

Value-Added Tax (VAT) Implications within the South African environment arising from the classification of cryptocurrencies as financial services under the VAT Act

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Date. 20 September 2022.....

DEDICATION

I dedicate this study to my late parents who always supported and encouraged me to complete my schooling and tertiary education. Their memory will forever live on in my heart.

ACKNOWLEDGEMENTS

Firstly, I would like to take this opportunity to thank God Almighty who has provided me with the health, focus and determination in order for me to complete this mini-thesis.

Secondly, I would like to extend my heartfelt thanks and gratitude to my supervisors, Professors Jennifer Roeleveld and Shaun Parsons for their professionalism, support and expert guidance throughout this study.

ABSTRACT

Cryptocurrencies have been growing rapidly in South Africa (SA) since the initial user alert in 2014 that was issued by National Treasury to South African citizens on the uses of cryptocurrencies. During this time, the number of cryptocurrency merchants, including popular online marketplaces in South Africa that began to accept cryptocurrencies for goods or services, has also increased steadily.

This rapid increase in the use of cryptocurrencies prompted the South African Revenue Services (SARS) to issue a media release in April 2018. The main points relevant to this study included inter alia the statement by SARS that the onus is on taxpayers to declare all cryptocurrency related transactions, cryptocurrencies are not legal tender as a means of payment or exchange and not regarded as currency, and, more relevant to this study, that the Value-Added Tax (VAT) treatment of cryptocurrencies would be reviewed. Pending policy clarity in this regard, SARS would not require VAT registration as a vendor for purposes of the supply of cryptocurrencies. After further consultative processes on the classification of cryptocurrencies involving National Treasury and other stakeholders, cryptocurrencies were classified as financial services in 2019.

This study was limited to the VAT implications arising from the classification of cryptocurrencies as financial services and did not look at the income tax implications. Also, the study discusses cryptocurrencies in general and not a particular cryptocurrency like Bitcoin.

The main objectives of this study were to firstly identify whether there will be a compliance risk or impact to the fiscus through the trading in cryptocurrencies by a vendor resulting in mixed supplies and apportionment issues that could lead to possible VAT leakage, and secondly to compare the classification to cryptocurrencies within the SA VAT system to the approach taken by foreign jurisdictions.

The study examined the nature and history of cryptocurrencies, the SA VAT system, the possibility of potential VAT leakage, and drew a comparison of SA VAT legislation to the approach taken by other countries with regards to cryptocurrencies.

The findings of this study suggest that there is likely to be a compliance risk with regards to VAT apportionment which has the potential to lead to VAT leakage for the fiscus or alternatively for the taxpayer. The study also found that the treatment that SA has adopted for the classification of cryptocurrencies for VAT purposes is comparable to other countries. Another important finding is also that the European Union (EU) appears to apply a more appropriate and fair method of apportionment than SA, as the EU turnover formula is more flexible and allows for adjustment for potentially distorting items, such as interest and dividends. In SA the debate between taxpayers and SARS as to what constitutes a fair and appropriate apportionment method is ongoing and the results of this study suggest that the classification of cryptocurrencies as financial services is likely to further fuel that debate. This study therefore recommends that SA move towards a more nuanced basis of apportionment in instances of mixed supplies.

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ABBREVIATIONS

Abbreviation	Definitions	Abbreviation	Definitions
AML	Anti-Money Laundering	FATF	Financial Action Task Force
ATM	Automated Teller Machine	FMCG	Fast Moving Consumer Goods
ATO	Australian Tax Office	FSCA	Financial Sector Conduct Authority
B2B	Business-to-Business	FSRA	Financial Sector Regulation Act
BASA	Banking Association of South Africa	FTA	Federal Tax Administration
BGR	Binding General Ruling	GST	General Sales Tax
BTC	Bitcoin	IBFD	International Bureau of Fiscal Documentation
CARWG	Crypto Assets Regulator Working Group	ICO	Initial Coin Offering
CASP	Crypto Asset Service Provider	IFWG	Intergovernmental Fintech Working Group
CATP	Crypto Asset Trading Platform	OECD	Organisation for Economic Co-operation and Development
CGT	Capital Gains Tax	PA	Prudential Authority

CJEU	Court of Justice of the European Union	QFI	Qualified Financial Instruments
CPU	Central Processing Unit	SA	South Africa
DTC	Davis Tax Committee	SARB	South African Reserve Bank
EBA	European Banking Authority	SARS	South African Revenue Services
ECA	Europe and Central Asia	SRLC	Swedish Revenue Law Commission
ECB	European Central Bank	TLAB	Taxation Laws Amendment Bill
EIOPA	European Insurance & Pension	VAT	Value-Added Tax
ESMA	European Supervisory Authority for Securities	VATCOM	Value-Added Tax Committee
EU	European Union		

KEY WORDS

Bitcoin	Non-Taxable Supplies
Crypto Assets	Taxable Supplies
Cryptocurrency	Use Cases
Exempt Supplies	Value-Added Tax (VAT)
Financial Services	VAT Apportionment
Input Tax	VAT Leakage
Mixed Supplies	Virtual Currencies
Crypto Asset Service Provider	Crypto Asset Trading Platform

CHAPTER 1 – INTRODUCTION

1.1 BACKGROUND

In an article published in the Business Times in 2017¹ named “Tax principles apply for transactions in cryptocurrencies” it was mentioned that “with Bitcoin’s popularity and value growing significantly, many wonder how cryptocurrencies will be treated by the South African Revenue Service (SARS) and other regulators”.² Against the backdrop that no legislation with regards to cryptocurrencies was in place at the time, the South African Reserve Bank (SARB) cautioned against the use of cryptocurrencies as payment, stemming from identifiable risks associated with their use, including the increased risks of money laundering as well as the legal uncertainty caused by the lack of regulation.

The SARB also pointed out that the South African Rand was the only declared fiat currency and as such cryptocurrencies are not considered legal tender.³ The latter implies that suppliers or creditors were not obliged to accept cryptocurrencies in settlement for debts as they would be obliged to accept South African Rands.

The paragraphs that follow provide a timeline of the progression of legislation and guidance in South Africa (SA) with regards to cryptocurrencies.

The rapid increase in the use of cryptocurrency in SA prompted the SARS to issue a media release on the 6th of April 2018.⁴ The main points in this media release relevant to this study can be summarised as follows:

- The onus is on taxpayers to declare all cryptocurrency-related taxable income in the tax year in which it is received or accrued. Failure to do so could result in interest and penalties.
- In SA, the word ‘currency’ is not defined in the Income Tax Act No.58 of 1962 (‘the Act’). Cryptocurrencies are neither official South African tender nor widely used and accepted in SA as a medium of payment or exchange. As such, cryptocurrencies are not regarded by SARS as a currency for income tax purposes or for Capital Gains Tax (CGT). Instead, cryptocurrencies are regarded by SARS as assets of an intangible nature.

¹ Businesslive, (2017). ‘Tax principles apply for transactions’, available at <https://www.businesslive.co.za/bd/opinion/2017-09-20-tax-principles-apply-for-transactions-in-cryptocurrencies/>, accessed on 05 November 2020.

² In the 2020 TLAB the Income Tax reference to ‘cryptocurrency’ was changed to ‘crypto asset’ however the VAT Act was not changed. Since the study covers VAT the author will predominantly refer to the term cryptocurrency.

³ National Treasury, (2014). ‘User Alert – Monitoring of virtual currencies’, available at http://www.treasury.gov.za/comm_media/press/2014/2014091801%20-%20user%20alert%20virtual%20currencies.pdf, accessed on 3 July 2021.

⁴ South African Revenue Service, (2018). ‘SARS’s stance on the tax treatment of cryptocurrencies’, available at <https://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx>, accessed on 31 October 2020.

- The 2018 annual budget review indicates that the Value-Added Tax treatment of cryptocurrencies will be reviewed. Pending policy clarity in this regard, SARS will not require VAT registration as a vendor for purposes of the supply of cryptocurrencies.

Following the SARS media release in April 2018, the Draft Taxation Laws Amendment Bill (Draft TLAB) was published on 16 July 2018.⁵

The main points in the Draft TLAB at the time relevant to this study, were as follows:

- Cryptocurrencies is to be included in the definition of ‘Financial Instrument’ for income tax purposes.
- Section 2(1) of the Value-Added Tax Act No.89 of 1991 (the VAT Act) is to be amended under paragraph s (o), to include “the issue, acquisition, collection, buying, or selling or transfer of ownership of any cryptocurrency”.
- Cryptocurrencies must be included in the definition of ‘financial services’ under the VAT Act which will then imply that a cryptocurrency will be considered an exempt supply for VAT purposes.
- No definition of cryptocurrency is proposed for income tax (or VAT).

No further detailed guidance has been provided by SARS apart from the media release in April 2018.

Following the publication of the Draft TLAB, a draft response document was issued by National Treasury on the 12th of September 2018⁶ where it was noted that the proposal to include cryptocurrencies under exempt financial services of section 2 of the VAT Act was welcomed in submissions received. However, the submission that a definition of ‘cryptocurrency’ be added to the Act and VAT Act was not accepted, as it was submitted that it is not necessary since there is a general understanding of the meaning of ‘cryptocurrency’.

Of specific relevance to this study, at pages 32 and 33 of the response document under the subject heading ‘Value Added Tax’, is the comment on the Draft TLAB that “if the issue acquisition, collection, buying or selling or transfer of ownership of any ‘cryptocurrency’ is exempt, then a vendor making 100 per cent taxable supplies who chooses to accept cryptocurrencies as a form of payment and then on-sells such cryptocurrency, will no longer be making 100 percent taxable supplies and will no longer be entitled to full input credits”. It is important to note that National Treasury recognises VAT leakage in the above example.⁷

The term ‘VAT leakage’ is not defined in the VAT Act. Essentially tax revenue leakage could occur if there are loopholes in the recovery system due to a lack of compliance or infrastructure challenges with regards to the administration and or collection of these taxes. VAT leakage

⁵ National Treasury, (2018). ‘Draft Taxation Laws Amendment Bill’, available at

<http://www.treasury.gov.za/public%20comments/TLAB>, accessed on 06 November 2020.

⁶ National Treasury, (2018). ‘Draft Response Document -2018 TLAB and 2017 TLAB’ at 32-3, available at <http://www.treasury.gov.za/public%20comments/TLAB>, accessed on 06 November 2020.

⁷ National Treasury, (2018). ‘Draft Response Document -2018 TLAB and 2017 TLAB’ at 32-3, available at <http://www.treasury.gov.za/public%20comments/TLAB>, accessed on 06 November 2020.

specifically could occur in a situation as described above where a vendor is making mixed supplies and would need to apply VAT apportionment rules, but does not, and instead claims full input VAT credits, resulting in non-compliance around VAT apportionment rules.

It was further put forward that National Treasury should re-consider the proposed inclusion of cryptocurrencies into ‘financial services’ contained in the 2018 Draft TLAB and should rather treat cryptocurrencies as or deem it to be ‘money’.⁸ In the reply from National Treasury in the Final Response Document; the comment that cryptocurrencies should rather be treated as or deemed to be money was rejected.⁹

In a presentation on cryptocurrencies and tax in SA, it was pointed out that although the proposal that it is not currently required for businesses engaged in the supply of cryptocurrencies to register as a VAT vendor seems positive at first glance, it could be potentially fraught with complexities including issues of mixed supplies, VAT apportionment and VAT leakage.¹⁰

In January 2019, it was declared that cryptocurrencies will be classified as ‘financial instruments’ after the President of the Republic signed the Taxation Laws Amendment Act 34 into law.¹¹ This change was effective from the 1 April 2019 (s2(1)(o)).¹²

The results of a study into the output tax consequences of Bitcoin transactions for a South African VAT vendor, point out and illustrate the rationale for the classification of cryptocurrencies as financial services and consequent exemption from VAT. Prior to this, it was found, when interpreting the VAT Act as it then read, that the receiving of bitcoin in exchange for the supply of goods or services, as well as the exchange of bitcoin for South African rand, would be subject to output tax at the standard rate of 14% (now 15%), which would lead to double taxation. That study also pointed out that the output treatment above could possibly result in a decrease in the use of bitcoin by South African taxpayers.¹³

⁸ National Treasury, (2018). ‘Draft Taxation Laws Amendment Bill’, available at

<http://www.treasury.gov.za/public%20comments/TLAB>, accessed on 06 November 2020.

⁹ National Treasury, (2018). ‘Final Response Document on Taxation Laws Amendment Bill 2018 and Tax Administration Laws Amendment Bill’, available at

<http://www.treasury.gov.za/legislation/acts/2018/Response%20Document%20on%20the%202018%20TLAB-17%20January%202019.pdf>, accessed on 14 February 2022.

¹⁰ Williams, P., Hare, R. (2018). ‘Cryptocurrency and tax in South Africa’ at pages 13 &14, available at <http://www.bowmanslaw.com/wp-content/uploads/2018/11/Session-3-Cryptocurrency-and-Tax.pdf>, accessed on 01 November 2020.

¹¹ de Wet, P. (2019). ‘Cryptocurrencies have just been declared hobbyist ‘financial instruments’ in South Africa’, available at <https://www.businessinsider.co.za/cryptocurrency-is-now-a-financial-instrument-for-tax-purposes-after-law-change-2019-1>, accessed on 15 October 2020.

¹² National Treasury, (2019). ‘Final Taxation Laws Amendment Act’, available at

https://www.gov.za/sites/default/files/gcis_document/201901/42172gon19taxationlawsamendact23of2018.pdf, accessed on 16 June 2021.

¹³ Greeff, C. (2019). ‘An investigation into the output tax consequences of bitcoin transactions for a South African value-added tax vendor’, *South African Journal of Economic and Management Sciences* 22(1), a2162., available at www.doi.org/10.4102/sajems.v22i1.2162, accessed on 28 June 2021.

In an article published by the Financial Sector Conduct Authority (FSCA) in November 2020, the FSCA proposes regulating crypto intermediaries as financial service providers.¹⁴

In SA, banks and insurance companies are the biggest providers of financial services, and some of these financial services are exempt from VAT (sections 2 and 12(a) of the VAT Act). The reason why financial services are exempt is because it is difficult to always determine the value of supply for VAT purposes.¹⁵

It is important to point out at this stage that, although the provision of financial services is an exempt supply, it will be zero-rated if physically rendered outside SA. The zero-rating of financial services therefore takes priority over exemption. It is therefore important for vendors to determine whether the financial services they supply are zero-rated or not, as their input tax claim could increase substantially when compared to the input tax credit if the supply of services was an exempt supply.¹⁶

1.2 PROBLEM STATEMENT

From the above timeline of events and the other remarks on cryptocurrencies; there are certain concerns that start to emerge.

One of these concerns is that, since cryptocurrencies were included under the definition of financial services in the VAT Act and therefore exempt supplies for VAT purposes, the possibility exists that South African VAT vendors who supply fully taxable supplies could be converted to supplying ‘mixed supplies’ if the vendor accepts cryptocurrency as a form of payment. This could give rise to VAT apportionment issues including possible VAT leakage.

Furthermore, the debate between taxpayers and the SARS, as to what constitutes a fair and appropriate apportionment formula to determine the deductible VAT incurred on expenses where the taxpayer makes both taxable and exempt supplies, is ongoing.¹⁷

1.3 RESEARCH OBJECTIVES

To assist in addressing the concerns mentioned in the problem statement, the following primary and secondary objectives will be formulated:

1.3.1 PRIMARY RESEARCH OBJECTIVES

- To determine if there will be a compliance risk or impact to the fiscus due to the possibility that South African VAT vendors who supply fully taxable supplies could be converted to ‘mixed supplies’ vendors, if the vendor accepts cryptocurrency as a form

¹⁴ Financial Sector Conduct Authority, (2020). ‘FSCA publishes a draft declaration of crypto assets as a financial product under the Financial Advisory and Intermediary Services Act’, available at <https://www.fsca.co.za/News%20Documents/FSCA%20Press%20Release%20FSCA%20publishes%20a%20draft%20Declaration%20of%20crypto%20assets%20as%20a%20financial%20product%2020%20November%2020.pdf#search=CRYPTO>, accessed on 21 August 2022.

¹⁵ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1033.

¹⁶ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1034.

¹⁷ CliffeDeckerHofmeyer, (2020). ‘VAT apportionment v direct attribution: A (preliminary) win for the taxpayer’, available at <https://www.cliffedeckerhofmeyer.com/en/news/publications/2020/tax/tax-alert-11-june-2020-vat-apportionment-v-direct-attribution-a-preliminary-win-for-the-taxpayer.html>, accessed on 15 November 2020.

of payment and later on-sells the cryptocurrency. Since the latter scenario gives rise to VAT apportionment issues including non or improper apportionment of VAT, the question arises if there is a likely risk that this could lead to possible VAT leakage. This will be discussed in Chapter 4.

The question which the author aims to answer within the first objective is:

- Will there be a compliance risk or impact to the fiscus due to the possibility that South African VAT vendors who supply fully taxable supplies could be converted to ‘mixed supplies’ vendors, if the vendor accepts cryptocurrency as a form of payment and later on-sells the cryptocurrency, and, since this gives rise to VAT apportionment issues including non- or improper apportionment of VAT, is there a likely risk that this could lead to possible VAT leakage?
- To draw a comparison of the development and interpretation of South African VAT legislation with regards to cryptocurrencies, to the VAT approach taken by countries in foreign jurisdictions. This will be discussed in in Chapter 5.

The question which the author aims to answer with the second objective is:

- What does a comparison of the treatment that SA has adopted for the classification of cryptocurrencies to that of other countries reveal about the relative risks of VAT leakage?

To assist in achieving the primary objectives, the author will be listing certain secondary objectives.

1.3.2 SECONDARY RESEARCH OBJECTIVES

- To undertake a brief overview of the origins and development as well as the concept and workings of cryptocurrencies, and to look at vendors in SA that are currently accepting cryptocurrency as payment, as well as local exchange platforms that are exchanging cryptocurrencies for traditional currency or other cryptocurrencies. This is discussed in Chapter 2.
- To undertake an overview of the South African VAT system discussing the concepts of ‘mixed supplies’, VAT cascading, VAT apportionment, and VAT leakage, and to also look at the two cryptocurrency use cases that will be discussed in this study. This will be discussed in Chapter 3.
- To look at VAT on financial services from a South African perspective to understand the treatment of transactions classified as financial services under the VAT Act. This will be discussed in Chapter 3.

1.4 RESEARCH DESIGN AND METHOD

The research method to be used for this study will be a doctrinal research method, which falls under legal interpretative research. This research will be of a qualitative nature, and applicable to the non-empirical research paradigm. The research will therefore be based on existing literature review in this area.

Doctrinal research can be described as a research methodology which “provides a systematic exposition of the rules governing a particular legal category, analyses the relationship between rules, explains areas of difficulty and, perhaps, predicts future developments”.¹⁸ This is sometimes referred to as ‘black letter’ law, as it is based purely on documentary data.¹⁹ A doctrinal research approach includes the following steps:²⁰

- Gathering all the relevant facts
- Identifying the legal issue
- Analysing the legal issue from a legal perspective
- Collecting and studying research sources such as statutory laws, case law, interpretations and guides, academic articles, dissertations, academic books and non-academic articles
- Analysing primary research sources such as legislation
- Combining all issues within the context
- Drawing up a conclusion

In this study, a problem statement and specific research objectives have been identified which the author will aim to answer through applying some or all the above steps.

Comparative law, which compares the legal systems of different countries and possibly also a comparative analysis of the law over time, also falls into this research methodology. As pointed out under the secondary objectives, comparative research will also be performed as part of this study in Chapter 5.

It is the author’s submission that this research method will allow the author to achieve the research objectives as the author will be analysing existing and new legislation as well as doing comparative research looking at the VAT treatment of cryptocurrencies in other countries. This research will also be based on documentary data, such as academic articles or journals, media releases, interpretations from SARS, statutory provisions, taxations bills from National Treasury, dissertations/theses, academic books, Organisation for Economic Co-operation and Development (OECD) releases, and online publications from trusted sources.

