other financial instrument, if that is what it essentially consists of, aside from securities.
- VAT should be charged when the service or good is used if the cryptocurrency or token possesses qualities of a utility token, such as the ability to be used to access particular commodities or services. Certain utility tokens serve two purposes, such as security-characterized tokens that can also be used as utility tokens. For VAT purposes, these tokens should be handled according to how they are used in the transaction in question; that is, they should be handled as utility tokens when their usage is primarily utilitarian and vice versa.
- Unless otherwise exempt, transaction costs for the listing of an ICO or ITO and other traceable transactions should be subject to VAT.

Cryptocurrencies are now widely used in transactions involving significant sums of money in the commercial world. It is now utilised by companies as a source of capital funding. To enable the efficient administration and preservation of VAT neutrality in a climate that is supportive of cryptocurrencies, its VAT consequences must be recognised and handled appropriately.

Therefore, to simply exempt the issue, acquisition, collection, buying, selling or transfer of ownership of any cryptocurrency is not correct as the source of the cryptocurrency and nature of supply need to be considered for the correct VAT implications.

In conclusion, financial services are associated with the financial industry, as discussed in detail in Chapter 3. Financial sector services consist of banking, insurance, investments and the financial market. In their most fundamental form, financial services are transactions involving the exchange of money for money. At the heart of these transactions is the bank's role as an intermediary. When one considers that financial services rely on intermediaries and, in most cases, banks, it becomes evident that cryptocurrencies and their designation as financial services under the VAT Act have no connection. The absence of a connection renders the existing characterisation of cryptocurrency operations in the VAT Act meaningless because cryptographic transactions do not utilise banks as

intermediaries (Kwabe, 2020). In addition, it is generally acknowledged that cryptocurrencies do not meet the criteria for 'money' for VAT-related purposes. Today, banks do not lend borrowers cryptocurrency as 'money', which raises the critical question of why South African tax authorities choose to designate cryptocurrency-related activities as financial services.

Chapter 7: Conclusion

To address each primary and secondary research topic, the author will give a final chapter reflection on specific subject areas. The study's findings will be analysed by the author, who will also offer suggestions for addressing the problems found and point out specific areas that require more investigation.

7.1 What is a cryptocurrency?

Time, value and location are the issues plaguing the current VAT system or treatment of cryptocurrencies, as these transactions are not regulated by governmental bodies. At present, no global VAT classification or system provides universal guidelines on how to handle these transactions; consequently, each country has its separate rules and timeline for assessing and implementing such restrictions, making it more difficult to provide clear guidance on how cryptocurrencies should be treated at present.

At least eight different words are used to describe what are generally known as crypto assets in the various guidance documents, position statements, and legislative revisions of the nations under consideration. Frequently, these documents offer definitions of the terminology specific to the relevant jurisdiction. Whether those variations in terminology or definitions are meant to indicate the favoured vocabulary of that jurisdiction or to differentiate their intended scope or meaning in that jurisdiction is rarely evident (Parsons, 2022).

A progression in terminology seems clear if the review is extended to include other noteworthy regulatory announcements and literature on crypto assets, while there are (maybe inevitably) outliers and divergent viewpoints at different periods. Early discussions of the concept of crypto assets were usually framed in terms of "fiat currency," often known as "legal tender" or just "currency." A country's fiat currency, which takes the form of tangible notes or coins, is governed by its central bank and is mandated by law to be acknowledged as payment for debts owed in that country (Parsons, 2022).

7.2 Financial services and crypto asset VAT treatment in South Africa

The spectrum of differences in identity or nature encompasses various categories, such as property, commodity, or asset; more specific categories include movable asset, intangible asset, and intangible property; and very specific designations, such as financial asset, financial instrument, and derivative financial instrument, that may lead to the application of particular tax provisions. While not all differences in identity or nature indicate that there would be differing tax implications, they can occasionally result in inconsistencies between jurisdictions. For instance, although some jurisdictions not covered in this study declare that crypto assets cannot be financial instruments, South Africa has declared them to be financial instruments.

It is difficult to determine which identity is "correct" to use in jurisdictions where there hasn't been a clear declaration to that effect because of this variation and the possibility for disagreement. The lack

of a standardised method for identifying the nature or identity of a given crypto-asset may result in differing tax implications for transactions involving crypto-assets in various jurisdictions and make it more difficult to determine taxation rights in cross-border transactions involving nations using various designations.

