

# **The scope for multilateral international co-operation in tax affairs**

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## I. INTRODUCTION

### *(a) Background*

Action 15 of the Organisation for Economic Co-operation and Development's Base Erosion and Profit-Shifting Project envisages the creation of a multilateral instrument that provides a new approach to international tax matters and addresses the 'evolving nature of the global economy'.<sup>1</sup>

Existing multilateral instruments and methods which adequately address international tax law issues are few and far between. There is historical resistance to a rigid scheme which does not necessarily cater for each States' needs, or which inhibits a State's abilities to react to changing economic conditions.

One example of large-scale multilateral co-operation in tax is the Convention on Mutual Administrative Assistance in Tax Matters, which was signed by 15 member states in 1988.<sup>2</sup> While it was not the first example of multilateral co-operation in tax affairs, it did set a new bar for the sharing of information between member states. There have been other examples of co-operation since then, and more may yet arise. This raises the question of how far international multilateral co-operation might go to address current tax issues.

### *(b) Purpose and Scope*

The purpose of this dissertation is to identify what is contemplated by Action 15 of the BEPS Report, how the multilateral aspects of the Convention on Mutual Administrative Assistance in Tax Matters and other instruments could be extended to better address the mischief at which they are aimed, and in particular whether a universal multilateral double taxation convention or universal tax affairs treaty is plausible for this purpose.

Since the latter topic is potentially very large in scope, for the purposes of this paper, the focus will be limited to the selected issues and concepts taken from the

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<sup>1</sup> OECD *OECD/20 Base Erosion and Profit Shifting Project: Action 15: A Mandate for the Development of a Multilateral Instrument on Tax Treaty Measures to Tackle BEPS* (2015).

<sup>2</sup> Convention on Mutual Administrative Assistance in Tax Matters, 1988.

examination of Action 15 and other existing multilateral instruments related to international tax law issues.

*(c) Overview*

Part II of this dissertation is a brief history of bilateralism in international tax law. Part III will explain the details and scope of the various existing multilateral international tax law instruments, which will be followed in Part IV with an analysis of the theoretical issues surrounding the multilateral aspects of the existing instruments in an international law and international political economy context. Part V examines how multilateralism may be better suited to addressing double taxation than bilateralism, and Part VI will conclude the dissertation by addressing the extension of the existing instruments to a completely universal international tax law treaty.

*(d) Literature review*

The topic of multilateralism is not a new field of interest – there have been several works related to multilateralism in different contexts. These are briefly outlined below in terms of their relevance to the topic at hand.

Blum covered in depth the various schools of thought on systems of international law. However, while brief mention is made of multilateralism in international tax law, Blum's article is a more general piece dealing with multilateralism in a broader sense.

Zagaris in 2009 argued that increased efforts to create multilateral bonds in tax by the United States of America would go a long way to curbing tax avoidance in that jurisdiction.<sup>3</sup> However, this was limited to enforcement through membership in various multilateral organizations such as the IMF; Zagaris was happy with the continued reliance on existing bilateral double tax agreements, with a long term prospect of the creation of an 'international organization for taxation with universal membership',<sup>4</sup> no more detailed in definition than in those words. Furthermore, the article was focused on the United States, and was not sufficiently detailed, leaving room for more depth on the topic.

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<sup>3</sup> Zagaris, Bruce 'Use a Multilateral Approach in International Tax Enforcement', in W Elmore (ed) *Towards Tax Reform: Recommendations for President Obama's Task Force* (2009) 119-122.

<sup>4</sup> *Ibid* at 120.

Multilateralism in tax was more meaningfully covered to by Brooks in 2010.<sup>5</sup> Brooks was supportive of an alternative to bilateralism in international tax law as a means to further the harmonization and co-ordination thereof in an increasingly integrated world. However, that was prior to the OECD/G20 BEPS project's reports, and hence there is scope for a further analysis based on that development alone.

Finally, some elements of multilateralism from a South African perspective were investigated by Van Schalkwyk – particularly in terms of the exchange of information.<sup>6</sup> However, the focus of that paper examined how various multilateral treaties would impact upon Southern African taxpayers, not on the actual role of multilateralism on an international tax law level.

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<sup>5</sup> Brooks, Kim 'The Potential of Multilateral Tax Treaties' in M Lang et al. (eds) *Tax Treaties: Building Bridges between Law and Economics*, IBFD (2002) 211-223.

<sup>6</sup> JM Van Schalkwyk, An analysis of treaties for the exchange of information for tax purposes impacting the South African retail sector in the Southern African Development Community region (2015)

## II. BRIEF HISTORY OF BILATERALISM IN INTERNATIONAL TAX LAW

Bilateralism in treaties related to trade and economic affairs has been centuries in the making, and modern double tax agreements find their roots in further development of those trade agreements in the late 19<sup>th</sup> century.<sup>7</sup> The tax components of those agreements formed the basis of research conducted by the League of Nations in the 1920s.<sup>8</sup> This research consisted of several reports, the first of which was published in 1923 and related to the theory and principles surrounding double taxation.<sup>9</sup> This included the notion that residence should be adopted as the basis for taxation. Part of the terms of reference for discussion in the first report included the following question for discussion:

‘(2) Can any general principles be formulated as the basis for an international convention to remove the evil consequences of double taxation, or should conventions be made between particular countries, limited to their own immediate requirements? In the latter alternative, can such particular conventions be so framed as to be capable ultimately of being embodied in a general convention?’<sup>10</sup>

This question, clearly related to the potential creation of a single multilateral double tax treaty, does not appear to have been answered in that report. Several recommendations of the first report were nonetheless adopted by the League of Nations, and further questions related to double taxation were submitted to the Finance Committee thereof for consideration. A second report was published in 1925, which contained several recommendations culminating in the first draft of a model double tax convention in 1927.<sup>11</sup> It is also noteworthy that this convention was drafted alongside a model convention on administrative assistance in tax matters and two other related conventions, all of which were drafted on a bilateral basis.