1.5 SCOPE AND LIMITATIONS

This study will be limited to the VAT implications within the South African environment arising from the classification of cryptocurrencies as financial services and will not address the income tax implications of cryptocurrencies. The countries that will be looked at for comparative research purposes will be countries that have classified cryptocurrencies in the same manner as SA, i.e. as financial services, exempt from VAT. The study will discuss

¹⁸ Pearce, D., Campbell, E., & Harding, D. (1987). Australian Law Schools: A Discipline Assessment for the Commonwealth Tertiary Education Commission, cited in <http://www.elevenjournals.com/doi/10.5553/ELR.000055> at 131.

¹⁹ McKerchar, M.A. (2008). ‘Philosophical Paradigms, Inquiry Strategies and Knowledge Claims’: Applying the Principles of Research Design and Conduct to Taxation. eJournal of Tax Research, Vol. 6, No. 1, pp. 5-22, UNSW Law Research Paper No. 2009-31, available at <https://ssrn.com/abstract=1464141>, accessed on 18 November 2020.

²⁰ Hutchinson, T. & Duncan, N. (2012). ‘Defining and describing what we do: Doctrinal legal research’, Deakin Law Review 17(1), 83–119, available at <https://ojs.deakin.edu.au/index.php/dlr/article/view/70>, accessed on 18 November 2020.

cryptocurrencies in general and not a particular cryptocurrency like Bitcoin. There will however be a focus on Bitcoin during the discussion of the origins and development of cryptocurrencies, because Bitcoin is regarded as the first modern cryptocurrency.²¹

This study will only look at two out of the five specific crypto-asset use cases as identified by the Intergovernmental Fintech Working Group (IFWG), namely:

- (i) buying and/or selling of crypto assets by individual consumers and legal persons and
- (ii) payments using crypto assets.²²

The study will focus on these two use cases because the author is particularly looking at Crypto Asset Service Providers (CASP's) such as merchants whose primary focus is to facilitate the trading of crypto assets and CASP's that facilitate the payment of goods and services using cryptocurrencies. The other three use cases which involve the raising of finance using crypto assets, investment fund or derivative product options with crypto assets as the underlying asset, and crypto asset mining are beyond the scope of this study.

The study only looked at a limited number of countries both in the EU (European Union) and Non-EU as well as outside Europe who have classified cryptocurrencies as exempt from VAT. A summary of these countries will be given in Chapter 5.

1.6 CHAPTER OUTLINE

Listed below are the chapters that will be included in this study and a brief overview of each.

CHAPTER 1: Introduction, Background, Problem Statement, Research Objectives, Research Design and Method

Chapter 1 gives an introduction and background to the present research topic. This chapter also details the problem statement, and the primary and secondary research objectives that the research aims to achieve. This chapter also outlines the research approach that will be used in the study to achieve the stated objectives.

CHAPTER 2: Origins and Nature of Cryptocurrencies

Chapter 2 will examine the origin and history of cryptocurrencies across the world and will also briefly look at the regulation of such currencies in light of the risks of money laundering. It will also look at the concept of cryptocurrencies including mining, wallets and blockchain and how this system of cryptocurrencies works.

²¹ Iwamura, M., Matsumoto, T., & Kitamura, Y. (2014). 'Is Bitcoin the Only Cryptocurrency in the Town?' Economics of Cryptocurrency and Friedrich A.Hayek, available at <http://ssrn.com/abstract=2405790>, accessed on 16 February 2022.

²² The Intergovernmental Fintech Working Group, (2021). 'Position paper on crypto assets', available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

CHAPTER 3: Overview of the SA VAT System

Chapter 3 will give a basic overview of the SA VAT system and will discuss the concepts of ‘mixed supplies’, ‘VAT cascading’, and ‘VAT apportionment’. The chapter will also give an overview of VAT on financial services from a South African perspective, and will look at the history of the taxation of financial services in SA, the definition of financial services, the current SA VAT Act provisions dealing with financial services, and will also briefly look at the providers of and regulation of financial services.

CHAPTER 4: Assessing the Possibility of VAT Leakage Arising From the Classification of Cryptocurrency as a Financial Instrument

Chapter 4 will look at the different ‘use cases’ for cryptocurrencies and briefly discuss the concept of VAT leakage, and explore the possibility of VAT leakage under each use case. This chapter focuses on the first research question of the study.

CHAPTER 5: Comparison of South-African VAT Legislation to the Approach Taken by Other Countries with regards to Cryptocurrencies

Chapter 5 looks at the development and interpretation of VAT legislation with regards to cryptocurrencies in the European Union (EU) and selected countries. This chapter will also discuss the method of VAT apportionment applied in the EU to businesses offering ‘mixed supplies’. This chapter focusses on the second research question of the study.

CHAPTER 6: Conclusion and Recommendations

Chapter 6 concludes on the key findings and provides recommendations and also identifies areas for further research.

CHAPTER 2 – ORIGINS AND NATURE OF CRYPTOCURRENCIES

In this chapter the author will present the origin and history of cryptocurrencies as well as the concept of cryptocurrencies, including features such as blockchain technology, user anonymity, the two-key system, mining, wallets, and cryptocurrency exchanges, and how this system of cryptocurrencies works. The author will also list the uses of cryptocurrencies and lastly look at the evolution of cryptocurrencies in SA. This information is necessary to set the scene for the further discussion and analysis in the following chapters.

2.1 ORIGINS AND HISTORY OF BITCOIN

Bitcoin is widely regarded as the first modern cryptocurrency. Bitcoin’s origins date back to the early 1980s, when the algorithms that support modern cryptocurrency were first developed. Its closest predecessor was Bit Gold, a proto-cryptocurrency developed in the late 1990s by Nick Szabo. Although Bit Gold never gained widespread traction, it shared many features in common with Bitcoin, including ironclad protections against duplication, the blockchain as the ultimate transaction ledger, public keys identifying individual users, and built-in scarcity.²³

²³ Martucci, B. (2021). ‘What Is Bitcoin – History, How It Works & Security Features’, available at <https://www.moneycrashers.com/bitcoin-history-how-it-works-pros-cons/>, accessed on 06 June 2021.

Julian Assange was probably unsurprised when PayPal, a corporation with large market share susceptible to government pressure, stopped processing donations to his whistleblowing organization, Wikileaks, due to what Paypal deemed 'illegal activity'. In the 1990s, Assange was a member of the cypherpunks mailing list, a group that disdained most government regulation and discussed achieving privacy and libertarian ideals by using cryptography. In 1998, another member of the cypherpunks proposed a digital, distributed, anonymous currency called 'bmoney' that would allow "untraceable pseudonymous entities to cooperate with each other more efficiently, by providing them with a medium of exchange". About ten years later, a programmer working under the pseudonym Satoshi Nakamoto figured out how to implement such a currency, publishing a description of his invention and also releasing software to make it work.²⁴

Bitcoin, or the framework for the Bitcoin system, originated in a paper entitled Bitcoin: A Peer-to-Peer Electronic Cash System. As mentioned in the previous section, the author or individual credited with the development is a computer programmer named Satoshi Nakamoto, a name many believe is a pseudonym for an individual or group who collectively developed the Bitcoin system. Nakamoto's system allowed for a self-regulating, electronic exchange between individuals, in which members of the system determine or verify the veracity of every Bitcoin transaction without relying upon third-party intermediaries such as banks or payment processors. Nakamoto's purpose was to remove third-party intermediaries who raise the cost of transactions.²⁵

Bitcoin experienced some growing pains in its first few years of life. In 2010, a coding flaw resulted in the creation of huge numbers of un-mined Bitcoin, temporarily crashing the currency's value. A subsequent fix repaired the blockchain and erased the unauthorised Bitcoin. Something similar occurred in 2013, although the effects were less drastic. Bitcoin's open-source code has been modified to make such systemic flaws less likely in the future.²⁶

In 2010, when bitcoin reached some monetary value, people tried to buy pizzas with it. This was the first official record of bitcoin being used to buy goods and services. On 22 May 2010, two Papa John's pizzas were exchanged by Laszlo Hanyecz for 10,000 BTC. This was the first official documented purchase of goods using bitcoins.²⁷

²⁴ Grinberg, R. (2011). 'Bitcoin: An Innovative Alternative Digital Currency' at 3, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1817857, accessed on 24 August 2021.

²⁵ Akins, B.W., Chapman, J.L. & Gordon, J.M. (2015). 'A Whole New World: Income Tax Considerations of the Bitcoin Economy. Pittsburgh Tax Review', [S.l.], v. 12, n. 1, p. 24-56, ISSN Pittsburgh Tax Review 1932-1996, available at <http://taxreview.law.pitt.edu/ojs/index.php/taxreview/article/view/32>, accessed on 25 August 2021.

²⁶ Martucci, B. (2021). 'What Is Bitcoin – History, How It Works & Security Features' at 3, available at <https://www.moneycrashers.com/bitcoin-history-how-it-works-pros-cons/>, accessed on 06 June 2021.

²⁷ Kwatwani, S. (2020). 'First Bitcoin Transaction' 9 September 2020, available at <https://themoneymongers.com/first-bitcoin-transaction/>, accessed on 01 August 2021.

2.2 HOW BITCOIN WORKS

Bitcoin is a cryptocurrency, meaning it is supported by a source code²⁸ that uses highly complex algorithms to prevent unauthorised duplication²⁹ or creation of bitcoin units. The code's underlying principles, known as cryptography³⁰, are based on advanced mathematical and computer engineering principles. It is virtually impossible to break Bitcoin's source code and manipulate the currency's supply.³¹

Satoshi Nakamoto in the abstract to the widely known 'white paper' proclaimed that:

“A purely peer-to-peer version of electronic cash would allow online payments to be sent directly from one party to another without going through a financial institution. Digital signatures provide part of the solution, but the main benefits are lost if a trusted third party is still required to prevent double-spending. We propose a solution to the double-spending problem using a peer-to-peer network. The network timestamps transactions by hashing them into an ongoing chain of hash-based proof-of-work, forming a record that cannot be changed without redoing the proof-of-work. The longest chain not only serves as proof of the sequence of events witnessed, but proof that it came from the largest pool of CPU power. As long as a majority of CPU power is controlled by nodes that are not cooperating to attack the network, they'll generate the longest chain and outpace attackers. The network itself requires minimal structure. Messages are broadcast on a best effort basis, and nodes can leave and rejoin the network at will, accepting the longest proof-of-work chain as proof of what happened while they were gone”.³²

Essentially, when a merchant decides to accept bitcoin as payment for his goods, there are several things that need to be in place. Both the buyer and the seller would presumably have Bitcoin wallets on their computers to facilitate the transaction. The Bitcoin wallet is where the actual bitcoins are stored with special information of their owners. Once you have installed a Bitcoin wallet on your computer or cellphone it will generate your first Bitcoin address and you can create more addresses whenever you need one. You can disclose your addresses to counterparties so that they can pay you or vice versa. Bitcoin addresses should only be used once.³³

The merchant will create a new unique address and send it to the purchaser, and the purchaser will instruct his Bitcoin client to send a payment to the address of the merchant. When the

²⁸ A Source Code is a set of commands or instructions written in a language that a computer understands. The PC then uses these instructions to perform specific functions.

²⁹ Unauthorised duplication in this context can be referred to as data or software piracy.

³⁰ In Cryptography the techniques which are used to protect information are obtained from mathematical concepts and a set of rule-based calculations known as algorithms to convert messages in ways that make it hard to decode it.

³¹ Martucci, B. (2021). 'What Is Bitcoin – History, How It Works & Security Features', available at <https://www.moneycrashers.com/bitcoin-history-how-it-works-pros-cons/>, accessed on 06 June 2021.

³² Nakamoto, S. (2008). 'Bitcoin: A Peer-to-Peer Electronic Cash System' at 1, available at <https://bitcoin.org/bitcoin.pdf>, accessed on 24 November 2021.

³³ Bitcoin.Org, (2021). 'How-it-works', available at <https://bitcoin.org/en/how-it-works>, accessed on 21 August 2021.

merchant creates this new address, two keys consisting of a private key and public key are generated. The private key is only known to the merchant and is kept in his wallet, whereas the public key is known to anyone. The purchaser will also have a private key in his wallet for each of his addresses. The Bitcoin client will use the private key almost like an ATM pin. To execute the transaction, the merchant will send his/her address to the purchaser and the purchaser in turn will instruct his/her wallet to send payment to the merchant's address. The transaction will then move into the verification phase, where it will go through a process of 'mining' performed by computers (nodes) with huge processing power, into a new transaction block on the chain. The competing miners' computers are set up to calculate cryptographic hash functions and solve complex equations. Each block includes a 'coinbase' transaction that pays out a certain number of bitcoins to the winning miner. At this stage a new address is created in the miner's wallet and the new bitcoins are transferred to his wallet. The transaction between the merchant and the purchaser is now verified and added to the blockchain history.³⁴

2.3 FEATURES AND CAPABILITIES

- **Blockchain Technology.** A blockchain is defined as a shared ledger of transactions between parties in a network, not controlled by a single central authority. One can think of a ledger like a record book: it records and stores all transactions between users in chronological order. Instead of one authority (like a bank) controlling this ledger, an identical copy of the ledger is held by all users on the network, called nodes.³⁵

One can think of blockchain as an operating system. Bitcoin is just one of many applications that runs on that system.³⁶

³⁴ Organisation for Economic Co-operation and Development, (2015). 'Addressing the Tax Challenges of the Digital Economy', available at <https://www.oecd-ilibrary.org/docserver/9789264241046-en.pdf?expires=1645020671&id=id&accname=guest&checksum=75048F66D6FE0FA001C7B0D5C14AF330>, accessed on 16 July 2021.

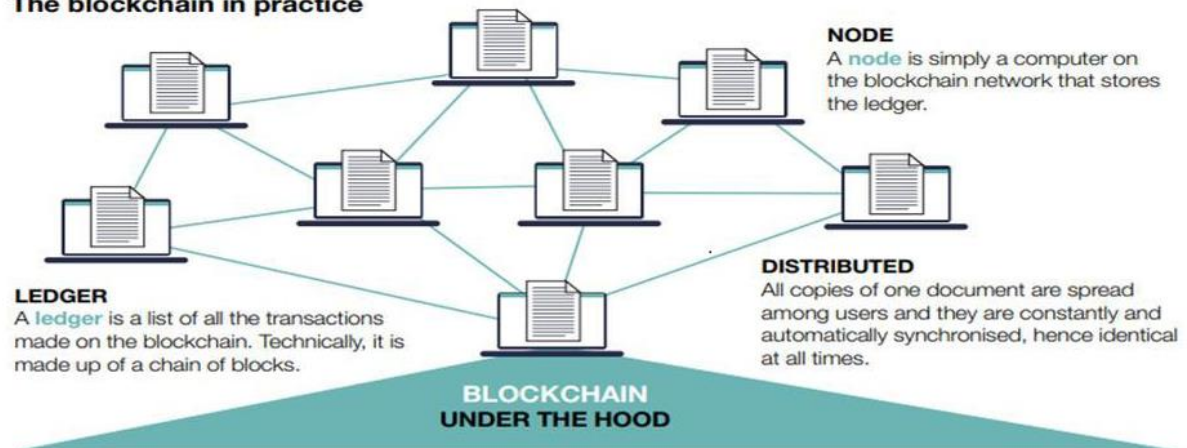
³⁵ Organisation for Economic Co-operation and Development, (2019). 'Blockchain Primer', available at <https://www.oecd.org/finance/OECD-Blockchain-Primer.pdf>, accessed on 17 July 2021.

³⁶ Bal, A. (2018). 'Blockchain, Initial Coin Offerings and Other Developments in the Virtual Currency Market', available at https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/dfi_2018_02_int_1, accessed on 24 August 2021.

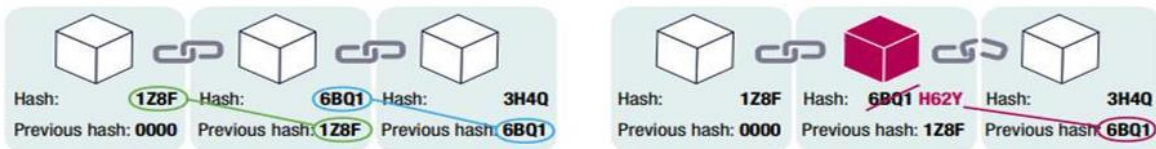
Virtual Currency is a term that is used interlinked with the terms cryptocurrency and crypto assets – essentially they refer to the same thing.

Diagram I: The blockchain in practice

The blockchain in practice



A block is comprised of a group of transactions from the same time period, like a page from a record book.



Source: Savjee, (2017)

Inside each block:

Hash
Previous block's hash
Transaction data
Timestamp

Along with its own hash, each block stores the hash of the block before it.

A hash is a unique string of letters and numbers created from text using a mathematical formula. Blocks are therefore "chained" together making the ledger (almost) **immutable** or unable to be changed. To add a block, it may first need to be mined and then approved by a number of nodes through a consensus mechanism.

Source: Adapted from OECD (2018a), 'OECD blockchain primer'³⁷

- Mining. Mining is a distributed consensus system that is used to confirm pending transactions by including them in the blockchain. It enforces a chronological order in the blockchain, protects the neutrality of the network, and allows different computers to agree on the state of the system. To be confirmed, transactions must be packed in a block that fits very strict cryptographic rules that will be verified by the network. These rules prevent previous blocks from being modified, because doing so would invalidate all the subsequent blocks. Mining also creates the equivalent of a competitive lottery that prevents any individual from easily adding new blocks consecutively to the blockchain. In this way, no group or individuals can control what is included in the blockchain or replace parts of the blockchain to roll back their own spends.³⁸
- Pseudo-anonymity. Each node or user has a unique address that identifies it. The identity of the parties is not disclosed during transactions.³⁹

³⁷ Organisation for Economic Co-operation and Development, (2019). 'Blockchain Primer', available at <https://www.oecd.org/finance/OECD-Blockchain-Primer.pdf>, accessed on 17 July 2021.

³⁸ Bitcoin.Org, (2021). 'How-it-works', available at <https://bitcoin.org/en/how-it-works>, accessed on 21 August 2021.

³⁹ Bal, A. (2018). 'Blockchain, Initial Coin Offerings and Other Developments in the Virtual Currency Market', available at https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/dfi_2018_02_int_1, accessed on 24 August 2021.

- Two-key system. Blockchain uses asymmetrical encryption methods that are referred to as ‘public’ and ‘private keys’. Public keys are user addresses to which data are transmitted. Private keys work similarly to passwords and enable users to access their accounts.⁴⁰
- Cryptocurrency wallets. Actual bitcoin units are stored in ‘wallets’, or secure cloud storage locations with special information confirming their owners (Bitcoin users) as the guardians of the bitcoin units contained within. Although wallets like Coinbase theoretically protect against the theft of bitcoin units that are not currently being used, they are vulnerable to hacking. Indeed, hackers often target public wallets that store users’ private keys, enabling them to spend the stolen BTC.⁴¹
- Cryptocurrency exchanges. Bitcoin exchanges allow users to exchange bitcoin units for fiat currencies, such as the United States dollar and Euro, at variable exchange rates. Many Bitcoin exchanges also exchange bitcoin units for other cryptocurrencies, including less popular alternative coins that cannot directly be exchanged for fiat currencies. Most Bitcoin exchanges take a cut of each transaction’s value, typically less than 1%. Due to its popularity, Bitcoin is more liquid than most other cryptocurrencies on these exchanges.⁴²

2.4 WAYS OF ACQUIRING CRYPTOCURRENCIES

There are generally three ways to acquire cryptocurrencies:

- 1) Purchasing through a cryptocurrency exchange;
- 2) Receiving it as consideration for goods or services through commercial activities; and
- 3) Mining for bitcoins.⁴³

Another way to buy bitcoin in SA is through Bitcoin ATMs, though there are not many of them available in the country. As of January 2021, South Africa had a total of six ATM’s.⁴⁴ The drawback of buying bitcoin through an ATM is the high transaction fees that range between 5% and 10%.⁴⁵

⁴⁰ Bal, A. (2018). ‘Blockchain, Initial Coin Offerings and Other Developments in the Virtual Currency Market’, available at https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/dfi_2018_02_int_1 accessed on 24 August 2021.