In accordance with the Financial Advisory and Intermediary Services Act, 2022 (FAIS Act), the Financial Sector Conduct Authority (FSCA) published a notice on October 19, 2022, along with its policy document, listing cryptocurrency assets as financial products.

The VAT Act's definition of "financial instrument" includes cryptocurrency in addition to other financial instruments such as bonds, debentures, interest-bearing arrangements, financial arrangements based on the time value of money, and option contracts. As discussed in Chapter 6, the characteristics of Bitcoin cryptocurrency do not meet the definition of a financial instrument. Therefore, crypto assets might have been categorised as financial instruments prematurely.

Financial services are considered challenging to tax and are, therefore, exempt from VAT. Providers of these services cannot claim VAT on expenses directly related to providing these services. However, if a financial services provider charges a separate fee, such as a commission or merchant's discount, then the service is no longer exempt and is subject to VAT (Hendricks, 2022).

Some financial services providers make (i) exempt supplies (where no separate fees are levied) and (ii) taxable supplies of financial services (where separate fees are charged). This could result in two VAT repercussions for a single provision of financial services, with one being exempt and the other chargeable (Hendricks, 2022).

Financial service providers can deduct the VAT they incur for consumption, use or supply as part of taxable supplies. However, they cannot deduct VAT incurred for exempt supplies or non-taxable purposes. For mixed supplies, where goods or services are obtained for taxable and exempt purposes, VAT deduction must be allocated according to the five stages outlined in the VAT Act. Moreover, if the financial service provider receives fees and other payments, then the attribution cannot be applied directly (Hendricks, 2022).

Subsequently, the vendor will only be able to claim input VAT on a proportional basis. To use direct attribution to VAT on expenses incurred (for taxable, exempt or other purposes), a supplier of financial services must demonstrate that VAT's direct and immediate aim is to make taxable supplies. This needs a direct connection between the VAT on expenses incurred and the subsequent taxable supply. Insofar as a provider of financial services can directly attribute VAT on expenses incurred solely for exempt purposes, VAT cannot be claimed (Hendrick, 2022).

It is important to note that although financial services are exempt from taxation, they can be zero-rated if supplied outside of South Africa. This means that zero-rating takes precedence over the exemption. Suppliers must determine if their financial services are exempt from taxation because their input claim could significantly increase relative to the input tax credit if the service is exempt. For

example, if a cryptocurrency is supplied to a non-resident outside South Africa during the supply, it can be zero-rated. Similarly, a long-term insurance policy offered to a non-resident who was not in South Africa during the supply would also be zero-rated (Hendricks, 2022).

Offering financial services, such as paying suppliers with cryptocurrencies, can change a business from only providing taxable products to delivering a mix of taxable, exempt and zero-rated goods. This is called 'mixed supplies', and it may affect the allocation of input VAT (Hendricks, 2022).

After reviewing the relevant literature, the author believes that the classification of crypto assets as financial services needs to be corrected simply because there is no link after considering the nature and characteristics of both crypto assets and financial services. Improper categorisation of cryptocurrency assets can lead to loss of tax revenue due to potential loopholes in the recovery system, due to non-compliance or infrastructure issues related to tax administration and collection. SARS had indicated in the 2018 annual budget that the supplies of cryptocurrency would not be required to register for VAT regardless of having met the VAT registration threshold of R1 million in 12 months. Hendricks (2022) listed the potential VAT leakages, and one of them was cases where a vendor provides mixed supplies and fails to apply VAT apportionment rules but claims full input VAT credits, which leads to non-compliance with VAT apportionment rules, as discussed in the case of *Commissioner for the South African Revenue Services v Tourvest Financial Services (Pty) Ltd*.

Mans (2019) was of the view that it would be practical to categorise cryptocurrencies as money or currency as this would have the least effect on existing VAT systems. No physical changes or deployment of new systems or procedures would be required, which would be helpful for both regulators and users. This might be considered a temporary answer or guideline for cryptocurrency taxation until a single VAT classification or treatment is adopted.

To support Hendricks (2020), the author contends that South Africa's categorisation of crypto assets for tax purposes is equivalent to that of other countries. The law may not have evolved similarly, but the designation of cryptocurrencies as exempt financial services is the same for South Africa and most foreign jurisdictions analysed in the study. However, due to the associated complexities, the buying and selling of actual cryptocurrency should be out of scope until such a time when there is universal guidance on how they should be treated. However, these services should be accounted for and considered for VAT purposes.

