

Impact Summary: Tax treatment of cryptocurrencies

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be made by Cabinet.

Key Limitations or Constraints on Analysis

Due to the nature of blockchain and distributed ledger technology, there are a number of constraints on the data that is available for analysing the policy problem. First, it is very difficult to determine the identify or tax residency of a crypto-asset user or the counterparty to any given transaction. Second, there are many crypto-assets (over 10,000) and the underlying technology is extremely complex and constantly evolving. These issues could pose an inherent challenge to crypto-asset tax compliance generally.

It is noted that these constraints have not had a large impact on the current proposals. This is because the preferred option was for a broad exemption to exclude crypto-assets from GST and the Financial Arrangement (FA) rules, which makes identifying an individual's identity and tax residency along with the underlying crypto-assets that they invested in not as relevant. These constraints could be more important if one was looking at applying different treatment depending on the nature of the crypto-asset or required mechanisms to determine tax residency to enforce tax compliance. We suspect that these issues may be greater constraints when wider reform options for income tax are undertaken.

Responsible Manager (signature and date):

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Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the *Tax treatment of cryptocurrencies* Regulatory Impact Assessment prepared by Inland Revenue, and considers that the information and analysis summarised in the Regulatory Impact Assessment **meets** the quality assurance criteria.

Reviewer Comments and Recommendations:

The reviewer's comments on earlier versions of this Regulatory Impact Assessment have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Background

Crypto-assets are digital assets (commonly known as coins or tokens) that use cryptography to secure transactions and verify the transfer of the coins or tokens. Instead of relying on a financial institution to verify transactions, crypto-asset transactions are confirmed by computers operating on the currency's network (distributed ledger technology).

Tax rules in New Zealand and many other countries do not contemplate crypto-assets and can be difficult to apply as crypto-assets will often not fit into existing definitions that were designed for other investment products such as fiat currency or shares. Because of their innovative nature, they will often also have different features to these other investment products.

Due to the nature of blockchain, we do not have a sense of scale as to how many New Zealand tax residents are crypto-asset users or holders. However, on a global scale the number of crypto-assets and the amount of money that is invested in them has been growing prolifically over the last couple of years (at time of writing there are over 10,000 crypto-assets with a global market capitalisation of almost \$1.7 trillion dollars).

Current law

The current position is that crypto-assets are likely to 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.

If GST were to apply to crypto-assets this could create biases to sell to non-residents (zero-rated) and would result in double taxation in some cases (e.g. if a car dealer sold a car and accepted a payment in bitcoin the dealer would have to account for GST on the sale of the car for bitcoin, and then a second time when transferring that bitcoin into NZD).

In this regard, the current GST rules provide an uncertain and variable GST treatment. This could make using or investing in crypto-assets less attractive than using money or investing in other financial assets. Similarly, applying the FA rules to crypto-assets would lead to accrual based taxation on large unrealised gains and losses and could bias investment decisions. The FA rules are complex to apply and do not apply to shares (which are a similar investment product).

2.2 Who is affected and how?

Holders of crypto-assets: Anyone who holds crypto-assets is potentially impacted by the GST treatment of these assets. This includes investors, New Zealand businesses which issue crypto-assets or accept them as payment, and NZ based exchanges. Anyone that is GST registered who holds crypto-assets will be confronted by the GST treatment upon the disposal of their asset (potentially including trading one crypto-asset for another, selling it for money or trading it for other goods). As the current law is unclear, there is likely to be a high degree of non-compliance or inconsistent treatment being applied across the board.

More generally, it can also be argued that the current ambiguity in the rules means that *potential* users of crypto-assets are disincentivised from using or investing into these assets.

2.3 What are the objectives sought in relation to the identified problem?

- It is intended that crypto-assets should have a similar tax treatment to other investment products or asset classes which are close substitutes for the crypto-asset (it is not intended that crypto-assets would receive a concessionary treatment);
- NZ crypto-asset holders are not disadvantaged from issuing or selling tokens in NZ (relative to selling tokens outside NZ or capital raising through other means); and
- any solution does not impose undue compliance costs or create perverse incentives.