⁴¹ Martucci, B. (2021). ‘What Is Bitcoin – History, How It Works & Security Features’, available at <https://www.moneycrashers.com/bitcoin-history-how-it-works-pros-cons/>, accessed on 06 June 2021.

⁴² Martucci, B. (2021). ‘What Is Bitcoin – History, How It Works & Security Features’, available at <https://www.moneycrashers.com/bitcoin-history-how-it-works-pros-cons/>, accessed on 06 June 2021.

⁴³ Greeff, C. (2019). ‘An investigation into output tax consequences of bitcoin transactions for a South African value added tax vendor’ *South African Journal of Economic and Management Sciences* 22(1), a2162, available at www.doi.org/10.4102/sajems.v22i1.2162, accessed on 29 October 2020.

⁴⁴ De Best, R. (2021). ‘Number of Bitcoin ATMs in 58 countries worldwide as of January 2021’, available at <https://www.statista.com/statistics/343147/number-of-bitcoin-atms-countries/>, accessed on 10 July 2021.

⁴⁵ Selena. (2020). ‘How to buy and sell Bitcoin in South Africa’, available at <https://azcoinnews.com/how-to-buy-and-sell-bitcoin-in-south-africa.html>, accessed on 23 July 2021.

2.5 CLASSIFICATION OF CRYPTOCURRENCIES

While Bitcoin still dominates the market, several other digital currencies are catching up. As of August 2021, there are over 6000 different cryptocurrencies being traded currently as per data available at Coinmarketcap, compared to over 1500 that existed in 2018. Currently Bitcoin is the largest cryptocurrency, with almost 43% of the total cryptocurrency market, followed by Ethereum, on 18%.⁴⁶

‘Cryptocurrency’ is the umbrella term used to describe encrypted digital assets powered by blockchain technology. The use of this term is misleading as it implies that all these digital assets meet the definition of currency or money, i.e. that they represent a unit of account, a store of value and a medium of exchange. This is not always the case.⁴⁷

Cryptocurrencies can be divided into two categories: (i) alternative cryptocurrency coins (also called ‘altcoins’, ‘cryptocoins’ or simply ‘coins’) and (ii) tokens. Although the terms ‘coins’ and ‘tokens’ are often used interchangeably, there are significant differences among those two categories. Coins, for instance, bitcoin, are a cryptocurrency type that operates independently of any other platform. In other words, a coin has its own blockchain-powered platform. The purpose of a coin is to act like money. In contrast, a token is a unit of value that exists on an existing blockchain. It is a cryptocurrency which requires another platform, such as Ethereum, to exist and operate. Tokens are issued by means of Initial Coin Offerings (ICOs).⁴⁸

2.6 THE DIFFERENT USE CASES OF CRYPTOCURRENCIES

In its position paper on crypto assets, the IFWG identified the following five crypto asset specific use cases:⁴⁹

(i) buying and/or selling of crypto assets by individual consumers and legal persons;

“Crypto assets are purchased for different reasons, such as speculative investing, as a medium of exchange in facilitating transactions for goods and/or services, or for accessing specific products, services, and utilities. Crypto assets can also be purchased for the specific purpose of on-selling or trading”.⁵⁰

(ii) payments using crypto assets;

⁴⁶ Coinmarketcap.com, (2021). ‘bitcoin’, available at <https://coinmarketcap.com/currencies/bitcoin/>, accessed on 23 August 2021.

⁴⁷ Bal, A. (2018). ‘International -Blockchain, Initial Coin Offerings and other developments in the Virtual Currency Market’, available at https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/dfi_2018_02_int_1, accessed on 23 August 2021.

⁴⁸ Bal, A. (2018). ‘International -Blockchain, Initial Coin Offerings and other developments in the Virtual Currency’ Market, available at https://research-ibfd-org.ezproxy.uct.ac.za/#/doc?url=/document/dfi_2018_02_int_1, accessed on 23 August 2021.

⁴⁹ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

⁵⁰ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ 11 June 2021 at 16, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

“This use case identifies crypto asset service providers (CASPs) that facilitate payment for goods and services using crypto assets as a means of payment or a store of value being exchanged. It therefore includes all the entities providing payment intermediary services when using crypto assets as the medium of exchange”. This includes both domestic payments as well as international remittances, although the possibility of South African legal entities making outgoing international transfers or payments using cryptocurrencies is not currently considered by the IFWG.⁵¹

(iii) capital raising through Initial Coin Offerings (ICOs);

“This use case identifies CASPs that offer tokens as a method to raise capital for their projects. Other intermediaries involved in this use case can be advisory firms or legal consultants that assist the entities in offering the tokens to raise capital or provide financial services related to an issuer’s offer and/or sale of crypto assets”.⁵²

(iv) crypto asset funds and derivatives; and

“This use case identifies CASPs that offer investment fund or derivative product options with crypto assets as the underlying asset”.⁵³

(v) crypto assets market support.

“This use case identifies CASPs that provide any market support services for crypto asset-related activities. These activities may include services such as safe custody services for crypto assets, digital wallet provisioning for crypto assets and crypto asset mining”.⁵⁴

The IFWG further acknowledged that new use cases may arise, as the crypto asset market is a rapidly evolving market. Similarly, the underlying economic function and related activity will be assessed from time to time to identify any possible new use cases.⁵⁵

2.7 PREVALENCE OF CRYPTOCURRENCIES IN SOUTH AFRICA

In September 2014, National Treasury issued a joint statement together with the South African Reserve Bank, the Financial Services Board, the South African Revenue Service and the

⁵¹ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ at 17, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

⁵² The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ at 18, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

⁵³ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ at 18, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

⁵⁴ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ at 20, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

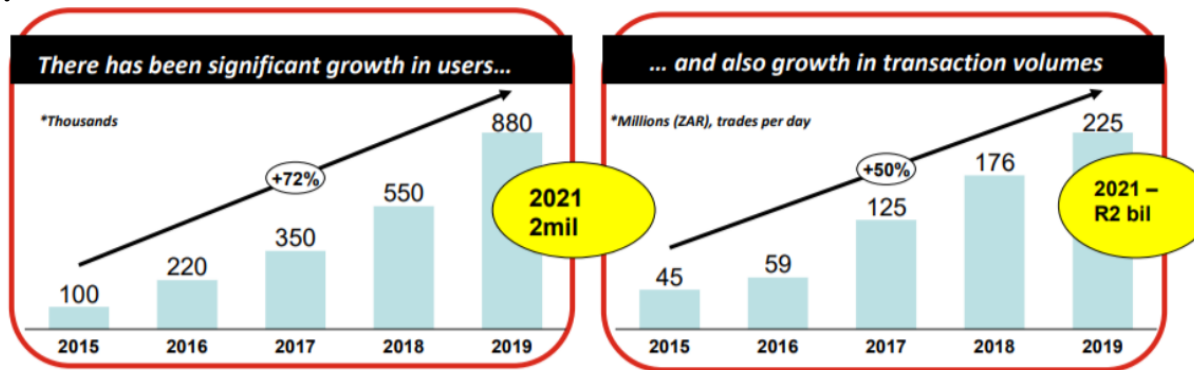
⁵⁵ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

Financial Intelligence Centre, in which they alerted members of the South African public to the uses of virtual currencies.⁵⁶

In a presentation to parliament at the end of May 2021, National Treasury said that crypto assets have grown rapidly in SA over the last five years, with users primarily investing in 12 major crypto asset trading platforms, including Luno, Altcoin Trader, Ovex and VALR.⁵⁷

Across these platforms, National Treasury estimates that there are at least two million retail investors in the country, with R2 billion in transaction volumes recorded each day. However, there is concern that at least half of these investors are not fully grasping the concept of how these assets work, but rather focusing on returns of 50% or more. “Crypto-assets have become too big to ignore and pose a number of risks for consumers if not sufficiently regulated,” it said.⁵⁸

Figure I: The below figure shows the rapid growth of cryptocurrency users and volumes over the last five years.



Source: Adopted from National Treasury 2021.⁵⁹

In September 2020, one of the more popular platforms in SA, Luno, published a directory of 30 Bitcoin merchants in SA.⁶⁰ It is however submitted that it is likely that there are more Bitcoin merchants in the South African market.

The merchants on this directory include popular online marketplaces such as Bidorbuy, which acts as a convenient way for people to buy and sell virtually anything online at a fixed price or in an auction format. Another notable merchant is Checkout, which is a supermarket chain in the fast moving consumer goods (FMCG) retail industry and which operates 45 stores across

⁵⁶ National Treasury, (2014). ‘User Alert – Monitoring of virtual currencies’, available at http://www.treasury.gov.za/comm_media/press/2014/2014091801%20-%20user%20alert%20virtual%20currencies.pdf, accessed on 3 July 2021.

⁵⁷ National Treasury, (2014). ‘The real number of people investing in Bitcoin and other cryptos in South Africa’, available at <https://businesstech.co.za/news/banking/495569/the-real-number-of-people-investing-in-bitcoin-and-other-cryptos-in-south-africa-treasury/>, accessed on 10 July 2021.

⁵⁸ National Treasury, (2014). ‘The real number of people investing in Bitcoin and other cryptos in South Africa’, available at <https://businesstech.co.za/news/banking/495569/the-real-number-of-people-investing-in-bitcoin-and-other-cryptos-in-south-africa-treasury/>, accessed on 10 July 2021.

⁵⁹ National Treasury, (2014). ‘The real number of people investing in Bitcoin and other cryptos in South Africa’, available at <https://businesstech.co.za/news/banking/495569/the-real-number-of-people-investing-in-bitcoin-and-other-cryptos-in-south-africa-treasury/>, accessed on 10 July 2021.

⁶⁰ Luno Exchange, (2020). ‘Where to Spend Bitcoin in South Africa – Luno’, available at <https://discover.luno.com/south-africa-pay-with-bitcoin/>, accessed 10 July 2021.

seven provinces in SA. Expedia Travel, which is one of the world's leading travel companies, allows customers to pay for car rental, flights and hotels with bitcoin.⁶¹

Some of the other businesses that accept Bitcoin transactions in SA include Takealot, which is SA's largest homegrown e-commerce store, weFix, which is a repairer of consumer smart devices, and RunwaySale, an online retailer which is today one of the largest online fashion retailers in the country.⁶²

2.8 REGULATION

Cryptocurrencies evoke strong reactions. Doubters argue that the number of useful applications has been exaggerated, that lack of regulation can have disastrous effects, and that in most cases trusted intermediaries will continue to provide useful services. In Europe and Central Asia (ECA), cryptocurrencies and blockchain pose difficult challenges for policy makers as they are challenged with how they should adjust regulations and reform policies to benefit from the digital revolution while mitigating the risks of this transition. The World Bank in its ECA economic update makes a number of suggestions to overcome policy challenges created by cryptocurrencies. The World Bank has suggested that if these technologies become successful, they should be integrated into the formal economy. Tax codes and regulations should be adjusted, so that both old technologies like e-commerce and new blockchain and cryptocurrency technologies operate on a level playing field. Switzerland aims to become a cryptocurrency and blockchain hub and is leading in adjusting regulations to these new technologies.⁶³

“In SA, the Crypto Assets Regulatory Working Group (CARWG) of the IFWG agrees that crypto assets cannot remain outside of the South African regulatory purview, and recommends that SA employ a staged approach to bring crypto assets within the regulatory remit through the regulation of CASPs”.⁶⁴ The CARWG observes that the Financial Action Task Force (FATF) cautioned against banning crypto asset related activity as such action could drive activities underground with little or no regulatory oversight. Like countries in Europe, “SA similarly aims to mitigate the risks posed by crypto assets around money laundering, the financing of terrorism and consumer protection, while not shutting out the potential benefits such financial innovations can bring. The South African authorities thus aim to enable responsible innovation by regulating CASPs through an appropriate regulatory framework that proportionately balances the potential benefits against the risks that may be introduced into the

⁶¹ Luno Exchange, (2020). ‘Bitcoin Merchant Directory South Africa (2020)’, available at <https://www.luno.com/blog/en/post/south-africa-pay-with-bitcoin>, accessed on 12 July 2021.

⁶² Byron. (2020). ‘Some business that accept Bitcoin Transactions in South Africa’ 16 July 2020, available at <https://learn.easycrypto.ai/businesses-that-accept-bitcoin-in-south-africa/>, accessed on 12 July 2021.

⁶³ World Bank, (2018). ‘Cryptocurrencies and Blockchain Europe and Central Asia Economic Update’, available at <https://openknowledge.worldbank.org/handle/10986/29763>, accessed 23 August 2021.

⁶⁴ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’ at 3, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

financial system, while ensuring a level playing field is maintained by not unduly advantaging or disadvantaging either the incumbent role players or new fintech entrants”.⁶⁵

2.9 CONCLUSION

In conclusion, cryptocurrencies, of which Bitcoin is by far the most popular, had their origins dating as far back to the 1980's and 1990's when cryptocurrencies with similar features to Bitcoin were developed but never really received widespread traction. It was not until 2009 that a computer programmer named Satoshi Nakamoto developed a framework for the Bitcoin system and published this in a 'white paper' titled 'Bitcoin: A Peer-to-Peer Electronic Cash System' and in 2010 the first Bitcoin transaction was recorded. The main feature of Bitcoin and many other cryptocurrencies is that it uses technology called 'blockchain'. Blockchain can be said to be an operating system like 'Windows' and the cryptocurrency is just one application that runs on that operating system. Some of the other fundamental principles underlying blockchain are that communication occurs directly between peers, the identity of the parties is not disclosed during the transaction, and once a transaction has taken place, the transaction cannot be altered or reversed. There are over 6000 cryptocurrencies being traded worldwide currently, of which Bitcoin has the largest percentage of the market, followed by Ethereum. Cryptocurrencies are divided into two categories, one, 'alternative cryptocurrency coins' like bitcoin that operates independently of any other platform and has its own blockchain-powered platform; and two, 'tokens' which are units of value that exist on an existing blockchain and which require another platform such as Ethereum to exist and operate.

There has been a rapid increase in cryptocurrencies, users, and volumes of transactions worldwide. The total worldwide cryptocurrency market capitalisation grew from \$5.5 Billion in 2015 to \$2.2 Trillion at the end of 2021.⁶⁶This growth curve is also evident in the South African market for the same period as illustrated in Figure I. A number of merchants have also started to accept cryptocurrencies as payment for goods as was discussed in section 2.7. In 2014 a user alert was issued by National Treasury in response to this growth, to alert citizens of the uses of cryptocurrencies, as National Treasury was concerned that users did not fully grasp the concept of cryptocurrencies.

Cryptocurrencies and blockchain pose difficult challenges for policymakers around the world as they are challenged with how they should adjust regulations and reform policies. There have however been suggested guidelines published in the ECA economic update by the World Bank Group to overcome these policy challenges. These include the changing of tax codes and regulations. These suggested guidelines are based on previous experiences with digital technologies that preceded digital currencies. In SA it was agreed by policy makers that cryptocurrencies cannot remain outside of the regulatory purview.

⁶⁵ The Intergovernmental Fintech Working Group, (2021). 'Position paper on crypto assets' at 6, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

⁶⁶ CoinMarketCap, (2022). 'Global Cryptocurrency Charts', available at <https://coinmarketcap.com/charts/>, accessed on 05 September 2022.

CHAPTER 3 – OVERVIEW OF THE VAT SYSTEM

In this chapter the author gives a basic overview of the VAT system in SA to serve as background and foundation for further topic discussions. The overview also includes discussions on the requirements for a transaction to attract VAT and the basic calculation of VAT.

The author also gives a brief history of the taxation of financial services in SA and reviews the current legislation in relation to VAT on financial services as per the VAT Act. A brief discussion on providers of financial services in SA and the regulation of these service providers is also given in order to inform the rest of the study.

After this initial overview, the concepts of ‘mixed supplies’, VAT cascading and VAT apportionment (including the Binding General Ruling 16 (BGR16)) will be discussed, providing illustrative examples.

3.1 SOUTH AFRICAN VAT SYSTEM – BASIC OVERVIEW

Almost every time a consumer purchases goods or services from a business in SA, they have to pay a price that includes VAT. VAT is a tax on the consumption of goods and services in SA and is levied in terms of the VAT Act. VAT is an indirect tax, which means that the tax is not assessed directly by SARS, but indirectly through the taxation of consumption of goods and services. VAT is currently levied at a standard rate of 15%.⁶⁷

The SA VAT system seeks to tax final domestic consumption, and removes tax from exports through the zero-rating mechanism (thus, it is a destination-based VAT system). The ideal VAT system is broad-based, with no or limited exceptions of supplies of goods or services which are not subject to VAT. However, certain supplies by their very nature cannot be taxed under a VAT system. These include difficult-to-tax supplies such as certain components in financial services that do not represent immediate consumption but elements of saving or investment, which should by design not be subject to VAT. These are often subject to VAT exemption.⁶⁸ The exemption of certain products or services, like financial services, could be said to be in contravention of some of the underlying principles of a sound VAT system, which aims that the final tax burden should be borne by the final consumer and not the supplier in the supply chain.

Having regard to the consumption rule above, OECD guideline 2.1 on International VAT/GST provides that the burden of VAT taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.⁶⁹ Although financial services are specifically

⁶⁷ VAT Act 89 of 1991.

⁶⁸ Schneider, F. (2019). ‘VAT and apportionment-some considerations’, available at <https://stakonsult.com/news/vat-and-apportionment-some-considerationsservices#:~:text=This%20could%20result%20in%20one%20supply%20of%20financial,deduct%20such%20VAT%20against%20output%20tax%20in%20full>, accessed on 7 September 2021.

⁶⁹ Organisation for Economic Co-operation and Development, (2011). ‘International VAT/GST guidelines - Guidelines on neutrality’, available at <https://www.oecd.org/tax/consumption/guidelinesneutrality2011.pdf>, accessed on 28 March 2021.

exempt from VAT in the legislation, it does not alleviate the fact that the underlying consumption principle has been breached.⁷⁰

The basic principles on consumption taxes contained in the OECD's publication on international VAT/GST guidelines, can be summarised as follows:

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation;
- **Efficiency:** Compliance costs for businesses and administrative costs for the tax authorities should be minimised as far as possible;
- **Certainty and simplicity:** The tax rules should be clear and simple to understand so that businesses can anticipate the tax consequences of a transaction, including knowing when, where and how the tax is to be accounted;
- **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to risks involved; and
- **Flexibility:** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.⁷¹

A business that is registered for VAT and levies VAT on the selling price of its goods is referred to as a VAT 'vendor'. For VAT purposes, the business activities that are carried on by such a VAT vendor are referred to as an 'enterprise'. If a VAT vendor, in the carrying on of an enterprise, sells goods to another person, the VAT vendor selling the goods is also referred to as the 'supplier' of the goods. The person buying the goods is referred to as the 'recipient' of the goods. In order for a transaction to attract VAT, there must therefore be a supply of goods or services by a vendor in the course or furtherance of an enterprise.⁷²

A VAT vendor carrying on an enterprise sells goods to the recipient and levies VAT on the selling price. The VAT that the supplier levies on the selling price is output tax. The VAT vendor must pay the output tax, levied on the goods sold, to SARS. The recipient of the goods is the one who paid the VAT when he bought the goods. VAT is a direct cost to the recipient if that person is a final consumer. A final consumer cannot usually claim the amount of VAT paid back from SARS. However, if the recipient is also a business registered as a VAT vendor, that recipient may claim the VAT it has paid back from SARS providing the input claim is in respect of expenses used in the making of taxable supplies. Any VAT paid by a recipient that the recipient may claim back from SARS is referred to as input tax.