7.3 The treatment of crypto assets by other jurisdictions for VAT purposes

Although there are still jurisdictions that have not yet formally adopted this position, it appears that jurisdictions inside and outside of the EU are moving in the direction of the idea that transactions involving the payment and sale of crypto assets should be exempt from VAT because of the *Skatteverket v. David Hedqvist* ruling. Payments made with crypto assets are exempt from taxes, which aims to eliminate double taxation (i.e., indirect tax on both the supply of the crypto asset and the counter-supply of the good or service). Additionally, the exemption of sales and payments from crypto assets attempts to establish parity (or equity) between payments made with crypto assets and fiat currency.

Outside the EU, laws pertaining to VAT that do not contain provisions that could apply to payments made in cryptocurrency in order to maintain fiscal neutrality may have to be amended to achieve fiscal neutrality. One example of this is the special exemption for cryptocurrency transactions that was added to the Value-Added Tax Act in South Africa in 2019. However, it is not always obvious where the limits of the required VAT treatment are. The adoption of the idea that bitcoins are only meant to be used as a form of payment—a belief that was questioned at the time—formed the basis of the *Skatteverket v David Hedqvist* verdict. As a result, the decision only affects exchange tokens; transactions involving other kinds of tokens are not expected to be covered by it.

By specifically mentioning "medium of exchange" in its definition, Canada's planned inclusion of "virtual payment instrument" in the Excise Tax Act narrows the scope of its use. In contrast to Australia, which uses the term "digital currency" instead of the default "cryptocurrency," the UK refers to "Bitcoin and similar cryptocurrencies" in its 2014 VAT guidance. The UK also uses the preferred term "crypto assets" in its 2018 guidance, though this could just be the result of evolving preferred terminology over time. It is uncertain in many cases whether or not these exclusions are intended and should be inferred, though, as not all VAT guidelines or legislation mention exclusions. This implies that, at the very least, there is still uncertainty surrounding the VAT ramifications of a variety of crypto asset transactions, and, at the very worst, there is inconsistency in the outcomes across nations.

Likewise, the ECJ decision specifically focused on the services provided by cryptocurrency exchanges and the conversion of fiat money into cryptocurrency, even though it is reasonable to assume that the same rules would apply to cryptocurrency payments as well.

Other transactions involving crypto assets are less clear on their VAT status. Due to the absence of a counterparty that can be identified or a contractual relationship between mining actions and rewards received, a number of jurisdictions have voiced the opinion that crypto-asset mining is exempt or otherwise excluded from VAT repercussions. This appears to apply to both transaction costs and mining fees when taken into separate consideration. But this wasn't the precise result of the ECJ decision, so there could be other ways to read it.

Concerning the exemption of transactions involving cryptocurrencies from VAT, it seems that South Africa has adopted the most stringent stance, prohibiting "the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency".

The only two countries found to differ from the majority on the VAT implications of crypto asset transactions are Israel and Singapore, while Singapore is planning to change its stance to more closely resemble other nations' positions. To bring its viewpoint in line with that of the majority, Canada has suggested changes to its indirect tax laws.

Digital financial assets: A Value-Added Tax technical note from the African Tax Administration Forum, 2020. This paper suggests that the application of VAT to transactions involving crypto assets should be expanded, potentially involving the exchange of one crypto asset for another or fiat cash, as well

as utility tokens when they are utilised. It 'is possible that these recommendations represent more proof that there isn't yet agreement on the indirect tax implications of transactions using crypto assets.

7.4 Areas for further research

The author makes recommendations for further research in the following areas:

- **Regulatory environment**

Regulators may encounter challenges if cryptocurrencies are classified too soon. To ascertain whether there are taxable occurrences that are subject to tax in each unique circumstance, tax administrations must collaborate with their country's statutory framework. Similarly, to strengthen their control strategy, give certainty to the matter, and safeguard consumers, they can and should suggest changes to the regulations. They cannot wait to act on this matter while seeking potential multilateral solutions that could lead to an agreement on the taxation of cryptocurrency. SARS has yet to provide specific guidance on the Value-Added Tax (VAT) treatment of cryptocurrencies as of their 2018 annual budget review.

- **Preventative control management**

SARS must implement measures not only for cryptocurrencies but also for other cryptographic tokens that have seen significant advancements, like NFTs, which enable multiple operations to be carried out while concealing the identities of the parties involved, thereby enabling money laundering and tax fraud. Permanent training is also necessary to ensure that officials have a thorough understanding of the subject and are equipped with the latest methods for doing research and data analysis.

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