ATO's Bitcoin guideline and draft tax determinations may leave gap in interpretation for business Bitcoin users

The Australian Taxation Office (“ATO”) published a guideline and a series of draft taxation determinations relating to Bitcoin ahead of the 2014 tax return season. They are based on the premise that Bitcoin is not a currency, but rather, it is a property. While this is a view adopted by number of other tax authorities, including the US and potentially Japan, it appears that the ATO’s guidelines currently leave a gap in the proposed tax treatment. In this month’s article, we outline the tax treatment proposed by the ATO including the possible gap in the draft guidelines issued, briefly explain the alternative views, and compare this to the approach proposed by the US and the UK. We understand that as at the date of writing this article, the Japanese tax authority has not issued any formal guidelines on the treatment of Bitcoin.

Acceptance of Bitcoin in Australia

Bitcoin is described as a digital crypto-currency. It is a type of digital currency, a technology that uses encryption techniques to regulate the generation of units and verify the transfer of funds. It has been described as virtual currency that essentially operates as online cash, although it is not regulated by any central bank. The circulation of bitcoin has increased to approximately US$5 billion as at 30 September 2014, and in Australia, it has been reported that there are now half a million users. ABA Technologies has installed Automatic Teller Machines (ATMs) in Sydney, Melbourne and Canberra, and plans to roll out 100 more Bitcoin ATMs in Australia by the end of 2016.
The banks in Australia, however, have been distancing themselves from Bitcoin despite some major banks initially welcoming it.

What is it? Is it a currency? Is it a foreign currency?

Bitcoin has been described as a virtual currency – but its characteristics are different from government-created money in many ways including the fact that its value is not backed by gold or legal tender but rather what value people assign to it. The bitcoins are created through a process of “mining” the data, but the total supply is capped at an arbitrary limit of 21 million. For Australian tax purposes, “currency” is not a defined term and therefore takes on their ordinary meaning – having regard to their context and the legislative purpose. To be considered “foreign currency” for tax purposes, it firstly needs to be a “currency”.

Citing two Court cases, the ATO draft tax determination has concluded that it is not a currency on the basis that:

► The current use and acceptance of Bitcoin in the community is not sufficiently widespread
► It is not a generally accepted medium of exchange

So the draft concludes that Bitcoin should be treated as property.

To some, this reasoning may seem short-sighted. Submissions have also questioned what happens if Bitcoin, or other types of crypto-currencies, become more widely accepted in the community as a medium of exchange? Would the tax treatment need to be revised at that point?

Proposed tax treatment in Australia

The ATO Guideline and the draft rulings outline the following proposed tax treatments:

► Bitcoin is not a foreign currency for tax purposes. It is a Capital Gains Tax (CGT) asset for CGT purposes, and where it is held for the purpose of sale or exchange in the ordinary course of a business, a trading stock.
► Generally, there are no income tax or GST implications for individuals if they are not in business or carrying on an enterprise and they pay for goods or services in bitcoin. Any capital gain from disposal of bitcoin (difference between historical market value at acquisition and market value at disposal) will be disregarded provided the cost of the bitcoin is $10,000 or less.
► Businesses will need to record the value of bitcoin transactions as a part of their ordinary income. They must also charge GST when they supply bitcoin and may be subject to GST when receiving bitcoin in return for goods and services.
► Bitcoin mining may be considered a business for tax purposes. For Bitcoin miners the cost of undertaking the mining operation should be deductible.
► There may be fringe benefit tax consequences for businesses using bitcoin to pay employee salaries.
► Where there may be a taxation consequence, the following records should be kept:
  - The date of the transaction
  - The amount in Australian dollars
  - What the transaction was for
  - Who the other party was (bitcoin address)

What happens when … and alternative view

The ATO draft rulings and guidelines do not properly cover the treatment of value fluctuations in Bitcoin exchange transactions.

It is not clear what happens in the following scenario:

► A business accepts bitcoin for the sale of its products (say computer software) and, at the time of the acceptance, the bitcoin value was $800.
► When the business uses the bitcoin after a few weeks to purchase other trading stock for its business, the value may be different – e.g. it may have increased to $1000 or decreased to $500.

The draft rulings do not make clear what happens to the economic gain of $200 (in the case of the increase) or the loss of $300 (in the case of decrease).

Further, if the business acquires bitcoins at different times, and then uses them at future
times - the rule would require the business to trace the individual bitcoin that was acquired at a certain date and its market value at the time of acquisition until it is actually spent to be able to calculate the gains and losses correctly. This may be a significant compliance burden.

An alternative view exists that says Bitcoin should be treated as a foreign currency for tax purposes and apply the same rules for taxing the foreign currency gains and losses. This would provide more certainty in the taxation of the gain/loss on the value changes that is not dependent on the characterisation of whether the particular bitcoin is a revenue asset or a capital asset.

**US and UK tax authority guidelines**

In the US, the Internal Revenue Service issued a notice in March 2014 in the form of answers to frequently asked questions regarding the tax treatment of virtual currency, such as Bitcoin. It notes that virtual currency does not have legal tender status in any jurisdiction and for US Federal Tax purposes should be treated as property. In relation to the treatment of gains and losses it notes that the character of gain or loss realised by the taxpayer depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

The UK approach has been to not give a blanket classification of Bitcoin, but to approach it on a case-by-case basis taking into account the specific facts [UK HMRC Policy paper – Revenue and Customs Brief 9 (2014)]. In relation to Corporation Tax, the Policy paper provides that “the profits or losses on exchange movement between currencies are taxable. For the tax treatment of virtual currencies, the general rules on foreign exchange and loan relationships apply”.

**ATO yet to announce release date for finalised rulings**

The ATO draft rulings were open for public comments until 3 October 2014. The issue date of the final rulings is not confirmed. However, Australian Senate Economics References Committee inquiry on an effective regulatory system for digital currencies (including Bitcoin) was announced on 2 October 2014 and is due to table its report in March 2015.

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