In 1935, the Fiscal Committee of the League of Nations submitted a report on its fifth sitting, in which there was some discussion on a multilateral double tax treaty.<sup>12</sup> The report noted that only a few of the 33 states that had responded to a request for comment on a new draft double tax convention preferred the implementation of a

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<sup>7</sup> League of Nations Double Taxation and Tax Evasion: Report and Resolutions submitted by the Technical Experts to the Financial Committee (1925) at 11.

<sup>8</sup> Brooks *op cit* note 5 at 218-219.

<sup>9</sup> League of Nations *Report on Double Taxation* (1923).

<sup>10</sup> *Ibid* at 1.

<sup>11</sup> League of Nations Double Taxation and Tax Evasion: Report presented by the Technical Experts on Double Taxation and Tax Evasion (1927).

<sup>12</sup> League of Nations Fiscal Committee: Report to the Council on the Fifth Session of the Committee (1935).

multilateral agreement.<sup>13</sup> The Committee itself concurred with the majority in favour of a system of bilateral agreements, with the simple argument that “more progress” would result from these agreements and that they were generally “more appropriate”, without any further substantiation, but noted that there had been a proliferation of bilateral double tax treaties entered into between states since the adoption of the previous model convention.<sup>14</sup>

It is submitted, on analysis of the reports of the League of Nations, that while there was at the time the question of a single multilateral double tax treaty, it was never dealt with appropriately, since the practice of establishing bilateral treaties had already become popular and because it was trusted that a standard practice would emerge over time.

After the collapse of the League of Nations, the next attempt at the organisation and standardisation of bilateral double tax agreements was through the Organisation for Economic Co-operation and Development (the OECD) which published its own Model Convention in 1963,<sup>15</sup> followed by the United Nations’ Model Taxation Convention between Developed and Developing Countries in 1980.<sup>16</sup> These models have both been developed in the intervening years, but are limited to being models for bilateral agreements. It is estimated that there are currently over 3000 bilateral double tax agreements in operation.<sup>17</sup>

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<sup>13</sup> Ibid at 3-4.

<sup>14</sup> Ibid.

<sup>15</sup> OECD Model Tax Convention on Income and on Capital (1963).

<sup>16</sup> United Nations *Model Tax Convention* (1980).

<sup>17</sup> Brian Arnold ‘An Introduction to Tax Treaties’, United Nations, available at [www.un.org/esa/ffd/wp-content/uploads/2015/10/TT\\_Introduction\\_Eng.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2015/10/TT_Introduction_Eng.pdf), accessed on 20 September 2016.

### III. EXAMPLES OF MULTILATERALISM IN INTERNATIONAL TAX LAW

#### *(a) The Convention on Mutual Administrative Assistance in Tax Matters*

One of the more prominent examples of multilateralism operating in the international tax law environment is the Convention on Mutual Administrative Assistance in Tax Matters (hereinafter referred to as ‘CMAA’), which is a multilateral treaty developed in joint efforts by the Organisation for Economic Co-operation and Development and the Council of the Europe in 1988. It was initially only developed for operation within the OECD and Europe, but was subsequently amended by a Protocol in 2010 to allow any state to become a member.<sup>18</sup> The Convention is described by the OECD as ‘the most comprehensive exchange of information instrument for all forms of tax cooperation to tackle tax evasion and tax avoidance’,<sup>19</sup> and had a membership of 108 jurisdictions as of January 2017.<sup>20</sup>

The purpose of the CMAA, in terms of Article 1(1) thereof, is for the party states to ‘provide administrative assistance to each other in tax matters’,<sup>21</sup> which is a seemingly broad phrase.

In Article 1(2) of the CMAA, this administrative assistance is described as comprising:

- ‘a. exchange of information, including simultaneous tax examinations and participation in tax examinations abroad;
- b. assistance in recovery, including measures of conservancy; and
- c. service of documents.’<sup>22</sup>

In furtherance of the exchange of information referred to in Article 1(2)(a) of the CMAA, the provisions thereof indicate that party states are to provide information – either voluntarily or automatically – or request information that is ‘foreseeably relevant for the administration or enforcement of their domestic laws concerning the

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<sup>18</sup> Supra note 2.

<sup>19</sup> OECD ‘Convention on Mutual Administrative Assistance in Tax Matters’ available at [oecd.org/tax/exchange-of-tax-information/convention-on-mutual-assistance-in-tax-matters.htm](http://oecd.org/tax/exchange-of-tax-information/convention-on-mutual-assistance-in-tax-matters.htm), accessed on 12 January 2017.

<sup>20</sup> Ibid.

<sup>21</sup> Supra note 2 at Art 1(1).

<sup>22</sup> Ibid at Art 1(2).

taxes covered by this Convention'.<sup>23</sup> The taxes covered are outlined in Article 2(1) and include income taxes, capital gain tax, and wealth taxes.

The language of the Article indicates that its scope is broad, and the wording of Sub-Article (1)(b)(K) in particular implies that it can be used for any perceivable tax. It might be noted that no direct reference is made to taxes on dividends, royalties or interest, for example, while they are more prominent in the OECD Model Tax Convention. This is explained in the Commentary to the CMAA, which indicates that it is each signatory's prerogative to classify the taxes they levy as they deem them to fit into the provided categories.<sup>24</sup>

While it could be argued that this prerogative allows for party states to exercise some form of sovereignty in respect of their domestic tax law system, it might also simply be that the differences between various tax law systems are too vast for the CMAA to comprehensively cover. It would thus be easier for each state to classify their taxes themselves and so simplify the implementation and operation of the CMAA.

In terms of the party state obligations, Articles 5, 6 and 7 deal with the exchange of information. Article 5 deals with the exchange of information by request between signatories, and states that when a party state makes a request for any information referred to in Article 4 to another party state, the other party state shall supply such information.<sup>25</sup> Article 6 provides that party states can form their own procedures – in what amount to bilateral agreements – in respect of particular types of information.<sup>26</sup>

Article 7 provides for the spontaneous supply of information from one party state to another. Such provision of information must occur when:

- 'a. the first-mentioned Party has grounds for supposing that there may be a loss of tax in the other Party;
- b. a person liable to tax obtains a reduction in or an exemption from tax in the first-mentioned Party which would give rise to an increase in tax or to liability to tax in the other Party;

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<sup>23</sup> Article 4(1).