VAT is essentially an inclusive tax, which means that any price charged by a vendor includes VAT. This means that any price tag, advertisement, tender, quotation or other statement of a

⁷⁰ Moodley, P. (2016). 'VAT treatment of financial services: a comparative analysis between methodologies applied in South Africa and other Tax jurisdictions' (Unpublished mini-dissertation, University of Witwatersrand) at 26.

⁷¹ Organisation for Economic Co-operation and Development, (2021). 'International VAT/GST guidelines - Guidelines on neutrality', available at <https://www.oecd.org/tax/consumption/guidelinesneutrality2011.pdf>, accessed on 28 March 2021.

⁷² Stiglingh, M. (2019). 'Value-added tax (VAT)' in Silke: South African Income Tax 21 ed at 1012.

price must include VAT, unless the price is clearly broken down into the different components, namely, value, VAT and consideration (sections 64 and 65 of the VAT Act).⁷³ The term ‘VAT inclusive’ is used where VAT is already included in the price. ‘VAT exclusive’ is where VAT is not included in the price and the price, as stated, excludes VAT.⁷⁴

3.2 CALCULATION OF VAT

A simplified VAT calculation is the amount of output tax less the amount of input tax. Not all VAT calculations are simple though, and some require adjustments to be taken into account.

3.2.1 Basics of Output Tax

Output tax is the tax charged by a vendor for the supply of goods or services by him (section 7(1)(a)).⁷⁵ A person registered as a vendor levies VAT on all business transactions in respect of taxable supplies. This may also include the sale of capital assets and trading stock.

The VAT Act provides for two types of supplies, namely

- Taxable supplies, consisting of
 - Supplies at the standard rate (presently 15%), or ⁷⁶
 - Supplies at the zero rate (0%), and
- Exempt Supplies

Since there are essentially three scenarios (standard rate of 15%, zero-rated, exempt) into which supplies or transactions must be divided for VAT purposes, it will be important for a vendor to know exactly which scenario applies to his/her business. Furthermore, no apportionment will apply where a vendor acquires goods or services partly for making taxable supplies and then subsequently sell those goods or services in the furtherance of his business. The exception to this rule is however in the supply of fringe benefits and indemnity payments, as for both, the amount of output tax is payable only to the extent that it relates to taxable supplies made in the course of the furtherance of the enterprise.⁷⁷

⁷³ VAT Act 89 of 1991.

s65 ‘Prices advertised or quoted to include tax’ of the VAT Act reads Any price advertised or quoted by any vendor in respect of any taxable supply of goods or services shall include tax and the vendor shall in his advertisement or quotation state that the price includes tax, unless the total amount of the tax chargeable under section 7 (1) (a), the price excluding tax and the price inclusive of tax for the supply are advertised or quoted by the vendor and includes certain provisions that are not mentioned here.

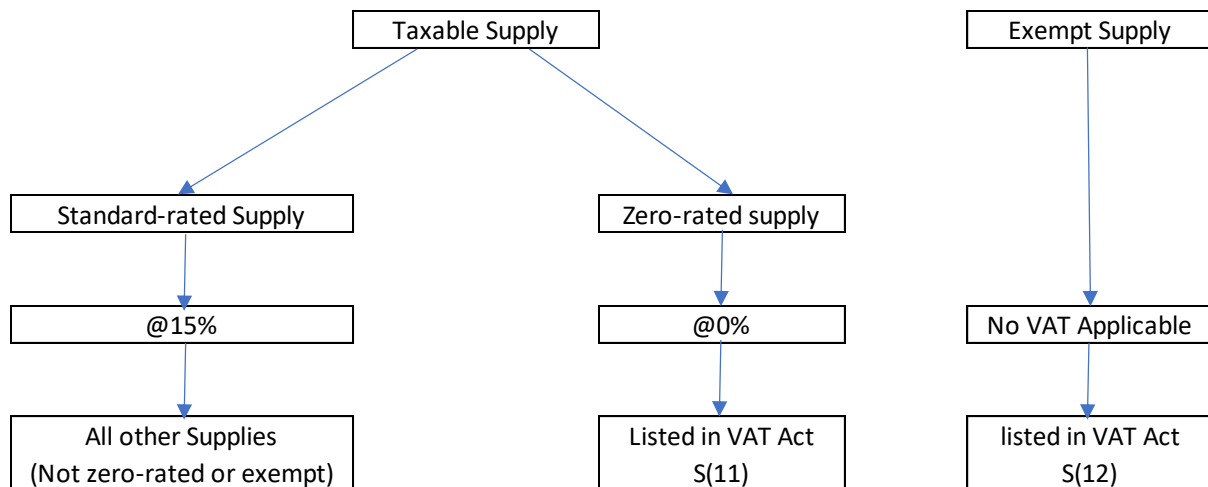
⁷⁴ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1012.

⁷⁵(s 7(1)(a))’Imposition of value-added tax’ (1) Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax-(a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him;

⁷⁶ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1012.

⁷⁷ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1012.

Diagram II: The following diagram summarises the different types of supplies for VAT purposes.



Source: Adopted from SILKE: 'South African Income Tax' 21 ed, 2019 at 1013.⁷⁸

3.2.2 Basics of Input Tax

To the extent that the goods or services that were purchased by a vendor are used wholly in the course of making taxable supplies, the vendor will be entitled to claim the full input tax. It is therefore important to determine the purpose for which the goods or services will be used. This input tax can be deducted from the output tax in order to calculate the total VAT payable or refundable to SARS.⁷⁹

Diagram III: Simple diagram of VAT through the 'Supply Chain'

CONSUMPTION OF GOODS	Purchase of Raw Material	R	
	VAT @ 15%	100	
	Total carried forward	15	
	1) Value added by Manufacturer	100	
	Wholesale Price	50	
	VAT @ 15%	150	
	Total carried forward	23	
	2) Value added by Wholesaler	150	
	Retailer Price	50	
	VAT @ 15%	200	
Total carried forward	30		
3) Value added by Retailer	200		
Price to Consumer excluding VAT	50		
VAT @ 15 %	250		
*Selling Price to Final Consumer (Inclusive of VAT)	38		
	288		

	(Output Tax - Input Tax)		
	R	R	R
Manufacturer	Output Tax	Input Tax	Net
Wholesaler	23	15	8
Retailer	30	23	7
SARS collects Net VAT	38	30	8
	91	68	23

Net VAT payable on value added (R50+R50+R50=R150 *0.15% = R23)
 The above diagram takes into account the VAT effect where tax is levied on the consideration(cost + value added)
 *The selling price to consumer is inclusive of VAT and based on the assumption that the final consumer cannot claim the VAT back as a non -vendor and has to bear the full burden of the tax

Source: Developed by Author, 2021.

⁷⁸ Silke, (2019). 'South African Income Tax' 21 ed at 1013.

⁷⁹ Stiglingh, M. (2019). 'Value-added tax (VAT)' in Silke: South African Income Tax 21 ed at 1051.

The above diagram is based on the idea that in order to manufacture a product, you first need to buy raw materials on which input VAT is presumably incurred. Then at each stage, as the product or service is consumed or passed on until it reaches the final consumer, value is added to the product or service. VAT is levied on the consideration, which is the sum of the value added and the cost. VAT payable or receivable is then calculated by adding all the costs involved in making and distributing goods or services, minus the amount that businesses can claim back during the supply chain for their ‘inputs’ – the raw materials, goods and services acquired in making the finished product. The net effect after claiming back the input is that the net VAT payable reflects the value added.

3.3 HISTORY OF VAT ON FINANCIAL SERVICES

The Davis Tax Committee in their report titled ‘Final VAT report’, dated March 2018, summarised the history of VAT on financial services, acknowledging the different contributors and observations on the development and history of VAT on financial services.⁸⁰ These contributors and observations are summarised in the following paragraphs.

The Margo Commission recommended in its report that a broad-based tax on sales and services should be implemented to replace the then general sales tax (GST). The White Paper on the Margo Report which was published in 1988 noted that Government was aware that VAT would give rise to many problems for different groups of taxpayers, including specialised financial institutions such as insurers, building societies and banking institutions.⁸¹

The draft VAT Bill that would give effect to the proposal to introduce an invoice/credit value-added tax system was published on 18 June 1990 (‘the Draft Bill’) and provided for the exemption of various financial services enumerated in the Draft Bill. A Value-Added Tax Committee (“VATCOM”) was appointed following the publication of the Draft Bill to consider the comments and representations made by interested parties on the Draft Bill. VATCOM noted, inter alia, the following with regard to financial services:

- Financial services provided by any vendor should be exempt. The institutions providing the services should in respect of their inputs be treated as ‘end users’. This would result in double taxation on the inputs of these institutions to the extent that their services are rendered to vendors;
- In theory, there does not appear to be any reason why financial services should not be subject to VAT. Financial services are consumption expenditure just like any other services and in fact, because they form a higher proportion of budgets of higher income households, there is every reason to subject them to VAT; and

⁸⁰ Davis Tax Committee, (2018). ‘Final Report on VAT for the Minister of Finance’, available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 07 September 2021.

⁸¹ Davis Tax Committee, (2018). ‘Final Report on VAT for the Minister of Finance’, available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 07 September 2021.

- In SA, banks and insurance companies which provide the greatest proportion of financial services have a high profile and this makes it even more difficult to justify exemption.⁸²

There is however an argument or reason for specifically exempting financial services from VAT because it is difficult to always determine the value of a supply for VAT purposes.⁸³

VATCOM considered the consequences and practical difficulties associated with the taxing of financial services and recommended that ‘financial services’ as defined in the Draft Bill be exempted from VAT, and that further consideration be given to subjecting the value added by financial institutions to tax. As an alternative, VATCOM recommended that other indirect taxes be imposed to ensure that tax, equivalent to what would have been collected from private investors, private policy holders and the like be collected from financial institutions. The VAT Act was implemented with effect from 30 September 1991 and adopted the VATCOM recommendations to exempt the supply of financial services, as defined in section 2 of the VAT Act, from VAT, in terms of section 12(a) of the VAT Act.⁸⁴ There were subsequent deletions and additions to section 2 of the VAT Act, some which will be pointed out under heading 3.5 below.

3.4 DEFINITION OF FINANCIAL SERVICES

Section 1 of the VAT Act defines the term ‘financial services’ to mean the activities which are deemed by section 2 of the same act to be financial services. These activities are referred to in section 3.5 below. Section 12(a) of the VAT Act defines financial services as an exempt supply.⁸⁵

3.5 CURRENT SA VAT ACT PROVISIONS DEALING WITH FINANCIAL SERVICES

Section 1 of the VAT Act 89 of 1991 defines the term ‘financial services’ to mean the activities which are deemed by section 2 to be financial services.⁸⁶

These activities include:

“(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise);

(b) the issue, payment, collection or transfer of ownership of a cheque or letter of credit;

⁸² Davis Tax Committee, (2018). ‘Final Report on VAT for the Minister of Finance’ , available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 07 September 2021.

⁸³ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1033.

⁸⁴ Davis Tax Committee, (2018). ‘Final Report on VAT for the Minister of Finance’ , available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 07 September 2021.

⁸⁵ VAT Act 89 of 1991.

⁸⁶ VAT Act 89 of 1991.

(c) the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security;

(d) the issue, allotment or transfer of ownership of an equity security or a participatory security;

(e) [Para. (e) deleted by s. 19 (1) (a) of Act 37 of 1996.]

(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; [Para. (f) substituted by s. 19 (1) (b) of Act 37 of 1996.]

(g) and (h) [Para. (g) and (h) deleted by s. 19 (1) (c) of Act 37 of 1996.]

(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 an activity shall not be deemed to be a financial service to the extent that it includes the management of a superannuation scheme;

[Para. (i) substituted by s. 19 (1) (d) of Act 37 of 1996.]

(j) the provision, or transfer of ownership, of an interest in a superannuation scheme;

[Para. (j) substituted by s. 19 (1) (e) of Act 37 of 1996.]

(k) the buying or selling of any derivative: Provided further that the open market value of those goods or services shall not be deemed to be consideration for a financial service as contemplated in this paragraph; and [Para. (k) substituted by Government Notice 2695 of 8 November 1991, by s. 13 (1) (a) of Act 136 of 1992 and by s. 82 (a) of Act 53 of 1999 and amended by s. 93 (a) of Act 32 of 2004.]

(l) [Para. (l) deleted by s. 44 of Act 16 of 2004.]

(m) [Para. (m) deleted by s. 10 (1) (a) of Act 20 of 1994.]

(n) [Para. (n) substituted by s. 10 (1) (b) of Act 20 of 1994 and deleted by s. 19 (1) (f) of Act 37 of 1996.]

(o) the issue, acquisition, buying, selling or transfer of ownership of any cryptocurrency is an exempt financial service”.⁸⁷

Provided that the activities contemplated in paragraphs (a), (b), (c), (d) and (f) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission, merchant's discount or similar charge, excluding any discounting cost. [Sub-s. (1) amended by s. 19 (1) (g) of Act 37 of 1996 and by s. 87 (1) (a) of Act 30 of 1998.]⁸⁸

An example of the above provision is given in section 3.7 under the heading ‘VAT and financial services in SA and its related intricacies’.

⁸⁷ VAT Act 89 of 1991.

⁸⁸ VAT Act 89 of 1991.

The most common financial services with reference to section 2 of the VAT Act that are exempt include:

- The issue or transfer of a tradable liability or loan, for example a debenture or government bond (section 2(1)(c)).
- The provision of credit and paying of interest (section 2(1)(f)).
- Issue or transfer of ownership of a share or members interest (section 2(1)(d)).
- The provision or transfer of ownership of a long-term insurance policy (section 2(1)(i)).
- The contributions and proceeds relating to membership of a retirement or medical aid fund (section 2(1)(j)). The management of these funds is, however, not an exempt supply.
- The issue, acquisition, buying, selling or transfer of ownership of any cryptocurrency is an exempt financial service (from 1 April 2019) (section 2(1)(o)).

3.6 PROVIDERS AND REGULATION OF FINANCIAL SERVICES IN SOUTH AFRICA

3.6.1 Providers of Financial Services in South Africa

In SA, banks and insurance companies are the biggest providers of financial services, some of which are exempt (see sections 2 and 12(a) of the VAT Act). The author has discussed relevant sections of the provisions of section 2 of the VAT Act in the previous section. It is important to note that as per the Financial Sector Regulation Act 9 of 2017, financial services providers require a licence to operate.⁸⁹

3.6.2 Regulation of Financial Services Sector in South Africa

On 21 August 2017, the Financial Sector Regulation Act (FSR Act) was signed into law. Among other changes, the FSR Act created a prudential regulator, the Prudential Authority (PA) and a market conduct regulator, the Financial Sector Conduct Authority (FSCA). The PA is responsible for regulating banks, insurers, cooperative financial institutions, financial conglomerates, and certain market infrastructures. The FSCA was given the mandate of market conduct regulator of financial institutions that provide financial products and financial services, financial institutions that are licensed in terms of a financial sector law, including banks, insurers, retirement funds and administrators, and market infrastructures. An authorised financial services provider is essentially an entity duly licenced in terms of a financial sector law which provides any of the financial services as contemplated in section 2 of the VAT Act 89 of 1991.⁹⁰

It is important to note though that if you are a merchant or person accepting cryptocurrency as payment, that would not necessarily make you a financial service provider for regulatory purposes, if you do not engage in other financial services. The transaction could however attract VAT, providing all requirements necessary for a transaction to attract VAT are met. A

⁸⁹ South African Government, (2017). 'Financial Sector Regulation Act 9 of 2017', available at <https://www.gov.za/documents/financial-sector-regulation-act-9-2017-english-sepedi-22-aug-2017-0000>, accessed on 18 September 2021.

⁹⁰ Wikipedia, (2021). 'Financial Services Board of South Africa', available at [https://en.wikipedia.org/wiki/Financial_Services_Board_\(South_Africa\)](https://en.wikipedia.org/wiki/Financial_Services_Board_(South_Africa)), accessed on 10 September 2021.

discussion on the separate requirements for a transaction to attract VAT in SA was discussed under section 3.1.

As was pointed out in Chapter 2, cryptocurrencies are not yet regulated as financial services in SA, but they may come under the ambit of the FSCA if the recommendations of the CARWG are followed and adopted. If the recommendations are adopted then it will mean that those entities that are not providing mainstream financial services, but that are currently providing cryptocurrency services, will have to be licensed as financial services providers.

3.7 VAT AND FINANCIAL SERVICES IN SOUTH AFRICA AND ITS RELATED INTRICACIES

The supply of financial services is VAT exempt due to its ‘difficult-to-tax’ nature.⁹¹ Suppliers of exempt financial services are not entitled to claim VAT on expenses incurred that relate directly to the supply of such services. To the extent that a financial services provider does not charge a separate fee (limited to certain predetermined activities) for its supplies, they are fully exempt. To the extent that a financial services provider charges a fee (including a commission, merchant’s discount, or similar charge) the supply is deemed not to be a financial service for VAT purposes and is subject to VAT. Certain financial services providers make supplies of financial services as (i) exempt supplies (where no separate fees are charged); and (ii) taxable supplies (where separate fees are charged). This could result in one supply of financial services having two VAT consequences, one being exempt, and the other taxable.⁹²

Financial services providers that incur VAT wholly for the purpose of consumption, use or supply in the course of making taxable supplies, may deduct such VAT against output tax in full. VAT incurred wholly for the purpose of consumption, use or supply in the course of making exempt supplies or some other non-taxable purpose may not be deducted at all. VAT incurred on goods or services acquired partly to make taxable supplies, and partly to make exempt supplies, or for another non-taxable purpose (mixed supplies), must be apportioned. The VAT Act requires a vendor to apply five steps to determine the extent to which VAT on expenses incurred can be claimed as an input tax deduction. If a financial services provider makes a supply of financial services and receives payment in the form of fees charged and other payment, the vendor will not be able to apply attribution directly. The vendor will then only be entitled to claim apportioned VAT input. To apply direct attribution to VAT on expenses incurred (to taxable, exempt, or other purposes), a financial services provider is required to demonstrate that the VAT’s direct and immediate purpose is to make taxable supplies. This requires the existence of a direct link between the VAT on expenses incurred

⁹¹ Schneider, F. (2019). ‘VAT and Financial Services’, available at <https://stakonsult.com/news/vat-and-financial-services#:~:text=This%20could%20result%20in%20one%20supply%20of%20financial,deduct%20such%20VAT%20against%20output%20tax%20in%20full>, accessed on 7 September 2021.

⁹² Schneider, F. (2019). ‘VAT and Financial Services’, available at <https://stakonsult.com/news/vat-and-financial-services#:~:text=This%20could%20result%20in%20one%20supply%20of%20financial,deduct%20such%20VAT%20against%20output%20tax%20in%20full>, accessed on 7 September 2021.

and the taxable supply to follow. To the extent that a financial services provider can directly attribute VAT on expenses incurred wholly to an exempt purpose, no VAT can be claimed.⁹³

Also important to note is that although the provision of financial services is an exempt supply, it will be zero-rated if physically rendered outside SA. The zero-rating of financial services therefore takes priority over exemption. Vendors must determine whether the financial services they supply are zero-rated or not, as their input claim could increase substantially when compared to the input tax credit if the supply of the service was an exempt supply. An example would be the supply of a cryptocurrency. If the cryptocurrency is supplied to a non-resident not in SA at the time of the supply, the cryptocurrency can be a zero-rated supply. Similarly, the provision of a long-term insurance policy, for instance to a non-resident not in SA at the time of the supply, would be zero-rated.⁹⁴

Vendors with business that usually only makes wholly (100%) taxable supplies have to remember that the supply of financial services (for example the supply of cryptocurrencies as payment to suppliers) could alter the nature of their business from one making wholly taxable supplies to one making ‘mixed supplies’. ‘Mixed supplies’ will include standard-rated and zero-rated taxable supplies and exempt supplies and might result in apportionment of input VAT.⁹⁵

Further discussions with explanatory examples on ‘mixed supplies’ and VAT apportionment will be provided in the following sections of this chapter.