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options:

- **Certainty:** It should be clear how the tax rules operate so that affected parties can plan their affairs accordingly.
- **Policy sustainability:** Crypto-assets are an emerging market. There are over 10,000 crypto-assets with various functions and constantly changing uses. It is important that the rules are stable enough to future proof against changes in this area.
- **Compliance costs and administration costs:** These should be minimised where possible. It is noted that crypto-assets have many different rights and features and are constantly changing. If prescriptive categorisations are required then this adds compliance costs for the taxpayer.

Option one: Status quo but provide more guidance

Pros:

- No legislation change would be required.

Cons:

- Given the many potential GST treatments that could apply to crypto-assets under existing law, this approach would potentially be more time consuming than enacting legislation.
- Would not have the legal weighting that legislation has.
- Would fail to future proof against future changes in the crypto-asset market.
- Would fail to reduce the complexity of the existing law and therefore still burdens taxpayers with heavy compliance costs to determine how their respective assets fit within guidance.
- Would not solve any of the problems identified to the extent that guidance on existing law determined that it did apply (e.g. if guidance on existing law determined that the FA rules applied to a particular crypto-asset then the taxpayer would still be subject to accrual based taxation on potentially large unrealised gains).

Option two: Token classification framework and deeming rules

This option would develop a framework for categorising different types of crypto-assets and use this to create deeming provisions that apply across all Revenue Acts. For example, crypto-assets could be categorised as a utility, security or asset token based on their particular rights and features, and then be given a tax treatment similar to other asset classes that hold such features.

Pros:

- This approach is principled and tax neutral. For example, it would provide a neutral tax treatment for those crypto-assets which are close substitutes for existing financial products such as currency or shares, whereas other tokens (such as utility tokens) could be subject to GST.

- **Comprehensive:** A taxpayer would have the advantage of being able to apply all the existing law that stands behind each respective classification. For example, if a particular crypto-asset was deemed to be money, the taxpayer could apply all relevant tax law and guidance that applied to money to their crypto-asset.

Cons:

- This approach assumes that crypto-assets all have similar uses to existing financial products. This may not be the case, meaning that existing rules may be impractical to apply to a number of crypto-assets.

Option three: Broad definition

This option would prioritise specific changes that create the most significant policy issues when applied to crypto assets (applying GST and the FA rules lead to significant policy and practical issues when applied to crypto-assets). The approach then creates a broad definition of “crypto-asset” and excludes those that meet the definition from GST and the FA rules (by classifying them as an excepted FA).

Pros:

- Utilising a broad definition of crypto-assets best future proofs against changes in the crypto-asset market. A broad definition prevents the need for regular reviews.

Making supplies of crypto-assets not subject GST

- Making crypto-assets not subject to GST creates certainty (under current principles the treatment would vary greatly depending on the residency of the buyer, the nature of the crypto-asset and the facts of the scenario at hand).
- Avoids compliance costs associated with categorising crypto-assets for purposes of determining GST treatment.
- Ensures NZ investors are not disadvantaged from selling tokens in NZ compared to overseas (zero-rated). It is also more attractive for businesses to undertake capital raising ventures with crypto-assets in NZ if they are not subject to GST and exempt from FA rules.¹
- Avoids double or multiple taxation that can occur when crypto-assets are used as a payment for an underlying supply.

Exempting from FA rules

- Avoids the application of the FA rules: if the FA rules were to apply to some crypto-assets and not others (similar in kind to other assets to which financial arrangements apply) then this creates inconsistencies. This would result in accrual-based taxation on large unrealised gains and losses from volatile crypto assets and the consequent biasing of investment decisions if some are taxed on a realisation basis and others aren't.