<sup>24</sup> OECD *Convention on Mutual Administrative Assistance in Tax Matters: Commentary on the Provision of the Convention* at 38-39.

<sup>25</sup> *Supra* (note 2) at Art 5.

<sup>26</sup> *Ibid* at Art 6.

c. business dealings between a person liable to tax in a Party and a person liable to tax in another Party are conducted through one or more countries in such a way that a saving in tax may result in one or the other Party or in both;

d. a Party has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises;

e. information forwarded to the first-mentioned Party by the other Party has enabled information to be obtained which may be relevant in assessing liability to tax in the latter Party.<sup>27</sup>

Article 7 thus seems to provide for the automatic right to information in respect of some of the most prominent challenges faced in the tax context at present, particularly transfer pricing and base erosion and profit shifting.

The aforementioned Articles seem to imply that there are rather onerous burdens placed on party states, and this brings about the question of whether it can be considered rational for a state to enter a treaty such as the CMAA considering the extent to which state sovereignty appears to be limited. This will be dealt with in Part 4 below.

***(b) Multilateral Competent Authority Agreement***

In January 2016, 31 states signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports ('MCAA'),<sup>28</sup> an agreement envisaged by Action 13 of the OECD BEPS Report.<sup>29</sup> The MCAA created new reporting standards to address transfer pricing issues, and is thus of a similar nature to the CMAA – in fact, it appears to be an extension thereof, and only operates in respect of states who are parties to the CMAA.

The MCAA does not create any obligations beyond requiring member states to file Country-by-Country reports on Multi-national Enterprises ('MNEs') operating within their jurisdiction, and enacting domestic laws requiring such MNEs to file their own reports. While this may go some way to helping member states combat transfer pricing issues, this does not go any further than the CMAA to change the broader

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<sup>27</sup> Ibid at Art 7.

<sup>28</sup> Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports, 2016.

<sup>29</sup> OECD OECD/G20 Base Erosion and Profit Shifting Project: Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting (2015).

international tax law regime, other than defining a different type of information to be exchanged and placing more obligations on MNEs.

*(c) BEPS Report Action 15*

Another outcome of the OECD's BEPS report is Action 15, in which a mandate has been created in respect of a multilateral instrument to address bilateral double tax treaties. In its own words, Action 15 states that:

‘interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.’<sup>30</sup>

The actual Mandate created by this Action is more descriptive regarding what it entails, with its objective stating that the multilateral instrument concerned will be developed to ‘modify existing bilateral tax treaties solely in order to swiftly implement the tax treaty measures developed in the course of the OECD-G20 BEPS Project’.<sup>31</sup> The word ‘solely’ is indicative of the limited scope of the mandate. It also only refers to modifying existing bilateral treaties – not replacing them. However, it is explained that the intended multilateral instrument will act as a means to update all existing bilateral double tax agreements that follow the OECD model without having to renegotiate each of them individually, thus saving time and resources, and the urgency of dealing with base erosion and profit shifting issues is used as the rationale for the need to do so.

In a sense, the contents of this multilateral instrument would have to be agreed to by each signatory and hence have to be appealing to each party. It can be argued that depending on its structure and wording, the very operation of this multilateral instrument might have the same effect as a single multilateral double tax agreement, but at the time of writing, it is unknown what the actual content of such an instrument will be, or how far it will go beyond the various BEPS Project Actions outlined in Articles 9 and 10 of Action 15.<sup>32</sup>

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<sup>30</sup> Op cit note 1 at 3.

<sup>31</sup> Ibid at 4.

<sup>32</sup> Ibid. Reference in particular is made in the Mandate to Actions 2, 6, 7 and 14 of the BEPS Project.

It is also unclear as to whom the new multilateral instrument would apply. While it is obvious that it would apply to those who sign the multilateral instrument, it is questionable whether it would apply only to those agreements between co-signatories to the multilateral instrument. It is furthermore doubtful whether it could apply to those agreements based on the OECD Model Tax Convention, considering that there are perhaps multiple variations on the usage of that model.

With all these questions raised, it is submitted that the proposed multilateral instrument will likely not have the desired effect in changing all bilateral agreements. It will also certainly not have the effect of creating a universal multilateral double tax convention.

***(d) Regional multilateral agreements***

There are also some examples of regional multilateral tax agreements. For example, the members of the South Asian Association for Regional Cooperation have signed a 'Limited Multilateral Agreement' for the purposes of 'Avoidance of Double Taxation and Mutual Administrative Assistance in Tax Matters'.<sup>33</sup> While its name seems to suggest that it addresses the treatment of income that is subject to tax in multiple jurisdictions, it does not actually do so. Parts of the agreement read very similarly to the OECD CMAA, if perhaps much more briefly, but is tailored specifically to the South Asian regional grouping.

It is noteworthy that the SAARC agreement precedes the protocol to the Amended CMAA by virtue of it having been signed in 2005. At the time, the SAARC countries were not part of the OECD and would not have been able to sign the CMAA - thus they would not have been able to receive the assistance it provided from existing members. It might thus be seen as a pioneering attempt by developing countries to co-operate in addressing multinational tax issues in the region.

However, while the treaty itself might have been progressive in its intention, the implementation thereof was not without problems. India, the country with the largest economy in that regional grouping, did not ratify the treaty until 2011.

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<sup>33</sup> SAARC Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance in Tax Matters, 2005.

The Nordic Double Tax Treaty,<sup>34</sup> as it is commonly referred to in English, is a multilateral double tax agreement entered into between the various states in the geographical region of Scandinavia, including Iceland and the Faroe Islands. It is one of the older multilateral tax instruments, having been signed and entered into by the member states on various dates during 1996 and 1997, and having effect from 1 January 1998. It is a successor to a line of multilateral double tax treaties between the member states which actually started in 1983.