3.8 MIXED SUPPLIES

Where goods or services are used partly for purposes of making taxable supplies, and partly to make exempt supplies or for another non-taxable purpose (mixed supplies), only the portion of the input tax attributable to taxable supplies may be claimed as an input tax credit (section 17(1)), i.e. the VAT incurred might need to be apportioned since there is no input tax credit on exempt supplies. However, if 95% or more of the purchased goods or services will be used in the making of taxable supplies, the full input tax credit may be claimed. In the latter case no apportionment is necessary (the so called *de minimis rule*) (First proviso to section 17(1)).⁹⁶

⁹³ Schneider, F. (2019). ‘VAT and Financial Services’, available at <https://stakonsult.com/news/vat-and-financial-services#:~:text=This%20could%20result%20in%20one%20supply%20of%20financial,deduct%20such%20VAT%20against%20output%20tax%20in%20full>, accessed on 7 September 2021.

⁹⁴ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1034.

⁹⁵ Stiglingh, M. (2019). ‘Value-added tax (VAT)’ in Silke: South African Income Tax 21 ed at 1034.

⁹⁶ VAT Act 89 of 1991.

Table I: Example of Mixed Supplies: Transactions for a vendor making clothing and also letting out residential properties. It includes cryptocurrency transactions.

Description	Supplies made	Supplies received
Income from manufacturing activities - clothing	175,000	
Income from letting activities - residential properties s 12(c)	200,000	
Dividend Income	100,000	
Raw material purchases - clothing business		100,000
Administration costs - letting and clothing business		25,000
Cryptocurrency payment to clothing supplier s 2(1)(o)	100	
Distribution costs - clothing business		3,500
Electricity & Rates - letting and clothing business		5,000
Petrol & Diesel Costs (s 11(1)(h)) - letting & clothing business		2,000
Interest paid s 2(1)(f)		1,000
Fringe benefit to clothing business employee		5,000
Interest received	15,000	
Purchased computer - used for both clothing & letting activities		25,000
Purchased cutting machine - used solely for clothing activities		15,000
	490,100	181,500

Source: Adapted from and based on SARS Binding General Ruling 16(BGR 16), April 2015.⁹⁷

In the above illustration, which shows transactions related to a clothing manufacture who is also letting out residential property, there is a mixture of exempt supplies and taxable supplies. The income from the clothing activities are full taxable supplies. The income from the residential letting will be exempt supplies under section 12(c). The input tax on petrol and diesel is zero-rated. The disposal of cryptocurrencies in payment to a local supplier for goods received (presumably raw materials), as well as the receipt of interest and dividends, constitute financial services in terms of section 2 of the VAT Act and are therefore exempt in terms of (section 12) of the VAT Act. It should be pointed out though that the supplier to the clothing manufacturer would have charged VAT, which can be claimed back as input tax by the clothing manufacturer notwithstanding that payment is made to the supplier in cryptocurrency. The fringe benefit by the employer/vendor to the employee is considered a deemed supply in terms of section 18(3) of the VAT Act to the extent it relates to taxable supplies.⁹⁸

Generally, the full amount of VAT on goods or services acquired locally or imported for the purposes of making taxable supplies can be deducted as input tax. However, if goods or services are imported or purchased locally partly for taxable and partly for other non-taxable purposes (i.e. mixed purpose), only a portion of the VAT or notional input tax may be claimed. If goods or services are not acquired exclusively in the course of making taxable supplies, the taxable portion and claimable input tax must be determined.⁹⁹The administration costs as well

⁹⁷ South African Revenue Service, (2015). 'BGR 16 Standard Apportionment Method', available at <https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BGR/LAPD-IntR-R-BGR-2013-05-BGR16-Standard-Apportionment-Method.pdf>, accessed on 18 September 2021.

⁹⁸ VAT Act 89 of 1991.

⁹⁹ Schneider, F. (2019). 'VAT and apportionment-some considerations', available at <https://stakonsult.com/news/vat-and-apportionment-some-considerations>, accessed on 7 September 2021.

as the electricity and rates attributable to both business in Table 1 would be examples where costs are attributable to both taxable and non-taxable supplies, and as a result the input claim will have to be apportioned.

3.9 VAT CASCADING

One cannot give an overview of some of the principles of VAT and not mention the cascading effect of VAT. The current VAT system in SA was preceded by a GST system and the Sales Tax Act of 1978. One of the factors that drove the transition to VAT was the cascading effect GST had on business inputs, especially businesses in capital-intensive industries, and the resultant increased export prices compared to countries operating a VAT system.¹⁰⁰

The Davis Tax Committee (DTC),¹⁰¹ in the final VAT report to the Minister of Finance in March 2018, acknowledges that the taxation of financial services continues to challenge the principles of good VAT design. While there does not seem to be any disagreement that the supply of financial services should be subject to tax when supplied to the final consumer, determining the consideration for that supply has proved to be elusive. The issue seems to be that in many instances no explicit charge is made for the supply of the financial service. While a very limited number of countries impose a type of proxy VAT, and a form of cash-flow VAT has been proposed, in most instances VAT jurisdictions exempt financial transactions. SA is no exception, albeit that it imposes VAT on most explicit charges made by financial institutions. In the DTC report it was noted that the most important area for consideration is VAT cascading.¹⁰²

The DTC noted that VAT cascading arises in consequence of the fact that a financial institution making exempt financial services is denied input tax relief in respect of VAT borne by it on the acquisition of goods and services from third parties. To the extent that the relevant financial services are supplied to businesses that themselves would have been entitled to input tax relief had the financial institution in effect on-charged the VAT paid by them, the VAT paid by the business in effect becomes a cost for the business.¹⁰³ This cost forms the basis on which the business determines its selling price and levies VAT to the final consumer. This effectively results in the final consumer paying a tax on a tax.

The non-recoverable VAT cost incurred by the financial services organisation has the following effects:

- It has a cascading effect in respect of financial services supplied to taxable businesses that are entitled to recover VAT. The economic impact is, however, difficult to determine and quantify; and

¹⁰⁰ South African Revenue Service, (2021). 'Key Revenue Sources -Brief History of Income Tax and VAT', available at https://static.pmg.org.za/docs/110215brief_0.pdf, accessed on 26 October 2021.

¹⁰¹ The Davis Tax Committee is advisory in nature and makes recommendations to the SA Minister of Finance. The chair of the committee is Judge Dennis Davis, and he is supported by several experts in the field of Taxation.

¹⁰² Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹⁰³ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

- There is a significant incentive for the financial services organisation to self-supply the services or infrastructure (‘vertical integration’) to avoid the additional VAT cost resulting from outsourced services which it is unable to claim as an input, since it makes exempt supplies.¹⁰⁴

Vertical integration in turns creates certain problems, including:

- Discrimination against third party suppliers;
- Discrimination against smaller financial institutions that are not in a position to vertically integrate; and
- Frustration of the natural development of specialisation and the creation of inefficiencies in the production and delivery of financial services.¹⁰⁵

In order to eliminate the incentive for financial institutions for vertical integration, and to eliminate or reduce the cascading effect of VAT under the current VAT exemption provisions, the Committee recommended that consideration be given to VAT grouping¹⁰⁶ as a measure to eliminate vertical integration and to reduce the cascading effect which the VAT exemption of financial services causes. The DTC recommended that research should be undertaken to establish best practice, potential risks need to be identified, and an anti-avoidance mechanism should be developed to counter abuse.¹⁰⁷

3.10 VAT APPORTIONMENT

According to Section 17(1) of the VAT Act, “where goods or services are acquired or imported by a vendor partly for consumption, use or supply (hereinafter referred to as the intended use) in the course of making taxable supplies and partly for another intended use, the extent to which any tax which has become payable in respect of the supply to him or the importation by him, as the case may be, of such goods or services or in respect of such goods under section 7(3) or any amount determined in accordance with paragraph (b) or (c) of the definition of ‘input tax’ in section 1, is input tax, shall be an amount which bears to the full amount of such tax or amount, as the case may be, the same ratio (as determined in accordance with a general written ruling by the Commissioner or a written ruling given by the Commissioner to such vendor) as the intended use of such goods or services in the course of making taxable supplies bears to the total intended use of such goods or services”.¹⁰⁸ There are certain provisions to this section, which include the following:

¹⁰⁴ This section on the non-recoverable VAT cost and vertical integration, is listed in the problem statement of the DTC final report to the Minister under the heading “VAT cascading and self-supplies”. Davis Tax Committee, (2018). ‘Final report on VAT for the Minister of Finance’, available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹⁰⁵ This section on the non-recoverable VAT cost and vertical integration, is listed in the problem statement of the DTC final report to the Minister under the heading “VAT cascading and self-supplies”.

¹⁰⁶ VAT grouping occurs when related companies or limited liability partnerships register as a single taxable person if certain criteria are met. The effect of a VAT group registration is that supplies of goods or services between members of the groups are ignored for VAT purposes and do not attract any VAT, thereby eliminating any non-recoverable VAT cost on centralised functions

¹⁰⁷ Davis Tax Committee, (2018). ‘Final report on VAT for the Minister of Finance’, available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹⁰⁸ VAT Act 89 of 1991.

- (i) “where the intended use of goods or services in the course of making taxable supplies is equal to not less than 95 per cent of the total intended use of such goods or services, the goods or services concerned may for the purposes of this Act be regarded as having been acquired wholly for the purpose of making taxable supplies; [Para. (i) substituted by s. 31 (a) of Act 97 of 1993 and amended by s. 88 of Act 53 of 1999.]”
- (ii) “where goods or services are deemed by section 9(3)(b) to be successively supplied, the extent to which the tax relating to any payment referred to in that section is input tax may be estimated where the calculation cannot be made accurately until the completion of the supply of the goods or services, and in such case such estimate shall be adjusted on completion of the supply, any amount of input tax which has been overestimated being accounted for as output tax in the tax period during which the completion occurs and any amount of input tax which has been underestimated being accounted for as input tax in that period; and”
- (iii) “where a method for determining the ratio referred to in this subsection has been approved by the Commissioner, by way of a general written ruling or a written ruling given to such vendor, that method may only be changed with effect from a future tax period, or from such other date as the Commissioner may consider equitable”.¹⁰⁹

3.10.1 When to Apportion

3.10.1.1 Direct Attribution

Before applying VAT apportionment, the first step is to determine whether the expense can be directly attributed to a taxable or non-taxable purpose. Direct attribution means that the VAT expense will have to be attributed according to the intended use or purpose of the goods or services acquired. Direct attribution means that permissible expenses are incurred either wholly for making taxable supplies, in which case the VAT can be deducted in full, or wholly for making exempt supplies or for other non-taxable purposes, in which case no VAT can be claimed as an input tax deduction.

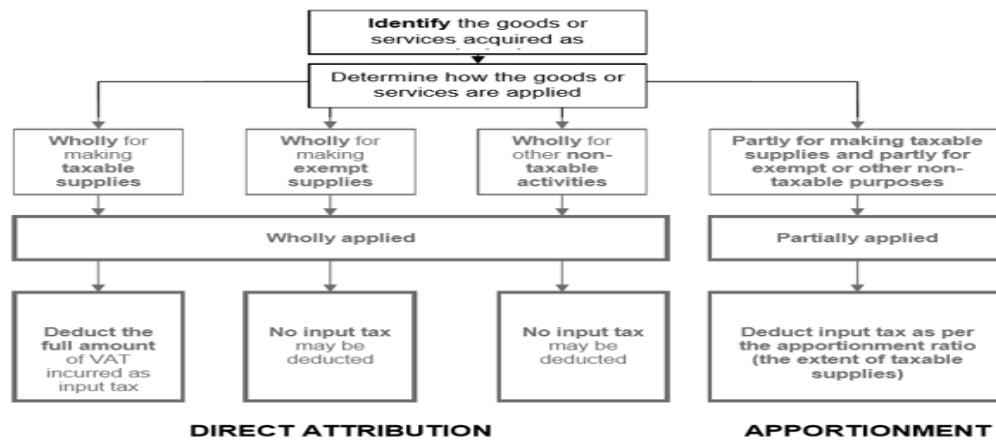
VAT apportionment only applies to expenses that have been incurred partly for the purpose of consumption, use or supply in the course of making taxable supplies and partly for exempt or other non-taxable purposes. If it is clear that the expense must be apportioned, the next step is to calculate the proportion of VAT which may be claimed as an input tax deduction. This is termed the apportionment ratio and is expressed as a percentage. The most common VAT on expenses incurred that needs to be apportioned are general business overhead expenses (refer Table I).¹¹⁰ The diagram below shows the flow of direct attribution and apportionment.

¹⁰⁹ VAT Act 89 of 1991.

Also refer judgment of the Supreme Court of Appeal on provision (iii) in the matter between *Mukuru Africa (Pty) Ltd v Commissioner for the South African Revenue Service* (Case no 520/2020) [2021] ZASCA 116 (16 September 2021), available at <http://www.saflii.org/za/cases/ZASCA/2021/116.html>, accessed on 06 November.

¹¹⁰ Jembula, B. (2020). ‘VAT apportionment in South Africa’, available at <https://www.grantthornton.co.za/contentassets/353a874577c04ac0ab0a847c8daa597a/vat-apportionment-in-sa.pdf>, accessed on 15 September.

Diagram IV: Direct Attribution and Apportionment



Source: Adopted from SNG Grant Thornton, 2020.¹¹¹

3.10.1.2 Apportionment Ratio Calculation

If it is clear that the expense cannot be directly attributed wholly to a taxable, exempt or other non-taxable purpose, the second level of enquiry or next step is to determine the portion of VAT which qualifies as input tax, based on the extent to which the intended use is for taxable purposes. The apportionment ratio must be determined by using an approved apportionment method to produce a fair and reasonable proportion of VAT that can be claimed as an input tax deduction.¹¹²

Vendors need to assess the appropriateness of various methods of apportionment to ensure equity. Methods of apportionment which, at least, should be considered include the turnover-based method, employee numbers or time-based method, floor space-based method, transaction-based method, the varied input-based method, or a hybrid of the methods. The turnover based method (discussed further below) is however the only method allowed by SARS currently unless permission is obtained from SARS for the use of another method.¹¹³

If the turnover-based method is inappropriate as it produces an absurd result, is impossible to use, or does not yield a fair approximation of the extent of taxable application of the enterprise's VAT-inclusive expenses, the vendor must request SARS to allow a more suitable alternative method. If a specific ruling is granted which is found to be inappropriate at a later stage, the vendor may not revert to the turnover method without a specific ruling from SARS.

¹¹¹ Jembula, B. (2020). 'VAT apportionment in South Africa', available at <https://www.granthornton.co.za/contentassets/353a874577c04ac0ab0a847c8daa597a/vat-apportionment-in-sa.pdf>, accessed on 15 September.

¹¹² South Arican Revenue Service, (2015). 'BGR 16 Standard Apportionment Method', available at <https://www.sars.gov.za/legal-counsel/legal-advisory/published-binding-rulings/binding-general-rulings-bgrs/bgr-1-20/>, accessed on 18 September 2021.

¹¹³ South Arican Revenue Service, (2015). 'BGR 16 Standard Apportionment Method', available at <https://www.sars.gov.za/legal-counsel/legal-advisory/published-binding-rulings/binding-general-rulings-bgrs/bgr-1-20/>, accessed on 18 September 2021.

3.11 Binding General Ruling 16 (issue 2)

The ruling that is currently in use, that is referred to in proviso (iii) of section 17(1) (see above), is Binding General Ruling 16 (issue 2) (BGR16), which was issued by SARS and came into effect on 1 April 2015. It will apply until it is withdrawn, or the relevant legislation is amended. This prescribes the method to be used in determining the ratio contemplated in section 17(1). BGR16 also states that the vendor may only use this method if it is fair and reasonable. Where the method is not fair and reasonable or inappropriate, the vendor must apply to SARS to use an alternative method.¹¹⁴

BGR16 Formula

The formula set out below in respect of the turnover-based method of apportionment constitutes a BGR under section 89 of the Tax Administration Act.

$$y = \frac{a}{a + b + c} \times \frac{100}{1}$$

Where:

“y” = the apportionment ratio/percentage.

“a” = the value of all taxable supplies (including deemed taxable supplies) made during the period;

“b” = the value of all exempt supplies made during the period; and

“c” = the sum of any other amounts not included in “a” or “b” in the formula, which were received or which accrued during the period (whether in respect of a supply or not)

Essentially, the calculation aims to limit the input tax deduction to the extent that the expenditure item in question is incurred in the furtherance of the VAT enterprise only.

The example below shows a company that is engaging in both clothing manufacturing and the letting of residential properties. During the year the company also purchased two capital assets, a computer, which is used for both activities, and a cutting machine for the clothing business.

¹¹⁴ South African Revenue Service, (2015). ‘BGR 16 Standard Apportionment Method’, available at <https://www.sars.gov.za/legal-counsel/legal-advisory/published-binding-rulings/binding-general-rulings-bgrs/bgr-1-20/>, accessed on 18 September 2021.

Table II: Example showing the application of BGR16 – The table shows VAT charged by the supplier

Description	Supplies made	Supplies received	VAT @15%	Formula Ref
Income from manufacturing activities - clothing	175,000		26,250	"a"
Income from letting activities - residential properties s 12(c)	200,000			"b"
Dividend Income	100,000			"c"
Raw material purchases - clothing business		100,000	15,000	
Administration costs - letting and clothing business		25,000	3,750	
Cryptocurrency payment to clothing supplier s 2(1)(o)	100		-	"b"
Distribution costs - clothing business		3,500	525	
Electricity & Rates - letting and clothing business		5,000	750	
Petrol & Diesel Costs (s 11(1)(h)) - letting & clothing business		2,000	-	
Interest paid s 2(1)(f)		1,000	-	
Fringe benefit to clothing business employee		5,000	750	"a"
Interest received	15,000			"c"
Purchased computer - used for both clothing & letting activities		25,000	3,750	
Purchased cutting machine - used solely for clothing activities		15,000	2,250	
	490,100	181,500		

Source: Adapted from and based on SARS Binding General Ruling 16(BGR 16), April 2015.¹¹⁵

To determine the apportionment ratio/percentage, we apply the formula prescribed in BGR16

$$y = \frac{175000(a) + 5000(a)}{175,000(a)+200,000(b)+100(b)+100,000(c) +15,000(c)}$$

$$y = \frac{180,000(a)}{490,100 (a+b+c)}$$

$$y = 36.73\%$$

The input tax on the computer will have to be apportioned, because it is partially used for exempt supplies (the letting of residential properties – section 12(c)) and for the taxable clothing manufacturing activity. The total input VAT of R3750 will be limited by the apportionment ratio of 36.73%, i.e. only R1377 (36.73% x R3750) can be claimed by the vendor as an input credit. The input claim on the administration cost will bear the same result. The full input VAT of R2250 can however be claimed as the cutting machine is used wholly for the making of taxable supplies (refer above discussion on direct attribution and VAT apportionment). As illustrated, the capital assets acquired during the period do not form part of the calculation as prescribed by BGR16.

The input claim on electricity and rates will have to be apportioned, i.e. only R239.68 (36.73% x R652) can be claimed by the vendor as an input credit

In the above example the taxable use is less than 95% therefore the apportionment method instead of the *de minimis* rule will have to be applied.

¹¹⁵ South African Revenue Service, (2015). 'BGR 16 Standard Apportionment Method', available at <https://www.sars.gov.za/legal-counsel/legal-advisory/published-binding-rulings/binding-general-rulings-bgrs/bgr-1-20/>, accessed on 18 September 2021.