¹ Another option would be to exempt them from GST. If crypto-assets were exempt from GST, a GST-registered person who makes supplies of crypto-assets to non-residents (zero-rated) would be able to claim GST input credits. This would make it more attractive for these persons to sell to non-residents. In order to ensure NZ businesses and investors are not disadvantaged when they sell crypto-assets to other NZ residents, removing crypto-assets from the GST net altogether is the preferred approach.

- Subjecting crypto assets to the FA rules also creates compliance costs: individual would be required to convert their crypto-assets into NZD, spread income over the term of the arrangement and undertake a base price adjustment.

Cons:

- If adopted, this proposal would not actually reduce the compliance cost of applying other tax rules (such as working out the income tax profit or loss, or record-keeping).
- Does lack accuracy to some extent as all crypto-assets regardless of their features would not be subject to GST and exempt from the FA rules.

Option four: Develop a standalone set of tax rules for cryptocurrencies

Pros:

- Comprehensive: Having a 'codified' body of law in respect of crypto-assets (for both income tax and GST) that prescribes comprehensive treatment for these assets for all aspects of tax would be very comprehensive and more accessible given it would be centralised in one place.
- Future proofed: Any future changes to crypto-assets would be more amenable to amendment if the laws that applied to these assets were all set out in one space and not intertwined with existing tax settings that were designed without any contemplation of crypto-assets (which were probably not in existence at that time).
- Reduction in compliance costs.

Cons:

- Risk of getting it wrong: It is noted that there would be risk in undertaking a comprehensive standalone set of rules for crypto-assets at this stage. This is still a developing area that is not yet well understood, and it would be best to understand it fully and how it develops in light of existing tax settings before attempting something more comprehensive.
- Time consuming (would require a lot of analysis, consultation and policy resource and would take a long time to develop, consult and implement).

3.2 Which of these options is the proposed approach?

Officials' preferred option is option three – applying a broad definition to crypto-assets and then focussing on the issues that provide the most problems from a policy perspective (being to make crypto-assets not subject to GST and exempt from the FA rules). It is noted that this option would also be supplemented to include the use of guidance to ensure that these changes were communicated and easily understood.

This option is preferable because:

- **Compliance costs:** The compliance costs to categorise and apply existing tax law to all crypto-assets (as would apply under the status quo or when designing a token classification framework) together with the compliance costs borne by individuals in determining which classification applies to their particular assets, outweighs the revenue neutrality benefit of a more prescriptive system. Having to determine the residency of the counter party to a transaction would also be required if GST potentially applied, and this is almost impossible with crypto-assets.
- **Certainty:** This option provides the most certainty as all crypto-assets will be exempt from the FA rules and not subject to GST.
- **Sustainability:** A broad exemption future-proofs the industry against future changes that would require constant reclassification under a token classification framework approach.
- Although option 3 is the best in the short term and is what is proposed in the Cabinet paper, officials will continue to work to develop and consult on option 4 as a second phase of potential reforms at a later date. This could help address other issues and concerns in this area.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties (GST registered owners of crypto-assets)	It is expected that the preferred option aligns with tax positions taken by nearly all taxpayers, so there would be no impact on them nor compliance costs. It is possible that some taxpayers will have taken tax positions based on the current law and a grandparenting provision would be provided to preserve those positions so they would be unaffected.	None/low
Regulators (Inland Revenue)	There should be no revenue impact. Given that the current law regarding GST, FAs and their application in respect of crypto-assets is unclear, it is understood anecdotally that not many taxpayers have taken a tax position in respect of their crypto-asset holdings. As mentioned above, a grand parenting clause will preserve tax positions already taken.	None/low
Wider government	No expected costs	
Other parties	No expected costs	
Total Monetised Cost		None/low
Non-monetised costs	It is noted that these changes will bring a small administrative cost to IR in terms of providing guidance and answering queries to aid taxpayer understanding and promote compliance.	Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties (GST registered owners of crypto-assets)	Although anecdotally the number of taxpayers that have returned GST on the sale of crypto-assets is low, removing them from the GST net will result in certainty for taxpayers.	Medium