The treaty itself is structured in a manner similar to the OECD model convention on double tax agreements, although with some differences. Given that it consists of multiple member-states, there are some provisions which do not apply to all member states in the same manner, but these relate more to the functioning of the treaty itself, not to the substantive provisions.

In contrast to the SAARC treaty, Helminen argues that the similarities between the member states of the Nordic Treaty, in terms of culture, socio-economic circumstances, as well as legal and tax systems have all contributed to it allegedly being successful in its operation.<sup>35</sup> Of equal importance in that instance is the limited number of signatories – being only five.<sup>36</sup> It is submitted that the corollary of this argument might be that any treaty operating over a broader base, with more variables and diversity in membership, would likely not share the same success.

One might deduce from the success of the Nordic Treaty that multilateralism can only work when the objectives of the treaty are shared by each member state with the requisite political will.

In order to understand why this argument is made, one needs to understand the issues of sovereignty related to multilateral treaties and how the circumstances thereof create different problems than is experienced with bilateral treaties.

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<sup>34</sup> Convention between the Nordic countries to avoid double taxation with respect to taxes on income and wealth (translated from Danish).

<sup>35</sup> Marjaana Helminen *The Nordic Multilateral Tax Treaty as a Model for a Multilateral EU Tax Treaty* (2013) at 4.

<sup>36</sup> *Ibid.*

#### IV. SOVEREIGNTY AND MULTILATERALISM

State sovereignty might be defined as the notion that each state has the autonomy and authority to make decisions in respect of its own laws and policies.<sup>37</sup> When any international agreement, treaty or convention creates obligations for signatories, the issue of sovereignty arises as the signatories are seemingly signing away powers or becoming obligated to assist others to exercise their own sovereign rights. This ‘waiver’ of sovereignty might be as a result of having the state’s citizens’ rights be affected by the treaty, by the state itself being limited in legislative power, or by having to do something for another state which it would ordinarily not be required to do.

Sovereignty, claims Blum,<sup>38</sup> is of paramount importance to the so-called ‘Unilateralist’ school of thought.<sup>39</sup> Unilateralists are most concerned with state sovereignty, patriotism or nationalism, protected interests and the power of individual states. A state’s sovereignty, represented by its ability to freely contract or otherwise act independently from external pressure or other external factors, is thus considered desirable, and should not be limited by a strict ‘legal system’ in which obligations are imposed and governed by any other party. According to Blum, the popularity of the Unilateralist way of thought is the reason for the lack of a comprehensive universal tax treaty.<sup>40</sup>

An example of unilateralist expression is through the employment of competitive advantages through domestic tax laws to make investment or residence in a particular state an attractive opportunity for potential taxpayers looking to reduce their tax liability. A state might do so by reducing the tax rate of, or making exempt from tax a certain type of income, or exempt certain individuals from tax. It could even amount to tax regimes which are set up specifically to allow potential taxpayers to hide their taxable income.

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<sup>37</sup> See the Oxford English Dictionary definition of ‘Sovereignty’ available at [en.oxforddictionaries.com/definitions/sovereignty](http://en.oxforddictionaries.com/definitions/sovereignty), accessed on 19 September 2016.

<sup>38</sup> Gabriella Blum ‘Bilateralism, Multilateralism, and the Architecture of International Law’ (2008) 49 *Harvard International Law Journal* 323.

<sup>39</sup> *Ibid* at 324.

<sup>40</sup> *Ibid* at 375-6

So-called ‘tax havens’ in the past have made particular use of this method to attract large-scale foreign direct investment.<sup>41</sup> For the purposes of this dissertation, a tax haven is equated to one in which harmful preferential tax regimes exist, allowing those activities that unfairly erode the tax bases of other countries and distort the location of capital and services.<sup>42</sup>

There are two potential responses to the unilateralist approach. The first is for states to negotiate in good faith with other states as individual parties, thus forming agreements that only act between that state and any given other state. This would represent bilateralism. The second response is for multiple states to co-operate and work together in a more integrated fashion for the purposes of attaining a certain objective, which follows the multilateralist approach.

There are varying degrees of multilateralism. A multilateral act can take the form of a cluster of states working together – in the tax law context, it can take the form of, for example, one of the existing regional multilateral double tax agreements mentioned above. It can also involve a much more complex structure to the extent that all or close to all states in the world co-operate. This latter form is an element of the Universalist approach.<sup>43</sup>

Universalists believe that international law would operate more efficiently with a harmonised ‘international law’ built on an almost democratic notion of states working together, and would be developed much like a typical domestic legal system.

Blum believes that there is a global shift from the Unilateralist train of thought to the Universalist, and that this is a modernisation of the international legal system that owes much to globalisation and the rise of international organisations such as the United Nations and the European Union.<sup>44</sup> This assertion, it is submitted, may not actually be supported by current affairs, as the referendum held in the United Kingdom to leave the European Union illustrated that deference to a regional

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<sup>41</sup> OECD Towards Global Tax Co-operation: report to the 2000 ministerial council meeting and recommendations by the committee on fiscal affairs: Progress in identifying and eliminating Harmful Tax Practices (2000) at 5.

<sup>42</sup> Ibid.

<sup>43</sup> Blum Op cit note 38 at 324.

<sup>44</sup> Ibid at 332.

authority is not necessarily popular, particularly when the citizens of a particular state feel threatened by the changes that an apparent loss of sovereignty brings.

It is furthermore submitted that the results of the 2016 Presidential Election in the United States of America were based partially on a mercantilist ticket, with the view to cancelling several trade and tax agreements entered into by previous administrations and replacing them with new agreements offering more favourable terms for the United States. This, it is submitted, demonstrates that the trend towards globalism, and hence universalism, is not necessarily as popular as may have been believed in the past.