3.11.1 Davis Tax Committee's view on SARS BGR16

According to the DTC's final report on VAT that was issued to the Minister of Finance in 2018, "financial services organizations are subject to VAT apportionment as a result of the fact that they render both taxable and exempt supplies". The very nature of the services rendered by the financial services organisations lends itself to VAT apportionment, as they supply services which are subject to VAT and services which are not.¹¹⁶

Due to the fact that financial intermediary services (other than loan intermediary services) are mainly subject to VAT, a substantial portion of such VAT is irrecoverable when supplied to a financial services organisation, which places an emphasis on the apportionment formula applied to minimise irrecoverable VAT cost. If direct attribution and VAT apportionment are correctly applied, it would also reduce the cascading effect of VAT on financial services supplied to taxable entities.¹¹⁷

According to the DTC, the criteria to present a fair and equitable basis includes:

- There is a correlation between the values of the different supplies made by a vendor with the taxable expenses incurred and taxable assets applied in making such supplies;
- There is a simple and constant relationship between the value of the vendor's supplies and the taxable expenses incurred, i.e. that each R1 of taxable output uses roughly the same amount of taxable costs and R1 of exempt output.
- There are no significant differences in the timing between costs incurred and corresponding taxable and exempt supplies; and
- There are no large once-off income receipts in respect of which few costs or expenses are incurred.¹¹⁸

The DTC's view on the BGR16 formula prescribed by SARS is that the formula hardly ever meets any of the criteria for a turnover-based method to be a fair and reasonable basis for financial institutions. BASA and SARS agreed a well-documented methodology of the VAT treatment of supplies and apportionment in the banking industry, which is currently under review.¹¹⁹ The fairness and reasonability of the prescribed turnover-based formula as set out in BGR16 for the purposes of section 17(1) of the VAT Act is further distorted by the inclusion in the denominator of the formula of any amounts received by or accrued to the financial institution, irrespective of whether it comprises proceeds for a supply or not. The formula thus requires that receipts in respect of which very little, if any, taxable expenses are incurred are

¹¹⁶ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹¹⁷ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹¹⁸ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

¹¹⁹ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

included in the apportionment formula, most notably dividends and income, which is passive in nature (Table II for treatment on dividend income). The inclusion of dividends and passive income in the denominator of the turnover-based apportionment formula is unique to SA.¹²⁰

From the above table, if for argument's sake the dividend income and the interest received (passive income) were excluded from the denominator, the apportionment ratio would have been 48% (180000/375000) implying that the input credit that could have been claimed back on 'mixed supplies' would have been significantly higher.

3.12 CONCLUSION

In conclusion, the South African VAT system aims to tax final domestic consumption, and removes tax from exports through the zero-rating mechanism (thus it is a destination-based VAT system). A simplified VAT calculation is the amount of output tax less the amount of input tax, where output tax is the VAT charged by the vendor on the supply of goods or services by them, and where input tax is the VAT component of the payment for goods and services supplied to the vendor for the purpose of making taxable supplies that can be claimed back. The VAT Act makes provision for two types of supplies, namely standard-rated or zero-rated taxable supplies and exempt supplies. The author in this chapter has shown illustrations of 'mixed supplies' and a general illustration of VAT through a basic supply chain.

Furthermore, the consideration for the classification of VAT on financial services in SA has been debated since the late 1980's. It was identified then that VAT would give rise to many problems for different groups of taxpayers, including specialised financial institutions such as insurers, building societies and banking institutions. Different committees made pronouncements on the classification of VAT on financial services. There were even assertions that, in theory, there does not appear to be any reason why financial services should not be subject to VAT. Financial services are consumption expenditure just like any other services and in fact, because they form a higher proportion of budgets of higher income households, there is every reason to subject them to VAT. However, it was ultimately accepted that the assertion that VAT on financial services be exempt from VAT, be adopted in the VAT Act. The VAT exemption in turn however could lead to 'mixed supplies', 'invite' compliance issues with regards to VAT apportionment and could lead to potential VAT leakage. The concepts of 'mixed supplies', VAT cascading and VAT apportionment were also discussed through examples and illustrations.

Major banks and insurance companies are currently the major providers of financial services and will undoubtedly remain so. They are regulated by a PA which was enacted by the Financial Sector Regulator Act. Cryptocurrencies as a 'financial service' are not currently regulated, but the IFWG in its position paper on crypto assets agrees that crypto assets cannot remain outside of the South African regulatory purview, and recommends that SA employs a

¹²⁰ Davis Tax Committee, (2018). 'Final report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 06 September 2021.

staged approach to bring crypto assets within the regulatory remit through the regulation of CASPs.

This chapter partly focused on businesses that predominantly deal in exempt supplies and which operate in the financial services industry. In most VAT jurisdictions financial transactions are exempt, and SA is no different. There is a general acceptance that the very nature of the services rendered by financial services organisations lends itself to VAT apportionment as they supply services which are subject to VAT and services which are not. The apportionment formula in BGR16 is currently the only method accepted by default.

The author has also pointed out that there are views, including the views of tax experts in the field, as well as business directly affected by the prescribed apportionment formula (BGR16), that the formula hardly ever meets any of the criteria for a turnover-based method to be a fair and reasonable basis for financial institutions.¹²¹

CHAPTER 4 – ASSESSING THE POSSIBILITY OF VAT LEAKAGE ARISING FROM THE CLASSIFICATION OF CRYPTOCURRENCY AS A FINANCIAL INSTRUMENT

In this chapter the author will look at two use cases for cryptocurrencies as defined by the IFWG and will assess the possibility of VAT leakage under each of these two use cases. This chapter focusses on the first research question of the study.

4.1 USE CASES FOR CRYPTOCURRENCIES

As discussed in Chapter two, the IFWG in its position paper identified five crypto-asset specific use cases. The author will only discuss the following two use cases:

- (i) buying and/or selling of crypto assets by individual consumers and legal persons; and
- (ii) payments using crypto assets.

4.1.1 Buying and/or selling of Crypto Assets by individual consumers and legal persons

This use case is probably more linked to services that both existing financial services providers as well as new CASPs would perform in terms of cryptocurrency purchases and sales. The author's submissions with regards to VAT compliance in offering these services are described below for each.

i) Existing Financial Services Providers

In SA, banks and insurance companies provide the largest portion of financial services. Currently there are no banks in SA acting as an exchange platform or providing other services as contemplated in section 2(1)(o) of the VAT Act with relation to cryptocurrencies.

If in future banks were to become part of cryptocurrency trading and become CASPs as well, it should just become one of the many exempt financial services they already supply. It is worth

¹²¹ Davis Tax Committee, (2018). 'Final Report on VAT for the Minister of Finance', available at <https://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf>, accessed on 6 September 2021.

mentioning that the original idea was to have a decentralised cryptocurrency without the involvement of the central bank and other banks, as was envisaged in the original published white paper by Satoshi Nakamoto.¹²²

Some banks in the United States of America have however started to create their own blockchain-based systems, including cryptocurrencies, to enable Business-to-Business (B2B) cryptocurrency payments between their customers. Proponents say the potential benefits include reduced transaction fees and faster money transfers. Japanese banks are also creating payment systems based on cryptocurrencies. The list of banks that support cryptocurrency transactions also include two banks in the United Kingdom, and one bank each in Germany, Estonia, the Czech Republic, and Canada.¹²³

It would probably be fair to assume that banks should be able to “slot in” more efficiently than other CASPs would be able to do. Banks would be familiar with the standard-turnover method of apportionment issued by SARS and with the binding class ruling to certain members of The Banking Association of South Africa (BASA), as well as with VAT legislation on qualifying taxable supplies related to the supply of cryptocurrencies.

ii) Newly Created Crypto Asset Service Providers

In SA, there are approximately 12 different crypto asset trading platforms at present, with a combined 24-hour trading value of roughly between R250 million and R2 billion.¹²⁴ A Crypto Asset Trading Platform (CATP) is one form of CASP. The primary business of these CASPs is cryptocurrency trading. Luno, which is a popular CATP in SA, allows both the buying and selling of cryptocurrencies on its platform. CASPs perform comparable financial service activities to activities provided by existing financial service providers.

As mentioned in Chapter 2, these CASPs may have to be licenced financial services providers in order to provide cryptocurrency services going forward. As with banks, the assumption is that these CASPs will largely provide exempt supplies, with some taxable supplies that could include items such as transaction fees. To the extent that these CASPs also charge a fee (transaction fee, withdrawal fee, commission, merchant’s discount or a similar charge), this will result in one supply of financial services but with two VAT consequences, one being exempt and the other being taxable supplies (i.e. mixed supplies).

In *ABC (Pty) Ltd v The Commissioner for the South African Revenue Service 2020 SA 1626 (ITC)*, the court was asked to determine whether the VAT on certain expenses incurred by the taxpayer were wholly attributable to making taxable supplies and therefore fully deductible as

¹²² Nakamoto, S. (2008). ‘Bitcoin: A Peer-to-Peer Electronic Cash System’, available at <https://bitcoin.org/bitcoin.pdf>, accessed on 24 November 2021.

¹²³ Banks.com, (2020). ‘Banks that accept Bitcoin’, available at <https://www.banks.com/articles/investing/cryptocurrency/banks-that-accept-bitcoin/>, accessed on 11 October 2021.

¹²⁴ The Intergovernmental Fintech Working Group, (2021). ‘Position paper on crypto assets’, available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

It should be noted that these values are reflective of traders that take advantage of price discrepancies between different CATPs and therefore trade multiple times per day, thus potentially inflating the figure quoted.

input tax, or whether the expenses were subject to apportionment. The facts and issues to be considered were as follows:

The taxpayer carried on business as a *bureau de change*, in the course of which it exchanged travellers' cheques and currencies for inbound and outbound travellers. It carried on business in three separate divisions, being the head office, treasury, and a branch network of 52 branches. The treasury division was responsible for setting exchange rates for buying and selling foreign currencies to the customers and setting the rate of the currency and added a margin thereon. The branch network was responsible for the exchange and sale of foreign currencies to customers. The branch processed the currency exchange transactions of customers and charged the customer a commission or fee for its services. The taxpayer argued that its branch network only made taxable supplies for which it charged commissions or fees to customers, and that the total amount of VAT incurred on expenses by its branch network was deductible as input tax. The Tax Court had to consider whether the branch network only made taxable supplies, or whether it was involved in making both taxable and exempt supplies.¹²⁵

The Tax Court found in favour of the taxpayer and held that the VAT was fully deductible as input tax. The judge in his judgment agreed that the payment of the commission/fee is 'consideration' as contemplated in the proviso to section 2(1) of the VAT Act. The judge was satisfied that the consideration in the form of a commission removes the activity of the 'exchange of currency' from being deemed financial services, and requires the vendor concerned to charge VAT as output tax, which is payable to SARS, subject to any input tax that may be deductible.¹²⁶ Where the vendor's business is altered to be one of 'mixed supplies', it will be important that the apportionment ratio be determined by using an approved apportionment method to produce a fair and reasonable proportion of VAT that can be claimed as an input tax deduction.

SARS had indicated in the 2018 annual budget that the VAT treatment of cryptocurrencies would be reviewed and that supplies of cryptocurrencies would not require VAT registration as a vendor in the interim.¹²⁷ As per section 23 of the VAT Act, compulsory vendor registration requires a person (including a company) to register as a VAT vendor

- "at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million"¹²⁸
- at the commencement of any month where there are reasonable grounds for believing that the total value of the taxable supplies to be made by that person in the period of 12

¹²⁵ *ABC (Pty) Ltd v The Commissioner for the South African Revenue Service* 2020 SA 1626 (ITC).

¹²⁶ *ABC (Pty) Ltd v The Commissioner for the South African Revenue Service* 2020 SA 1626 (ITC).

¹²⁷ South African Revenue Service, (2018). 'SARS's stance on the tax treatment of cryptocurrencies', available at <https://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx>, accessed on 31 October 2020.

¹²⁸ The amount of R1 million is the total value of taxable supplies therefore excluding exempt supplies.

months reckoned from the commencement of the said month will exceed the abovementioned amount”.¹²⁹

Based on the trading value referred to earlier, it is submitted that it is likely that at least some of the 12 CATPs currently in operation in SA engage in making taxable supplies (in this case transaction fees, withdrawal fees, etc) that exceed R1 million in 12 consecutive months, and therefore are required to register as VAT vendors with SARS. A remote possibility could exist in the latter scenario that the newly created CATPs could interpret SARS’ stance on VAT vendor registration for the supplies of cryptocurrencies as being that there is currently no obligation on them to register as a VAT vendor, and therefore that they do not have to levy output tax on qualifying taxable supplies and consequently to pay over output tax on these supplies or apply the apportionment ratio to claim input credits against output tax levied. This, it is submitted, is clearly not the case. Compliance with and knowledge of prescribed VAT legislation relating to financial services, ‘mixed supplies’, and VAT apportionment will need to be adhered to by the new CATPs.

If these entities are not registered as VAT vendors, they will presumably be ‘off the radar’ of SARS from a VAT perspective. The danger therefore exists that some of these CATPs may not declare VAT on administration fees levied to their clients for exchange services leading to a revenue under reporting to the fiscus.

4.1.2 Payments using Crypto Assets

This use case is linked to merchants who are accepting cryptocurrency as payment for goods or services.

Where goods are supplied for a consideration that is not money, this is generally referred to as a barter exchange transaction. Cryptocurrency is not considered legal tender by the South African Reserve bank, although it performs some of the functions of money. Therefore, where goods are supplied to a buyer and payment is made in cryptocurrency, this forms both the consideration given in return for the supply, as well as the supply of cryptocurrency. However, the supply of cryptocurrency will be exempt from VAT.

Accepting cryptocurrency as a payment method for goods and services will not require the vendor to register as a licensed financial services provider for regulatory purposes, provided the vendor is not providing any other additional financial services as contemplated in section 2(1)(o) of the VAT Act. However, there would be VAT implications because the vendor would be converted to providing both taxable supplies and exempt supplies. Where the vendor who receives the cryptocurrency as payment and who is making presumably 100% taxable supplies then on-sells, trades with, or supplies it as payment to a supplier for goods or services, it needs to be mindful that this could alter the nature of its business from making exclusively taxable supplies to one making ‘mixed supplies’, and therefore it will no longer be entitled to full input VAT credits. ‘Mixed supplies’ will lead to the application of VAT apportionment of inputs unless where the formula yields an apportionment ratio/percentage of 95% or more, the full amount of input VAT incurred on mixed expenses may be deducted (referred to as the so called

¹²⁹ VAT Act 89 of 1991.

de minimis rule). Although it is not a present requirement, the same vendor will presumably have to register as a financial services provider if it will be regularly engaging in similar transactions in the future unless it was purely incidental to its business.

The use case under discussion is broken up into domestic payments and international remittances. It should, however, be noted that the possibility for South African legal entities to make outgoing international transfers or payments using crypto assets is not currently being considered by the IFWG in its position paper on crypto assets.¹³⁰ Where the supply of a cryptocurrency is to a non-resident not in SA at the time of supply, the supply of that cryptocurrency could be a zero-rated financial service for VAT purposes.¹³¹ As was discussed in Chapter 3 under section 3.7, as a result of the zero-rating, the vendor's input tax claim could increase substantially when compared to the input tax credit if the supply was an exempt supply.

4.2 VAT LEAKAGE

The term 'VAT leakage' is not defined in the VAT Act and it is an informal term meaning different things in different contexts.

SA in 2014, introduced VAT rules on electronically supplied services in order to protect local suppliers, address VAT leakage and tax consumption in SA in the form of an amendment to the VAT Act. This amendment requires foreign electronic service companies supplying services to qualifying recipients to register for VAT in SA. This amendment was in response to the uncertainty South African E-Business Service providers have faced since the introduction of VAT on electronic services. It was noted at the time that the VAT treatment of the supply of cross-border intangibles and services needs to move at the pace of the digital economy.¹³² Before, anyone could have bought an electronic service from a foreign supplier and SARS would not practically have been able to collect the output tax on the sale from the supplier to the local consumer.

With reference to the above paragraph, VAT leakage for SARS could therefore occur if for instance there are loopholes in the recovery system due to a lack of compliance or infrastructure challenges with regards to the administration and or collection of VAT. Infrastructure challenges in this case could have been dealing with the ever-evolving digital economy that the introduction of electronically supplied services presented at the time. As discussed earlier, one of the basic principles of consumption tax is that the systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

On the other hand, inaccurate calculation and processing of the VAT by a VAT vendor resulting in SARS being 'overpaid', for example, could be said to be VAT leakage on the part of the

¹³⁰ The Intergovernmental Fintech Working Group, (2021). 'Position paper on crypto assets', available at http://www.treasury.gov.za/comm_media/press/2021/IFWG_CAR%20WG_Position%20paper%20on%20crypto%20assets_Final.pdf, accessed on 21 August 2021.

¹³¹ Stiglingh, M. (2019). 'Value-added tax (VAT)' in Silke: South African Income Tax 21 ed at 1034.

¹³² Van Der Merwe, S. (2017). 'Fine tuning VAT on Electronic Services', available at <https://www2.deloitte.com/za/en/pages/tax/articles/fine-tuning-vat-on-electronic-services-.html>, accessed on 07 October 2021.

vendor. For example if the supply of cryptocurrency is made to a foreign supplier not present in SA at the time of supply, the supply will be regarded as a zero-rated supply on which the vendor can potentially increase its input credit deduction for related expenses. But if the transaction is classified incorrectly as an exempt supply it will have the opposite effect. Some of the basic principles of consumption taxes are that there should be certainty and simplicity: “The tax rules should be clear and simple to understand so that businesses can anticipate the tax consequences of a transaction, including knowing when, where and how the tax is to be accounted”¹³³.

4.2.1 Possible VAT leakage under use case ‘Buying and/or selling of Crypto Assets’

As discussed under section 4.1.1(i), the author is of the view that existing financial services providers such as banks would presumably have little difficulty “slotting into” cryptocurrency trading in comparison to new CASPs. Banks would have the knowledge of the financial services industry as well as of VAT legislation pertaining to financial services. They will presumably also have a well-established digital infrastructure for dealing with financial services, as listed under section 2 of the VAT Act, which should make the addition of cryptocurrency trading to that list presumably straight forward. However, new CASPs may face more difficulty, increasing the risk of VAT leakage.

4.2.1.1 VAT leakage due to incorrect apportionment

As discussed under section 4.1.1(ii), because the new CASPs would presumably be converted into a business making both exempt and taxable supplies (mixed supplies), they will need to be aware of applying the appropriate apportionment method (refer section 3.8).

There are certain rules in the VAT Act to prevent VAT leakage when it comes to ‘mixed supplies’. One of the rules is the approved apportionment method, BGR16. Where the apportionment method prescribed by SARS yields an unfair result and a vendor motivates for the use of an alternative method, which at the discretion of SARS is not approved, such an unfair result stemming from the use of the default approved method would normally result in an under-apportionment and a loss to the taxpayer/vendor.

4.2.1.2 VAT leakage due to failure to apply apportionment

There is a possibility that VAT leakage can occur due to non-compliance of VAT-apportionment methods on taxable supplies where the formula suggested in BGR16 is not complied with. While the concept for VAT apportionment in the financial services industry is not a new area or subject, the author is of the view that new entrants like CASPs would need to familiarise themselves with VAT legislation pertaining to financial services.

4.2.1.3 VAT leakage due to failure to register as a Vendor

As explained in section 4.1.1(ii), there is also the issue that businesses engaging in cryptocurrency trading do not need to register as VAT vendors currently. Similarly to the requirement imposed on foreign electronic service companies to register as VAT vendors

¹³³ Organisation for Economic Co-operation and Development, (2015). ‘International VAT/GST guidelines’ at 4, available at <https://www.oecd.org/tax/consumption/guidelinesneutrality2011.pdf>, accessed on 11 September 2021.

locally to curb VAT leakage, the author is of the opinion that failure to require CASPs to register as VAT vendors currently could lead to VAT leakage for the fiscus. As mentioned in the previous section, a remote possibility exists that newly created CASPs could incorrectly interpret SARS's stance on VAT vendor registration for the supplies of cryptocurrencies to mean that there currently is no obligation on them to register as a VAT vendor at all, and therefore that they do not have to levy output tax on qualifying taxable supplies (such as separate fees). As discussed under section 3.1.1, the third requirement for a transaction in SA to attract VAT is that the transaction should constitute a supply of goods or services by a vendor. If a person is not a vendor, VAT is not levied on their supplies (selling price of goods and services does not include VAT) and no input tax can be claimed on the purchases or expenses. If they were required to register and were in default, serious consequences could follow such as penalties and interest levied by SARS.