	<p>Note that GST will continue to apply to supplies of goods and services which are brought using a crypto-asset as the 'currency'.</p> <p>Taxpayers will also have far fewer compliance costs, as they would not be required to consider the GST treatment of their various crypto-asset holdings going forward.</p>	
Regulators	Creates certainty in the law and therefore future proofs this space against future queries from taxpayers (which requires resources to respond to)	Medium
Wider government	Provides certainty regarding the wider crypto-asset market	
Other parties	No expected benefits	
Total Monetised Benefit	Hard to quantify as whether GST would have applied would largely depend on the nature of the transaction.	Low
Non-monetised benefits	Reduction in compliance costs for taxpayers over time	Medium

4.2 What other impacts is this approach likely to have?

There are unlikely to be any further material impacts of this approach.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Who has been consulted? What was the nature of their interest?

This issue was consulted on as part of the release of the *GST policy issues – an officials’ issues paper*. Inland Revenue received submissions from private sector tax advisers as well as from some crypto-currency groups, such as Blockchain NZ.

Do they agree with your analysis of the problem and its causes?

Yes. The submissions received on this issue in the GST issues paper outlined similar considerations to what has been discussed in this RIA (see above and in the pros and cons section of the discussion options).

Do they agree with your proposed approach?

Submitters were largely supportive of our preferred approach which is to provide a broad definition of crypto-assets and make those crypto-assets not subject to GST and exempt from the FA rules. CA ANZ preferred the first option, being the development of a token classification system and deeming rules, but did note that if this principled framework was not developed then they would support a broad definition option.

Has your proposed approach been modified as a result of stakeholder feedback?

Yes. Submitters have provided some valuable input into the detailed design of the proposals. Some examples of how the proposed approach has been modified as a result of stakeholder feedback includes how ‘crypto-asset’ should be defined, which is important to ensure the workability of the proposals, along with the potential inclusion of a grand parenting clause for prior tax positions (noting that these proposals would be retrospective to 1 Jan 2009, being the inception of bitcoin).

As the proposals also intend to exempt crypto-assets from the application of the FA rules (with the exception of crypto-assets with features that make them economically equivalent to debt arrangements), submitters noted the need for an anti-avoidance provision to prevent any deliberate abuse (e.g. an issuer of bonds converting its bond instruments into tokens for the purposes of reducing the tax impact for its investors).

Submitters also stressed the need for greater levels of guidance, which resulted in preparing for a more comprehensive approach than was in the issues paper (i.e. the issues paper advocated for the ‘broad definition’ approach as discussed earlier in this RIA, but this will now be supplemented with additional guidance to address submitters concerns).

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Goods and Services Tax Act 1985 and the Income Tax Act 2007, and could be included in the next available omnibus tax bill (expected to be introduced in August 2021).

Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with Select Committee and after the bill is enacted (by way of inclusion in a Tax Information Bulletin).

The proposals have been subject to consultation via a GST issues paper and would be subject to the standard legislative process. It therefore follows that there will be sufficient time for people to react to and understand the changes.

The proposals are quite simple in their execution (i.e. excluding crypto-assets from the Financial arrangements rules and GST) and align with existing taxpayer practices so are therefore unlikely to create any implementation risks.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Officials will continue to engage with submitters and other stakeholders to ensure the rules are operating correctly and to determine whether any remedials or further changes are required.

7.2 When and how will the new arrangements be reviewed?

There are no plans to undertake a formal post-implementation review of these changes. These changes are taxpayer friendly and simply ensure that the law accords with what most taxpayers have been doing in practice (i.e. by clarifying the application of the FA rules and GST to crypto-assets). That said, officials will continue to engage with submitters to ensure the rules are operating correctly and to determine whether any remedials or further changes are required.

As we have developed relationships with stakeholders throughout consultation on the issues paper, this engagement channel is open to stakeholders should they wish to provide feedback on the legislation.