However, assuming that the theory relating to the schools of universalism and multilateralism in itself is correct, one needs to apply the theory to existing law to see how the instrument is affected by the theory. On application of the theory to the CMAA, for example, it could be argued that by ‘waiving’ some of its sovereignty, each signatory gains ‘rights’ which can be exercised to assist in the enforcement of their own domestic tax laws. It seems to offer a zero-sum game in the trade of sovereignty. In other words, what is lost by allowing another state to make requests to enforce their domestic tax laws is gained by receiving the same rights as a *quid pro quo*, and no sovereignty is ultimately lost.

It might alternatively be argued that the international nature of modern tax law is of such import that it requires that states combine the ‘legal power’ of their tax authorities in order to combat the pitting of various domestic tax law regimes against each other. This implies that instead of losing any sovereignty, states would be combining their sovereignty to combat the abuse of domestic tax laws and the bilateral double tax treaty system by non-state entities.

On the other hand, the CMAA does in some respects defer to sovereignty in the form of domestic law, meaning that there are hurdles limiting the CMAA’s effectiveness or efficiency. For example, Article 21 of the CMAA states that none of its provisions shall affect the rights and safeguards granted to persons by any law or

practice of a requested state (being a state requested to provide information to another state).<sup>45</sup>

In South Africa, one might consider the effects of Chapter 6 of the Tax Administration Act,<sup>46</sup> Section 68 of which states that ‘a SARS official must preserve the secrecy of taxpayer information and may not disclose taxpayer information to a person who is not a SARS official.’<sup>47</sup>

However, this is subject to the proviso in Section 68(2) that SARS may disclose information in the course of performance of duties under a tax Act or customs and excise legislation. A ‘tax Act’ is defined in the Tax Administration Act as ‘this Act or an Act, or portion of an Act, referred to in section 4 of the SARS Act’.<sup>48</sup> Section 4 of the SARS Act pertains to the function of the South African Revenue Service and states that it must:

‘secure the efficient and effective, and widest possible, enforcement of-

- (i) the national legislation listed in Schedule 1; and
- (ii) any other legislation concerning the collection of revenue ... that may be assigned to SARS in terms of either legislation or an agreement between SARS and the organ of state or institution concerned;...’<sup>49</sup>

The national legislation listed in Schedule 1 of the SARS Act is a limited list of specific legislation, including the Income Tax Act and the VAT Act amongst others. There is no mention of treaties between the Republic of South Africa and other states.

Section 108 of the Income Tax Act states that the Republic may enter into agreements with other states for, amongst other things, the ‘rendering of reciprocal assistance in the administration of and the collection of taxes’.<sup>50</sup> It furthermore states that any such agreement, once the provisions of Section 231 of the Constitution have been met, shall be deemed to be part of the Income Tax Act, effectively making the

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<sup>45</sup> Supra note 2 at Art 21.

<sup>46</sup> Act 28 of 2011.

<sup>47</sup> Ibid at S68.

<sup>48</sup> Ibid at S1.

<sup>49</sup> Act 34 of 1997 at S4.

<sup>50</sup> Act 58 of 1962 at S108.

Convention a Tax Act for the purposes of the proviso to the prohibition on disclosure of information in the Tax Administration Act.<sup>51</sup>

Of course, Section 108(5) of the Income Tax Act specifically provides that the prohibition on disclosure does not apply when it is necessary for the provision or receipt of administrative assistance in terms of a treaty, but it is perhaps prudent to ensure that both the Income Tax Act and the Tax Administration Act do not conflict, which might allow SARS to rely on one Act to prevent the operation of the other and so derogate from their obligations in terms of a treaty.

On the other hand, it does not appear to have been established what the effect of the Protection of Personal Information Act<sup>52</sup> or of any other domestic legislation (including the Financial Intelligence Centres Act)<sup>53</sup> is on the operation of CMAA. If there were challenges in the courts of South Africa based on other laws related to privacy, or on the constitutionality of SARS's compliance with the CMAA, it could render it redundant.

However, it is submitted that South Africa's specific provision for the operation of administrative assistance treaties such as the CMAA, as well as consistency throughout the tax legislation, shows that it has accepted the slight loss of sovereignty in the form of the ability to enforce laws related to confidentiality in tax affairs. Of course, this loss is limited to the extent that the disclosure of information must be deemed necessary for the provision of assistance. In return, the Republic hopes that any needed reciprocal assistance will be received. This is obviously not a certainty, as it still rests with the other member states to fulfil their part of the agreement when requested, or with dispute resolution mechanisms should this not occur.

Another illustration of the theory of multilateralism and its interaction with sovereignty can be found in the decision of the European Commission in the matter of Alleged State Aid Implemented by Ireland to Apple Inc.,<sup>54</sup> in which the European Commission ordered Ireland to recover aid it effectively provided to Apple after two

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<sup>51</sup> Ibid.

<sup>52</sup> Act 4 of 2013.

<sup>53</sup> Act 38 of 2001.

<sup>54</sup> Commission Decision on Alleged State Aid Implemented by Ireland SA.38373 (2014/C) (ex 2014/NN) (ex 2014/CP) (European Commission).

tax rulings made in 1991 and 2007 provided two entities connected to Apple Inc. with an effective tax rate of 0.005 percent by 2014, which was a reduction from 1 percent in 2003.<sup>55</sup>

In that case, Apple's subsidiary, Apple Operations International, had established Apple Sales International (ASI) and Apple Operations Europe (AOE), both incorporated within the Republic of Ireland.<sup>56</sup> These companies furthermore each had head offices situated in the United States of America, although these head offices were perhaps nominal and did not attract any tax liability; neither of the companies was considered resident in the US by the United States' Internal Revenue Service. However, under Irish tax legislation – specifically, Section 23A of the Taxes Consolidation Act<sup>57</sup> – there were two exceptions which allowed for otherwise resident companies to be deemed non-resident in Ireland. The first exception was where the taxpayer was either listed in a foreign jurisdiction or controlled by a company resident in a foreign member state of a double tax treaty, which company or its subsidiaries conducted trading activity in Ireland.<sup>58</sup> The second exception was where the taxpayer was deemed to be resident in a foreign jurisdiction through the operation of a double tax treaty.<sup>59</sup>

ASI and AOE were both deemed by the Irish tax authority to be controlled by Apple Inc., which was resident in the United States, and hence the exception applied and both companies were deemed to be resident in the US, and hence not resident in Ireland. This effectively meant that they were not resident anywhere in the world, since neither company had any tax liability in any other country.