4.2.1.4 VAT leakage due to incorrect treatment and classification of transactions

As pointed out at the beginning of this section, if the supply of a cryptocurrency to a non-resident is incorrectly classified as exempt instead as zero-rated, on which the vendor could potentially have claimed increased input credits, this will result in VAT leakage on the part of the vendor.

4.2.2 Possible VAT leakage under use case 'Payments using Crypto Assets'.

4.2.2.1 VAT leakage due to incorrect apportionment

Merchants finding themselves 'accidentally'¹³⁴ providing financial services through the issuing or accepting of cryptocurrencies as payment, where the intention is to either sell them on or use them as a means of payment to a supplier, need to be aware that their business is potentially altered to one providing 'mixed supplies' (as was the case in the previous use case), and that they need to apportion input tax on qualifying expenses. Any input tax on expenses related directly to the supply of the cryptocurrency cannot be claimed.

4.2.2.2 VAT leakage due to 'over-apportionment'

Where cryptocurrencies accepted and on-sold were merely incidental, and where for example the amount of costs and resources that could be attributable to them are minimal or non-existent, it is likely that an insignificant portion of existing operating expenses will be applied for the purpose of generating cryptocurrency income. In this case there is arguably 'over-apportionment' due to the turnover method exaggerating the role of exempt supplies as an element of the whole business.

4.2.2.3 VAT leakage due to non-compliance

Although cryptocurrency has been around for a decade, it is still a relatively new concept in the financial services industry. The number of CASPs and merchants accepting cryptocurrencies for goods and services is still low in SA. However, as these businesses themselves grow and the industry is expanding, the risk of VAT leakage may become a more significant consideration. These new CASPs, which may in future also need to register as licensed financial services providers, may have little knowledge of the financial services

¹³⁴ 'Accidentally' in this sense means that the acceptance or issuing of cryptocurrency payments is merely incidental and not a normal everyday business practice of the merchant.

industry and VAT legislation pertaining to financial services. These argued shortcomings in the earlier stages of operating as new CASPs are likely to pose a risk when it comes to certainty and simplicity to understand and anticipate the tax consequences of cryptocurrency trading. This could lead to VAT leakage on the part of the fiscus if apportionment method rules pertaining to ‘mixed supplies’ are not complied with, or if input tax is incorrectly calculated and claimed on expenses related to the supply of cryptocurrency.

4.2.2.4 VAT leakage due to incorrect treatment and classification of transactions

There could also be VAT leakage on the part of the CASPs if input tax on expenses related to taxable supplies (transaction fee, withdrawal fee, commission, etc.) in their cryptocurrency trading business is not fully claimed but incorrectly apportioned due to complexity and uncertainty in determining the tax consequences of these transactions.

Although international transfers or payments using crypto assets are not currently being considered, new CASPs will have to be aware that where the supply of a cryptocurrency is to a non-resident not in SA at the time of supply, the supply of that cryptocurrency could be zero-rated, as opposed to being exempt, and their input claim could therefore be increased. Failure to classify this correctly could lead to VAT leakage on the part of the CASP.

4.3 CONCLUSION

In this chapter the author aimed to answer the first research question listed in chapter 1, which was to determine if there will be a compliance risk or impact to the fiscus due to the possibility of South African VAT vendors who supply fully taxable supplies being converted to mixed supplies vendors by accepting cryptocurrency as a form of payment. Since this may give rise to VAT apportionment issues, including non- or improper apportionment of VAT, this could lead to possible VAT leakage.

The author demonstrated in this chapter that there are a number of factors that increase the risk of VAT leakage when looking at the two cryptocurrency use cases that were discussed. These factors include incorrect apportionment, the failure to apply apportionment, i.e. non-compliance of VAT apportionment methods, over-apportionment, not registering as a vendor and the incorrect treatment and classification of transactions.

CHAPTER 5 - COMPARISON OF SOUTH AFRICAN VAT LEGISLATION TO THE APPROACH TAKEN BY OTHER COUNTRIES WITH REGARDS TO CRYPTOCURRENCIES

In this chapter the author will be giving an overview of the development of the application of VAT legislation to cryptocurrency in the European Union (EU) as well as non-EU countries and draw a comparison to the development of the same VAT legislation in SA. The author will use the EU VAT Directive as a proxy to look at how these jurisdictions apply input tax apportionment and compare to the South African method of apportionment. This chapter focusses on the second research question of the study.

5.1 DEVELOPMENT OF THE VAT LEGISLATION OF CRYPTOCURRENCIES IN THE EUROPEAN UNION

The VAT legislation for the European Union (EU)¹³⁵ is contained in what is referred to as the “Council Directive 2006/112/EC of 28 November 2006” on the common system of value-added tax.¹³⁶ The development of the application of VAT legislation to cryptocurrencies exchanges in the EU was determined and confirmed in 2015 through a landmark judgment involving the Swedish Tax Agency (“Skatteverket”) and a Mr Hedqvist (Skatteverket v David Hedqvist Case C-264/14).¹³⁷

Mr Hedqvist, a Swedish citizen, wished to set up a Bitcoin exchange, but before setting up the business he wanted clarity as to the VAT implications of such an exchange business. The transactions that Mr Hedqvist intended to carry out were limited to the purchase and sale of bitcoins in exchange for traditional currencies, such as the Swedish crown, or vice versa.¹³⁸

Before starting to carry out such transactions, Mr Hedqvist requested a preliminary decision from the Swedish Revenue Law Commission (SRLC)¹³⁹ in order to establish whether VAT must be paid on the purchase and sale of bitcoins. The SRLC in a decision in 2013 said that bitcoin is a means of payment used in a similar way to legal means of payment. Furthermore, the term ‘legal tender’ referred to in Article 135(1)(e) of the VAT Directive is used in order to restrict the scope of the exemption as regards to bank notes and coins. It follows, according to the SRLC, that that term must be taken to mean that it relates only to bank notes and coins and not to currencies. That interpretation, the commission mentioned, was also consistent with the objective of the exemptions laid down in Article 135(1)(b) to (g) of the VAT Directive, namely to avoid the difficulties involved in making financial services subject to VAT. The SRLC held that the exchange service Mr Hedqvist wished to carry out was covered by the exemption under

¹³⁵ European Union (EU). According to Wikipedia ‘The European Union is a political and economic union of 28 member states that are located primarily in Europe.’

¹³⁶ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹³⁷ Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14>, accessed on 16 November 2021.

¹³⁸ Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14>, accessed on 16 November 2021.

¹³⁹ Swedish Revenue Law Commission (Skatterättsnämnden) is a Swedish government agency. It is part of the Ministry of Finance and it is responsible for providing legally binding advance tax rulings in response to tax questions.

Chapter 3, para 9 of the law on VAT that provides that “supplies of banking and financial services and transactions involving securities and similar transactions are exempt from tax”.¹⁴⁰

The Swedish Tax Agency appealed against the SRLC’s decision to the Supreme Administrative Court, arguing that the service to which Mr Hedqvist’s request referred is not covered by the exemption under Chapter 3 (Exemptions for other activities)¹⁴¹, paragraph 9 of the Law on VAT.¹⁴²

The Court of Justice of the European Union (CJEU) was then asked by the Swedish court to clarify how an exchange which sold bitcoin for traditional currencies would be taxed. The relevant Swedish VAT legislation, as is the case with all other member states, was subject to the EU VAT Directive. This Directive determines that the supply of goods or services for consideration within the area of a Member State of the EU by a taxable person is subject to VAT. The CJEU replied and found that the sale and purchase of bitcoins should be considered a service exempted from VAT.¹⁴³

The questions that the judgment aimed to answer were:

- 1) “Whether Article 2(1)c of the VAT Directive must be interpreted as meaning that transactions such as those at issue, which consists of the exchange of traditional currency for units of the ‘bitcoin’ virtual currency and vice versa, in return for payment of a sum equal to the difference between, on the one hand, the price paid by the operator to purchase the currency and, on the other hand, the price at which he sells that currency to his clients, constitutes the supply of services for consideration within the meaning of that article”.¹⁴⁴

Article 2 of the EU VAT Directive falls under the heading ‘Subject Matter and Scope’, with subheading 1 that reads “The following transactions shall be subject to VAT...” of which paragraph “c” of Article 2(1) reads “the supply of services for consideration within the territory of a Member State by a taxable person acting as such.”¹⁴⁵

In a sense Article 2 of the EU Directive can be compared to section 7 ‘Imposition of value-added-tax’ of the South African (SA) VAT Act 89 of 1991, and more particularly section 7(1).

- 2) “Whether Article 135(1) (d) to (f) of the VAT directive must be interpreted as meaning that the supply of services such as those at issue in the main proceedings, which consist of the exchange of traditional currencies for units of the ‘bitcoin’ virtual currency and

¹⁴⁰ Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴¹ Article 135 falls under Chapter 3 of the VAT Directive which deals with ‘Exemptions for other activities’

¹⁴² Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴³ Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴⁴ Skatteverket v David Hedqvist Case C-264/14 at 5, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴⁵ Skatteverket v David Hedqvist Case C-264/14 at 9, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

vice versa, performed in return for payment of a sum equal to the difference between, on the one hand, the price paid by the operator to purchase the currency and, on the other hand, the price at which he sells the currency to his clients, are exempt from VAT”.¹⁴⁶

Article 135(1) (d) to (f) of the VAT Directive falls under the heading ‘Exemptions for other activities’ and can be compared more directly to section 2 of the SA VAT Act 89 of 1991.

The CJEU noted in paragraph 32 of the judgment, that the provisions contained under Article 135 are, by their, nature financial transactions even though are not necessarily carried out by banks or financial institutions. In paragraph 36 of the judgment the court makes the comment that “it is clear from case-law that the purpose of the exemptions laid down in Article 135 (d) to (f) of the VAT Directive is, inter alia, to alleviate the difficulties connected with determining the taxable amount and the amount of VAT deductible”.¹⁴⁷

The exemptions of Article 135 (d) to (f) of the EU VAT Directive are listed below for reference,

(d) transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection;

(e) transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest;

(f) transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities referred to in Article 15(2),¹⁴⁸

To the first question the CJEU answered that Article 2(1)c of the VAT directive must be interpreted as meaning that the supply of services such as those at issue in the main proceedings, which consist of the exchange of traditional currencies for units of the ‘bitcoin’ virtual currency and vice versa, in return for payment of a sum equal to the difference between, on the one hand, the price paid by the operator to purchase the currency and, on the other hand, the price at which he sells that currency to his clients, constitute the supply of services for consideration within the meaning of that article (refer paragraph 31 of judgment).¹⁴⁹

¹⁴⁶ Skatteverket v David Hedqvist Case C-264/14 at 6, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴⁷ Skatteverket v David Hedqvist Case C-264/14 at 7, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

¹⁴⁸ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁴⁹ Skatteverket v David Hedqvist Case C-264/14, available at <https://curia.europa.eu/juris/liste.jsf?num=C-264/14> , accessed on 16 November 2021.

To answer the second question, the CJEU ‘worked’ systematically through each of the exemptions contained under Article 135 (1)(d) to (f) mentioned above.

On exemption (d) the court held that the ‘Bitcoin’ virtual currency, being a contractual means of payment, cannot be regarded as a current account or a deposit account, a payment or a transfer. The court further went on to say that moreover, unlike a debt, cheques and other negotiable instruments referred to in Article 135 (1)(d) of the VAT Directive, the ‘Bitcoin’ virtual currency is a direct means of payment between operators that accept it (refer paragraph 42 of judgment). The court therefore held that transactions such as ‘Bitcoin’ virtual currencies do not fall within the scope of the exemptions provided under 135(1)(d).

With regards to the exemption in Article 135(1)(e) it was mentioned in paragraph’s 36 and 37 of the judgment, that these exemptions are intended to alleviate the difficulties connected with determining the taxable amount and the amount of VAT deductible which arise in the context of the taxation of financial transactions. The court further stated that transactions involving non-traditional currencies, in other words, currencies other than those that are legal tender, in so far as those currencies have been accepted by the parties to a transaction as an alternative to legal tender and have no purpose other than to be a means of payment, are financial transactions. The judgment in paragraph 51 further goes on to say that to interpret the provision of Article 135(1)(e) as including only transactions involving traditional currencies, would deprive it of part of its effect. The court therefore concluded in paragraph 53 of the judgment that Article 135(1)(e) also covers the supply of services consisting of the exchange of traditional currencies for units of the ‘bitcoin’ virtual currency and vice versa.

With regards to Article 135(1)(f), the court in its judgment in paragraph 55 concluded that ‘Bitcoin’ is neither a security conferring a property right nor a security of a comparable nature.

The court therefore ultimately ruled that the services of a Bitcoin exchange in exchanging bitcoin for a traditional currency is exempt from VAT on the basis of the ‘currency’ exemption. Before this judgment there was no consistency of approach within the EU. In some places Bitcoin was subject to VAT; in others it was exempt, and in some states there were no clarity as to how Bitcoin should be taxed. The judgment in this court case requires all member states¹⁵⁰ of the EU to exempt Bitcoin supplies from VAT.¹⁵¹ It is important to note that this case only deals with a very specific aspect of the Bitcoin sphere (services provided by an exchange platform). Accordingly, while the judgment is certainly useful, it does not offer a comprehensive solution to the VAT treatment of all Bitcoin related activity.

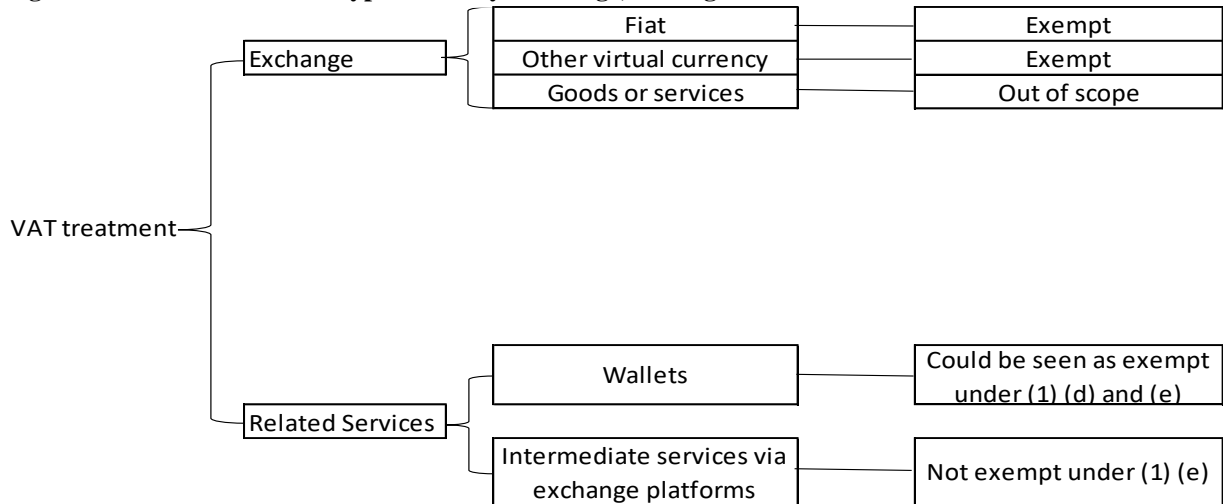
Following the Hedqvist decision, the EU Value Added Tax Committee re-considered its approach. As Hedqvist had already determined the appropriate treatment for the exchange of virtual currencies for fiat currency, the paper examined four further scenarios: (i) supplies of

¹⁵⁰ The European Union is an economic and political union of 28 countries as of 2021. It operates an internal (or single) market which allows free movement of goods, capital, services and people between member states”, available at <https://www.gov.uk/eu-eea>, accessed on 16 November 2021.

¹⁵¹ Norton Rose Fulbright, (2015). ‘Bitcoins - ECJ rules that buying and selling Bitcoin is exempt from VAT’, available at <https://www.nortonrosefulbright.com/en/knowledge/publications/a0f1c5bb/bitcoins---ecj-rules-that-buying-and-selling-bitcoin-is-exempt-from-vat>, accessed 16 November 2021.

goods and services, subject to VAT, remunerated by way of virtual currencies; (ii) services concerning the arrangement of transactions in virtual currencies (digital wallets); (iii) services concerning the verification of transactions in virtual currencies (i.e. mining); and (iv) services related to intermediation provided by exchange platforms for consideration. The decision in Hedqvist and the subsequent discussion in the EU’s VAT Committee, would result in the VAT treatment stylised in Figure II being applied to virtual currencies in EU Member States.

Figure II: Vat treatment of Cryptocurrency Exchange, Mining and Related Services in the EU



Source: Adopted from OECD Secretariat, based on the Hedqvist decision and European Commission Value Added Tax Committee, 2016.¹⁵²

* 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.

Note: Figure II should be read as considering the VAT treatment of virtual currency in the case of (i) exchange for fiat currency, for other virtual currency or for goods or services, and (ii) the related services provided to the virtual currency holder such as wallets or intermediate services via exchange platforms.

¹⁵² Organisation for Economic Co-operation and Development, (2020). ‘Taxing virtual currencies- An overview of Tax Treatments and Emerging Tax Policy Issues’, available at www.oecd.org/tax/tax-policy/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.htm, accessed on 25 October 2020.

5.2 VAT TREATMENT IN OTHER JURISDICTIONS

The table below shows the current VAT treatment of cryptocurrencies for the related major activities/transaction across different jurisdictions.

As can be seen from the table, all the countries included consider most of the cryptocurrency activities listed below as either exempt from or out of scope for VAT. There is however more variation around related services provided to the cryptocurrency holder, such as wallets and other intermediate services provided via exchange platforms. Apart from related services, the classification of the different activities is basically consistent with the approach in the EU.

Table III: VAT Treatment in other Jurisdictions

Countries	Related Services	Exchanges in/for Virtual Currencies	Exchange for supply of goods or services	*Services Provided by Exchange Services (Including service/administration fees)
European countries (Non EU Members)				
United Kingdom	Out of scope	Out of scope	Exempt	Exempt
Norway	Exempt	Exempt	Exempt	Exempt
Switzerland	Out of scope	Out of scope	Exempt	Exempt
Countries outside Europe				
Australia	Exempt	Exempt	Exempt	Exempt
Columbia	Exempt	Exempt	Exempt	Exempt
Israel	Could be liable for VAT	Exempt	Exempt	Exempt
Japan	Exempt	Exempt	Exempt	Exempt
Singapore	Subject to GST	Exempt	Out of scope	Exempt
**New Zealand(NZ)	Subject to GST	case by case basis	case by case basis	Subject to GST

* Services provided by exchange services can be compared to financial services provided by financial institutions. Services related to virtual currency exchanges but which are not integral to these exchanges have a more varied treatment across countries. VAT is not chargeable in the vast majority of countries, typically because it is considered to be covered by exemptions or provisions relating to financial services. In other countries, particularly outside the EU, services related to the exchange of virtual currencies are subject to the normal VAT rules as a supply of taxable services. These related services include wallets and other intermediate services such as withdrawal and transaction fees, administration and service fees, and commission associated with cryptocurrency trading.

** The approach in NZ is currently under review with the view to classify exchanges in cryptocurrencies as exempt. The GST treatment of crypto-assets that are traded or sold is determined on a case-by-case basis and they may be fully taxed, exempt or zero-rated, depending on the circumstances. Mining will continue to be subject to GST.