ASI and AOE therefore agreed with the Irish tax authority on a method for calculating the profit attributable to their Irish 'branches' in terms of Section 25 of their Taxes Consolidation Act.<sup>60</sup> Since the companies were not resident, they would only be taxed on income sourced in Ireland. A ruling was made by the tax authority in

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<sup>55</sup> European Commission 'Press Release: State Aid: Ireland gave illegal tax benefits to Apple worth up to €13 Billion' available at [Europa.eu/rapid/press-release\\_IP-16/2923\\_en.htm](http://Europa.eu/rapid/press-release_IP-16/2923_en.htm), accessed on 8 January 2016.

<sup>56</sup> Supra note 54 at 8.

<sup>57</sup> Taxes Consolidation Act 1997 (Ireland).

<sup>58</sup> Supra note 54 at 9-10.

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

1991, which was replaced by a second, similar ruling in 2007.<sup>61</sup> These rulings effectively allowed the companies to warp the profit allocation in respect of their Irish ‘branches’ by overvaluing their costs in Ireland attributable to other companies in the Apple group, and by overvaluing the profit attributed to the business activities of the head office.<sup>62</sup> This was in essence a form of transfer pricing.

This was eventually raised by the European Commission, which made enquiries regarding, amongst other things, the structure created by the rulings and how they compared with rulings granted to other non-resident taxpayers. It then opened an investigation on the grounds of the provision of state aid, which would be in breach of Article 107(1) of the Treaty on the Functioning of the European Union,<sup>63</sup> in that Ireland allowed Apple to gain large tax benefits by failing to enforce the arm’s length principle to connected party transactions.

Ireland made several averments in response, one being that since the rulings were provided in terms of legislation that constituted Irish law at the time, and since the arm’s length principle was not part of Irish law at that time, it had not actually provided any state aid to Apple.<sup>64</sup> Furthermore, the reason for the provision of the rulings, being that ASI and AOE were non-resident, was consistent with the laws of Ireland.<sup>65</sup>

The European Commission eventually upheld the charges and ordered Ireland to recover the unlawful aid, with interest.<sup>66</sup> What makes this a particularly interesting case is that Ireland was in opposition to the rulings constituting unlawful aid in the first place, and was now being ordered to recover something which it did not believe should be recovered in terms of its own laws.

This clearly demonstrates some of the issues with multilateralism and sovereignty. Ireland, being a sovereign state, believes that it is entitled not only to create its own laws, but also to enforce those laws as it seems fit. However, since it is

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<sup>61</sup> Ibid at 13.

<sup>62</sup> Ibid at 14.

<sup>63</sup> Consolidated Version of the Treaty on the Functioning of the European Union, 2012.

<sup>64</sup> Supra note 54 at 44.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid at 129.

also subject to the provisions of a multilateral treaty, being the aforementioned Treaty on the Functioning of the European Union and its associated treaties and regulations, it also has an obligation towards other states and a multilateral body which may conflict with its own domestic laws, which may also see a breakdown of its ability to enforce other laws due to a lack of legal certainty.

Ireland therefore displayed a unilateralist resistance to the loss of its sovereignty and opposed the imposition of a standard which was not in agreement with its own law. The key question which remains is what might happen if it then refuses to comply with an order made by a body which is imposing on its sovereignty, and what it would mean to the integrity of the multilateral body itself.

To explain why Ireland would have been so resistant to the investigation and subsequent hearing, one might consider that the enforcement of domestic tax law is of great importance for the protection of state sovereignty. This is because the ability of a state to govern itself and to enforce its sovereignty is largely determined by the resources at its disposal, a large component of which comes from the collection of revenue. If a state's revenue system is interfered with by a foreign source, that interference places at risk the ability of a state to collect revenue and by extension its ability to exert control over its domain.

In conclusion, therefore, tax law is vital to the sovereignty of a state and the efforts to create multilateral instruments which would affect a state's ability to collect revenue are bound to be resisted by the prevailing unilateralist attitude still present in the world today. Globalism, while on the rise for much of the 20<sup>th</sup> century, may not find itself having much more permanency if it continues to face the resistance it has in recent years.

## V. MULTILATERALISM IN DOUBLE TAX AGREEMENTS IN THEORY

Brooks describes the advantages and disadvantages of multilateralism, which take the form of facilitation of trade, reduction of evasion and avoidance, administrative advantages, and the potential to prevent tax competition.<sup>67</sup>

Trade might be facilitated through the increased co-operation that arises when states start aligning their economic and commercial affairs and so reduce double taxation which might serve as a barrier to entry in multiple markets.<sup>68</sup>

It is submitted that a second potential reason for the facilitation of trade is that multilateral double tax agreements would increase legal certainty within the member states, as they would have the effect of decreasing variations due to differing standards in the plethora of bilateral agreements. With increased simplicity and hence certainty, there may be higher levels of market confidence. Furthermore, the proliferation of multilateral treaties may also facilitate the creation of further multilateral trade agreements.

Multilateral double tax agreements would also reduce the level of treaty shopping – the process of identifying markets for investment based purely on the tax benefit that may be obtained by more favourable treaties – simply because there would be fewer treaties to choose from, and thus there would be fewer opportunities to abuse, and a decrease in tax avoidance.<sup>69</sup>

Tax avoidance and evasion would further be diminished by the pool of knowledge and information shared by a larger group of states, which would also mean that there are more participants in negotiations regarding transfer pricing issues and, for example, formulary apportionment.<sup>70</sup> There would thus be a greater willingness to depart from the constraints of bilateral treaties to become more creative with their solutions.

This pool of information may also assist with purely administrative functions, such as sharing skills and information related to the enforcement of purely domestic

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<sup>67</sup> Brooks op cit note 5 at 215.

<sup>68</sup> Ibid.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid at 216.

tax issues, or the organisation of a tax authority itself. It will also reduce the burden on weaker tax authorities to combat avoidance using cross-border transactions.

When addressing the last apparent advantage – that of preventing tax competition – one critical question which must be answered first is whether tax competition is something which should be prevented. This is where the application of the previous discussion on sovereignty begins to show that a typical state, being self-interested, would justify the use of double tax agreements to promote growth in its own tax base by arguing that for the purposes of retaining and promoting their sovereignty, they should not allow any other state to determine for them how they should conduct the running of their economy or financing their government. However, states are not the only stakeholders in the competitiveness of any particular state's tax system. Large multi-national corporations and other entities would be expected to make use of any advantage they could gain from a state's attempts to garner a larger tax base by moving their business to those jurisdictions, where one might expect some growth in the economy and employment as a result.

The issue, however, is that when these multi-national corporations are situated in a state in which they may expect tax liability, and where their direct investment is necessary to maintain the economy of that state, the government of that state would be reluctant to place that investment at risk by making any adverse decisions regarding the tax advantages that the multi-national corporations enjoy.

Tax competition, therefore, while potentially creating positive outcomes in the socio-economic circumstances of a state, and while it is considered part of the unilateralist school of thought, may create a situation where the tax sovereignty of a state is ceded to individuals and other high-wealth MNE's. Competition furthermore holds the decision-makers in government at ransom, in what Peters refers to as 'pressure from the tax law market'.<sup>71</sup>

For the purposes of this paper, and how it relates to issues of sovereignty, it may then be said that tax competition is not always a good thing bearing positive results. However, the very absence of tax competition is an unknown quantity, and the sudden

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<sup>71</sup> Cees Peters 'On the legitimacy of international tax' (2014) at 2.3.5.1.

loss of this competition may bring its own problems, not necessarily to the operation of tax law itself, but most likely to other socio-economic areas.

Multilateral double tax agreements would also be more effective in handling triangular cases. It occurs when the same income might be taxable in more than just two states.

For example, assume that Company A is a resident in Country X, and its permanent establishment in Country Y receives passive income from a source in Country Z. One would need to establish which state would be entitled to tax the income, and furthermore what the consequences of more than one jurisdiction taxing that same income would be.

Assume that Country Z taxes the income because that is where the income is sourced, and that Country Y would tax the income because it arises from a permanent establishment within that country. Finally, assume that Country X taxes the income in Country Z because it taxes worldwide income.

Assuming that all the DTAs concluded between the countries are the same and are based on the OECD model, the bilateral Double Tax Agreements might curtail double taxation to a certain extent in these cases. However, only the one between countries X and Y and X and Z would apply since the permanent establishment would most likely not be entitled to treaty benefits in the eyes of Country Y.

If the income was interest income, for example, payable by a third party in Country Z to the permanent establishment in Country Y, the relevant Article of the DTA (most likely Article 11) would apply and the income would be subject to limited tax in Country Z, while possibly being subject to tax at the full rate in Country X.

Country Y would probably also tax the full amount, but Country X would relieve the double taxation in both states on application of its DTAs with those countries,<sup>72</sup> However, this would still mean that there is double taxation between Country Y and Country Z.

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<sup>72</sup> Op cit note 15 at Article 23A.

A multilateral double tax treaty would be better positioned to police such a situation. It could specifically address triangular cases, binding each state involved in the triangular case. A bilateral double tax agreement would only be binding on two states and would have no effect on the relationship between each signatory and the third-party state, meaning that any state or taxpayer which is inconvenienced by the triangular case would have no right to recourse. Furthermore, since the multilateral agreement replaces the individual bilateral double tax agreements, each state would simply refer to the same document and hence the same rules of double taxation would be binding on all of them. In a situation where there are multiple bilateral double tax agreements involved, the rules may not be the same and a potentially exploitable gap in the law may appear.

In conclusion, the benefits of multilateralism may outweigh the drawbacks, especially in relation to the governance of double taxation or triple taxation issues. However, the cost of implementation, at least in respect of the loss of competitive advantage, stands as a barrier to the emergence of broader multilateral treaties.

## VI. EXTENSION TO UNIVERSALISM

### (a) *Practical issues*

The role of international politics and the international political economy is undoubtedly important to developments in international law that result in a shift in the manner in which states generate revenue.

The most obvious threat to a universal tax treaty would be a lack of interest or political will. While the most obvious reason for a lack of political will is that it would result in states foregoing their tax sovereignty to some extent, it could also be due to mistrust or resistance to the loss of competitive advantage.

A universal tax treaty would have to be universally adopted. While it may not be an issue if one or two states in the world decide not to sign the treaty, broad-based non-adherence would create a situation where non-member states create their own international tax law system which may appear more attractive to taxpayers, inevitably necessitating further tax agreements between states party to the 'universal' tax treaty and those non-party states, and effectively restoring the tax treaty system to its current position. In other words, it would completely undermine the purpose of the universal tax treaty and render it useless.

There would have to be such a great necessity for buy-in and compliance that no state could offer any resistance to a universal treaty that binds all member states, and to which all states would have to be party. As an alternative, the universal treaty would have to become customary international law and thus binding upon all states, whether signatories or not. In terms of the Rome Statute, customary international law is created when there is evidence of a general practice accepted as law, although this can range from customary laws accepted and practiced by only a few states, to wide acceptance and acknowledgement thereof. Ordinary customary international law can also be neutered by treaty, or it can simply be ignored by a state with a blasé attitude towards international politics and diplomacy.

However, if the customary international law became *jus cogens*, or a peremptory norm, then it would be non-derogable. A peremptory norm, in terms of the Vienna Convention on the Law of Treaties (the Vienna Convention), is:

‘a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character.’<sup>73</sup>

The effect of Article 53 of the Vienna Convention is that any treaty which conflicts with a peremptory norm is void, and thus the possibility of creating any other treaty to somehow extricate a state from its obligations in terms of the universal tax treaty, or to create more favourable conditions between itself and another state, would be null and void. This, however, would not stop an informal but consistent practice which falls outside of the scope of the treaty, but which allows for its circumvention.