Source: Developed from the findings of the OECD report, 2020.¹⁵³

¹⁵³ Organisation for Economic Co-operation and Development, (2020). ‘Taxing virtual currencies- An overview of Tax Treatments and Emerging Tax Policy Issues’, available at www.oecd.org/tax/tax-policy/taxing-virtual-currencies-an-overview-of-tax-treatments-and-emerging-tax-policy-issues.htm, accessed on 25 October 2020.

5.3 VAT APPORTIONMENT IN THE EU

VAT apportionment is dealt with in Chapter 2 (Proportional Deduction) under Articles 173-175 of the EU VAT Directive. Article 173 is more directly comparable to section 17(1) ('permissible deductions in respect of input tax') of the SA VAT Act.¹⁵⁴ The wording in both sections/articles aims to achieve the same result. Article 173(1) basically prescribes that where there are mixed supplies (taxable and non-taxable supplies) made, only a proportion of the input VAT that relates to the taxable supplies (Articles 168-170) can be deducted.¹⁵⁵

Article 173(2) allows Member States of the EU certain 'relief' measures covered under paragraphs (a)-(d), which includes instances where if the portion of VAT which is not deductible is insignificant it is to be treated as nil. It also authorises the vendor to determine a proportion for each sector of his business, provided that separate accounts are kept for each sector. It is submitted that Member States through these measures are essentially allowed to somewhat depart from the prescribed apportionment method covered under Article 174.¹⁵⁶

Article 174(1) explains what the deductible portion should be made up of. It should be made up of a fraction comprising the following amounts:

“(a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;

(b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible”.¹⁵⁷

Article 174(2) highlights certain amounts that shall be excluded from the deductible proportion, which include:

“(a) the amount of turnover attributable to supplies of capital goods used by the taxable person for the purposes of his business;

(b) the amount of turnover attributable to incidental real estate and financial transactions;

(c) the amount of turnover attributable to the transactions specified in points (b) to (g) of Article 135(1) in so far as those transactions are incidental”.¹⁵⁸

Article 174 compares more directly with s17(1)(iii) that deals with the apportionment formula to be used which in the case of SA is BGR16(issue 2) which is the only approved method currently. The method in Article 174 is basically a turnover-based apportionment method as is

¹⁵⁴ S17 VAT Act 89 of 1991.

¹⁵⁵ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁵⁶ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁵⁷ Council Directive 2006/112/EC of 28 November 2006 at 37, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁵⁸ Council Directive 2006/112/EC of 28 November 2006 at 38, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

the case with BRG16. It is important to note that although the formula is prescribed by Article 174, Member States have the flexibility to apply the provisions of Article 173(2).¹⁵⁹

The numerator in both formulae uses total taxable supplies for the period. The denominator in both formulae includes both taxable and exempt supplies and both excludes capital goods (refer section 4.5.2), but there are a couple of differences as well. These include:

- With BGR16, dividend income as well as any passive income and any amounts received by or accrued to a business whether it comprises proceeds for a supply or not are all added to the denominator value, essentially decreasing the input credit that can be claimed. The inclusion of these variables is unique to SA and as was mentioned in the DTC report as distorting the fairness and reasonability of the prescribed turnover-based method. In *Sofitam SA v Ministre charg du Budget* [1993] C333/91, a case that dealt with the question of whether the receipt of share dividends by a French holding company called ‘Satam’ should be included in the denominator of the apportionment formula as prescribed in Article 174, the court held that share dividends received by such an undertaking are to be excluded from the denominator since the receipt of dividends is not the consideration for any economic activity within the meaning of the Sixth Directive¹⁶⁰, it does not fall within the scope of VAT, so that dividends resulting from holdings fall outside the deduction entitlement.¹⁶¹
- Apart from excluding capital goods, Article 174(2) also excludes from the denominator value, the amount of turnover attributable to incidental real estate and financial transactions as well as the amount of turnover attributable to the transactions specified in terms of Article 135 (I) (d)–(g). If we refer back to section 5.2.1, Article 135 (I) (d)–(g) deals with financial transactions/services that are tax exempt.¹⁶²
- Article 173(2)(e) above allows member states to set a *de minimis* rule threshold, under which apportionment is not necessary.¹⁶³

Article 175(1)–(3) largely deals with the administration of the deductible and or provisional proportion on an annual basis. The provisional deductible portion for the year will be calculated using the preceding year’s transactions and this provisional proportion will be estimated under the supervision of the tax authorities.¹⁶⁴ Article 175(1)–(3) can be compared to Section 17(ii)

¹⁵⁹ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁶⁰ The current EU VAT Directive was preceded by what was referred to as the Sixth Directive.

¹⁶¹ Ritchie, M.A. (2014). ‘International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa’ (Unpublished mini-dissertation, University of Cape Town) at 33.

¹⁶² Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁶³ Ritchie, M.A. (2014). ‘International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa’ (Unpublished mini-dissertation, University of Cape Town) at 33.

¹⁶⁴ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

which also deals with estimates where no accurate calculation can be made until the completion of the supply as well as the subsequent adjustment of the initial estimate.¹⁶⁵

5.3.1 Treatment of apportionment in EU Member States

The turnover-based apportionment method is by far the most used or favoured apportionment method within EU Member States according to a survey performed by the International Bureau of Fiscal Documentation (IBFD) in 2006.¹⁶⁶ Although the turnover method is the prescribed method as per Article 174, Member States also have certain provisions granted to them in Article 173(2), and many Member States are utilizing these provisions, especially since it was recognised by established EU case law that the turnover-based apportionment method cannot be universally applied to all types of business. To this end, Member States can use an alternative method like the indirect input attribution method which will basically follow the cost allocation method used by the business in its internal accounting systems or an alternative input allocation method based on actual use.¹⁶⁷

As noted in Chapter 3, in SA the standard turnover method is the only approved method of VAT apportionment. Vendors can apply for an alternative method at the discretion of SARS if they are of the view that the current method is not fair.¹⁶⁸

As far as the *de minimis* rule is concerned, it is common for Member States to apply different thresholds. Latvia and Lithuania, for instance apply, the same threshold as SA, i.e. 95% based on the apportionment ratio, whereas Poland has a threshold of 98%, and Luxemburg 90% with an additional proviso that the fiscal advantage to the taxpayer cannot exceed 250€ per year. Sweden and Cyprus base their threshold on the ratio of deductible inputs to total inputs.¹⁶⁹

5.4 CONCLUSION

In conclusion, the interpretation of VAT legislation in the EU with regards to cryptocurrency exchanges was largely established through the landmark *Skatteverket vs Hedqvist* case in 2015, where the judge ruled that the exchange of non-traditional currency such as Bitcoin as an alternative for traditional legal tender, where there is no purpose other than to be a means of payment, represents a financial transaction and should be exempt for VAT purposes under Article 135(1)(e) of the EU VAT Directive. The EU VAT Directive essentially aims to have a common system of VAT in place for Member States. The *Hedqvist* decision therefore compels

¹⁶⁵ Council Directive 2006/112/EC of 28 November 2006, available at <https://www.legislation.gov.uk/eudr/2006/112/contents>, accessed on 16 November 2021.

¹⁶⁶ Ritchie, M.A. (2014). 'International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa' (Unpublished mini-dissertation, University of Cape Town) at 34.

¹⁶⁷ Ritchie, M.A. (2014). 'International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa' (Unpublished mini-dissertation, University of Cape Town) at 34.

¹⁶⁸ South African Revenue Service, (2015). 'BGR 16 Standard Apportionment Method', available at <https://www.sars.gov.za/wp-content/uploads/Legal/Rulings/BGR/LAPD-IntR-R-BGR-2013-05-BGR16-Standard-Apportionment-Method.pdf>, accessed on 28 March 2021.

¹⁶⁹ Ritchie, M.A. (2014). 'International apportionment mechanisms for VAT inputs – is the turnover basis the best mechanism for all retail industries in South Africa' (Unpublished mini-dissertation, University of Cape Town) at 35.

EU Member States to apply the judgment equally. It should be noted though that the Hedqvist decision only dealt with services provided by a cryptocurrency exchange platform. A further study was later undertaken by the EU VAT Committee to look at other cryptocurrency scenarios, the outcome of which would result in a unified VAT treatment being applied to cryptocurrencies in EU Member States.

Countries that do not form part of the EU, including the United Kingdom (although the United Kingdom was still part of the EU at the time of the Hedqvist ruling), Norway and Switzerland, closely follow the decision in the Hedqvist case, i.e. exchanges for cryptocurrencies are exempt from or out of the scope of VAT, although VAT remains payable on the supply of the goods or services for which virtual currencies are exchanged.

Countries outside Europe, including Australia, Colombia, Israel, Japan, Singapore, and SA, all follow a similar approach in excluding exchanges in cryptocurrencies from VAT. New Zealand is one of the very few countries that is taking a different approach to other nations, in that it treats cryptocurrency transactions on a case-by-case basis. However, the current approach is under review through a discussion document, wherein the government propose treating exchanges in cryptocurrencies as exempt from GST.

In SA, the VAT classification of cryptocurrencies did not have its formation through a landmark court case, as was the case with the EU. Instead, SA went through a Tax Law Amendment Bill consultation process before the President of the Republic signed the Taxation Laws Amendment Act into law in 2019, four years after the Hedqvist ruling. Subsequent to this amendment, section 2(1)(a) - (o) of the SA VAT Act deems cryptocurrency trading to fall within financial services or financial transactions and exempt from VAT, consistent with Article 135(1) (d)-(f) of the EU Directive.

In the EU, cryptocurrency exchange platforms are regulated and can vary in each Member State, and are considered legal across the EU. EU laws do not prohibit banks, credit, or investment firms from holding, gaining exposure to, or offering services in, crypto assets or cryptocurrencies, and firms can rely upon their existing licences to provide cryptocurrency products and services. The author would assume any new exchange platforms providing such services would require a licence. As already mentioned in Chapter 3 under section 3.6, financial services providers in SA require a licence to operate, and new CASPs providing mainly cryptocurrency goods and services will likely also have to be in possession of a licence to carry out such services.

As discussed in Chapter 2, cryptocurrencies are not yet regulated in SA, but they will fall under the ambit of the FSCA if the recommendations of the CARWG are followed and adopted. Both the EU and SA VAT legislation prescribes that, where a vendor's business is of such a nature that it produces mixed supplies (taxable and non-taxable supplies), only a portion of the input VAT related to taxable supplies can be deducted. Both apportionment formulae are called the 'standard turnover-based' method and the numerator of both formulae is based on the total amount of taxable turnover for a period. There are however some significant differences where it comes to the denominator of the formulae. The SA default apportionment method (BGR16)

includes certain amounts in the denominator, such as dividends and other passive income such as interest. This is unique to SA, and potentially distorts the fairness and reasonability of the apportionment method, reducing the input credit a vendor is able to claim back from SARS. It is common knowledge that in SA the debate around the fairness of the turnover-based method is ongoing. The DTC in its report to the Minister of Finance pointed out that the formula in its current form hardly ever meets any of the criteria for a turnover-based method to be a fair and reasonable basis for financial institutions. The fact that receipts such as dividends and other passive income, against which very little or no expenses are incurred, are included in the formula, adds to the debate that the formula in its current form is not fair to businesses. It is submitted that receipts in respect of the disposal of cryptocurrency may, in at least certain circumstances, merit inclusion on this list.

In comparison, the EU apportionment method allows certain exclusions from determination of the deductible portion, such as turnover attributable to incidental¹⁷⁰ real estate and financial transactions (Article 135(1) (b)-(g)). To the extent that financial transactions such as cryptocurrency transactions are excluded from the denominator of the EU apportionment formula, this will prevent the growth of cryptocurrency transactions in the EU from distorting or exaggerating apportionment calculations.

The EU method further also allows Member States of the EU a couple of ‘relief’ measures, which makes it more flexible than the SA BGR16 method. Some of these measures include allowing a business to determine a proportion for each sector of its business, and allowing a business to make the deduction on the basis of the use made of all or part of the goods and services. It should therefore be understandable that there seems to be more consensus in the use of the turnover method, with 70% of Member States favouring the turnover-based method. It does appear that the EU apportionment method is a more fair and reasonable method compared to BGR16.

From the analysis performed in this chapter, it is clear that both SA and EU countries exempt cryptocurrency transactions, and they all use the turnover apportionment method. However, if the EU accepts that cryptocurrency transactions fall within the exclusions from the denominator of the turnover apportionment method, then the growth of cryptocurrency transactions is less likely to distort, exaggerate or cause dissatisfaction in VAT apportionment in the EU. However, it would seem likely to have that effect in SA. The growth of cryptocurrencies in SA makes it imperative that SA revisit its apportionment formula with a view to excluding non-cost consuming turnover amounts like interest and dividends and, in particular, cryptocurrencies.

In this respect, it is respectfully submitted that National Treasury’s view that “such a vendor must accept the fact that the nature of its business has fundamentally changed from one making

¹⁷⁰ Incidental – In Finanzamt Hildesheim v BLC Baumarkt GmbH & Co. KG [2012] C-511/10 (8 November 2012) at 64 - The court mentioned that “incidental transactions are likely to be those that involve only very limited use of assets or services subject to VAT”. The court noted that even where income from financial transactions is greater than the income generated from the taxpayer’s main activity, this does not automatically exclude such transaction from the classification as an incidental transaction.

wholly taxable supplies to one making mixed supplies and that the usual provisions of the VAT Act relating to mixed supplies and apportionment will apply”¹⁷¹ should be revisited with a view to determining an approach that is more nuanced and far-sighted.

CHAPTER 6 - CONCLUSION AND RECOMMENDATIONS

6.1 CONCLUSION

In this final chapter the author will reflect on certain areas of the study in answering each main/primary research question. The author will draw conclusions from the results of the study and make recommendations on the issues identified, and will indicate certain areas for further research.

6.1.1 Primary research objective 1

The first research objective was to determine if there will be a compliance risk or impact to the fiscus through the trading in cryptocurrencies by a vendor resulting in mixed supplies and apportionment issues that could lead to possible VAT leakage. To conclude on the first research objective, the author will reflect on the observations drawn from the discussions in chapter 3 and chapter 4.

In Chapter 4 the author identified a number of ways in which cryptocurrencies have the potential to increase compliance risk and impact the fiscus. The primary risks identified were the possible failure to apply apportionment; incorrect apportionment; over-apportionment; failure to register as a VAT vendor; and incorrect classification of transactions. These risks exist in both the buy/sell and payment use cases. New CASPs are likely to be more exposed to these risks than established financial service providers. The author therefore concludes that there is likely to be a compliance risk with regards to VAT apportionment which has the potential to lead to VAT leakage for the fiscus or alternatively for the taxpayer. The author is of the view that just as much as there exists the possibility of VAT cascading arising from financial services supplied to taxable entities, there now also exists the possibility of non-compliance or failure to apply apportionment correctly as VAT-exempt cryptocurrency transactions cause more businesses to make mixed supplies.

The important issues arising from the application of VAT apportionment formulae were discussed under sections 3.10 and 3.11 of chapter 3. One of the current issues is that in SA there is only one pre-approved VAT apportionment method, called the ‘standard turnover method’ (BGR16). This calculates the total value of all taxable supplies as a ratio of all income received. The inclusion of passive income items, such as dividend and interest income, is unique to the apportionment method used in SA. To date, this has brought the appropriateness or fairness of the current formula into question. Where the formula yields an apportionment ratio/percentage of 95% or more, the full amount of input VAT incurred on mixed expenses may be deducted (referred as the *de minimis rule*).

¹⁷¹ National Treasury, (2018). ‘Draft Response Document -2018 TLAB and 2017 TALAB’ at 32&33, available at <http://www.treasury.gov.za/public%20comments/TLAB>, accessed on 06 November 2020.

The debate between taxpayers and SARS as to what constitutes a fair and appropriate apportionment method is ongoing. To this end, the DTC in its final report on VAT to the Minister of Finance expressed the view that BGR16 does not meet the criteria of being fair and reasonable to financial institutions which have irrecoverable VAT, and is further distorted by the inclusion in the denominator of the formula of any amounts received by or accrued to the financial institution, regardless of their associated resource consumption. This therefore places emphasis on the appropriateness of the current apportionment formula.

6.1.2 Primary research objective 2

The second primary research objective was to compare the classification of cryptocurrencies within the SA VAT system to the approach taken by foreign jurisdictions. To answer the second research question the author will draw from the discussions in sections 5.1 and 5.2 respectively.

Firstly, it is observed from the literature that interpretation of the VAT legislation with regards to cryptocurrencies in the EU and elsewhere was developed a few years before SA finally made a classification in terms of the VAT treatment of related cryptocurrencies.

Secondly, in the EU the interpretation of VAT legislation with regards to cryptocurrencies was determined and confirmed in 2015 through a landmark judgment in *Skatterverket vs Hedqvist*. In this matter, The CJEU found that the sale and purchase of bitcoins should be considered a service exempted from VAT. European countries were required to henceforth apply the judgment, while countries outside Europe later closely followed the classification determined in the Hedqvist judgment, with the exception of one or two countries. (Refer discussion under 5.2).

The development of the VAT response with regards to cryptocurrencies in SA was not determined through a court case judgment, instead it followed a consultative tax law amendment process (discussed in Chapter 1). The outcome was that cryptocurrency transactions should be included under financial services and be exempt from VAT. It should be noted that financial services are specifically included under these sections of both VAT legislations to alleviate the difficulties connected with determining the taxable amount and the amount of VAT deductible.

To conclude, the author submits, after observing the above commentary and facts, that the treatment that SA has adopted for the classification of cryptocurrencies for VAT purposes is comparable to other countries. Legislation might not have developed in the same way, but the current classification that cryptocurrencies are exempt financial services are the same for SA and most foreign jurisdictions observed in the study.

From the comparison performed, however, the EU method appears to apply a more appropriate and fair method of apportionment than SA, as the EU turnover formula is more flexible and allows for adjustment for potentially distorting items, such as interest and dividends. The EU also allows Member States certain ‘relief’ measures. Even though cryptocurrencies have the potential to amplify VAT apportionment inequities, it does appear that some countries have measures in place that at least partially mitigate against these issues in ways that SA is not

currently doing. These observations support the author's view that such VAT apportionment issues could lead to VAT leakage in SA.

6.2 RECOMMENDATIONS

The author recommends that both merchants and CASPs acquire the necessary knowledge and information about the financial services industry and VAT legislation pertaining to financial services transactions. This knowledge could be acquired either internally through training, or from an external source such as SARS or professional expert advice. This recommendation should hopefully assist in reducing non-compliance with apportionment rules, incorrect VAT apportionment, and incorrect classification of cryptocurrency transactions.

The author also recommends that there be clear communication, training and pronouncements around the requirements to register as a VAT vendor for businesses, and especially for new CASPs engaging in cryptocurrency trading, since there will also likely make qualifying taxable supplies such as withdrawal fees, transaction fees, and commission associated with cryptocurrency trading.

The author also believes that it is imperative that SA review its turnover-based method of apportionment contained in BGR16 with a view to excluding non-cost consuming turnover amounts like interest, dividends, and cryptocurrencies in particular. This would align with the present approach in EU Member States with regard to interest and dividends. This recommendation should ideally address some of the shortcomings in the VAT recovery system and would mitigate against the risk of non-compliance that could lead to VAT leakage.

The author further recommends that SA consider alternative apportionment methods that can be used by companies and not apply the BGR16 universally to all types of businesses. In this respect, SA may take guidance from the 'relief' measures offered to businesses in the EU for which the turnover-based method of apportionment offers inequitable results.

6.3 AREAS FOR FURTHER RESEARCH

The author recommends further research in the following areas:

To determine if the South African Tax Infrastructure (collection, detection, administration, enforcement, regulation, etc) is equipped and ready for the challenges of the digital economy, including challenges related to local and foreign cryptocurrency transaction trading.

Alternative automation tax collection methods in SA to deal with the ever fast evolving digital economy involving cryptocurrency transactions to effectively identify and capture cryptocurrency transactions from the different trading platforms in order to close any tax revenue collection loopholes.

(25 451 words ,excluding footnotes and textboxes)

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