Ultimately, one would have to accept that the creation of a non-derogable norm relating to the entire international tax system is something which will not be achieved in the near or foreseeable future, if at all. As has been illustrated above, the history of attempts to create some form of common ground in international tax treaties has not produced many results – the mere existence of multiple models of bilateral double tax agreements being an example of the failure of a ‘one size fits all’ approach. Furthermore, a universal international tax law system would be enormously broad and complex in scope, would have to cover a vast amount of different factual instances, and would have to evolve over time to counter tax issues arising in the future. This does not lend itself to the creation of a non-derogable norm.

Supposing that there would be general acceptance of a universal tax treaty of some kind, the second issue is that of continued adherence. One method of ensuring sustained compliance would be through the use of sanctions imposed upon states which seek to undermine the universal double tax treaty. Such sanctions could be the imposition of trade and export bans, high customs, or even travel bans.

However, the marketed image of a universal multilateral double tax treaty should not be one of an imposition of heinous rules by a handful of powerful states upon a much larger group of weaker ‘dissidents’. Scare tactics and threats would be counterproductive to open engagement, co-operation and co-ordination in managing international tax affairs. Thus, penalties and sanctions may not be desirable; persuasion and appeals to a common rationality would most likely yield stronger

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<sup>73</sup> Vienna Convention on the Law of Treaties, 1969 at Art 53.

results. This might certainly have been the case after the 1998 report on Harmful Tax Practices issued by the OECD,<sup>74</sup> which looked at the role of perceived ‘Tax Havens’. As a result of the report and subsequent engagement to increase reporting standards, subsequent reports were issued, each detailing the various practices by states and tracking them over the years.<sup>75</sup>

**(b) *The composition of a universal double tax treaty***

While it can safely be concluded that the current consensus does not entail the creation of universal double tax agreements, one might consider what a universal multilateral double tax agreement would look like.

The provisions of a multilateral double tax agreement would not be too dissimilar from any particular bilateral treaty. However, the very crux of it being multilateral rests in the uniformity it provides. Hence, any particular provision in respect of source, residence and the operation of a treaty would have to be tailored so as to allow it to operate in respect of each party state.

Since the operation of any multilateral treaty will encounter difficulties in interpretation, and since the differences between domestic law systems is prone to creating mismatches, the definitions contained in the treaty will have to be specific enough and encompass multiple possibilities where, for example, an entity is treated differently in law from one jurisdiction to the next.

To ensure that it operates in the same manner throughout all member jurisdictions, and to prevent any one party from abusing the treaty to create an unfair competitive advantage, there would have to be a single dispute resolution adjudicator that would be bound by its own past rulings. Should there be found to be shortcomings in the wording of the convention by the adjudicator, these shortcomings would have to be raised with all member states, and amendments to the treaty would have to be put to a vote. Transparency and equality are therefore of paramount importance. This might particularly be the case for developing nations, who would not

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<sup>74</sup> OECD *Harmful Tax Competition* (1998).

<sup>75</sup> Cf. OECD op cit note 41.

necessarily be trusting of economically developed ones who have historically held the greater share of bargaining power.

To prevent the use of any consistent informal practice between two signatories, or between signatories and non-state entities, which practice is aimed at circumventing the universal tax treaty, reliance could be placed on a non-discrimination clause.

While it has been stated that it may be counter-productive to co-operation, this was in the context of forcing states to accede to entering the treaty to start with. After a universal treaty has been created, however, the situation is different, as all states would have willingly agreed to enter the treaty. Long-term adherence may necessitate harsh punishment for non-adherents, and so penalties and sanctions clause may be inevitable, as it may be insisted upon by some states to ensure that their co-operation does not result in exploitation and selective enforcement of the rules contained in the treaty. This penalties clause would relate to both contraventions of the treaty which negatively impact upon the rights provided by the treaty to any other state. However, it might also make provisions for penalties imposed on any state which attempts to withdraw from the treaty. These penalties would have to be sufficiently strong so as to act as a deterrent to defection – so strong as to make disengaging from the multilateral instrument nearly unthinkable, but not so strong as to discourage states from entering into the agreement in the first place. This balance would not be easily reached, but the most important factor in defining what an appropriate sanction would be, as mentioned above, is the necessity for the creation of the instrument. The greater the necessity for its formation, the greater the likelihood that states would be willing to take the potential penalties into the bargain.

Using necessity as a proverbial yardstick is moderately problematic in that the same level of necessity would not be felt by all states. There would surely be some states which are happy to conduct their affairs in a unilateral manner. For these states, there must be a benefit associated with entering the universal treaty. This benefit would most likely not be sourced in the substantive provisions of the treaty itself – if it were, they would sign the treaty without hesitation. It would most likely be in the form of a diplomatic solution found through negotiations with the states possessing the motivation to form the agreement.

In conclusion, while it is possible to conceive in general terms how a universal double tax treaty may be drafted, the greatest barrier to its creation is that it would most likely (at least at present) need to be imposed on unwilling states through harsh punitive measures, and as was argued earlier, without the necessary political will, a treaty will not operate successfully. Furthermore, with the differences in legal systems and interpretations, one standardised system of international tax law and perhaps domestic tax law would have to be developed, and it submitted that there is little prospect of universal agreement as to the structure of such a tax system.

## VII. CONCLUSION

It is submitted that while there is scope for a multilateral instrument which can address the weaknesses of bilateral tax treaties, such scope is currently limited by the existence of a plethora of differing domestic tax law systems, uneven economic conditions, diplomatic difficulties and resistance to a loss of sovereignty. However, with time and the growing need to combat abuse of the incumbent system, as well as other steps taken to facilitate international co-operation and the success of regional bloc treaties, it is clear that the current multilateral instruments might be used as a stepping stone to at least a multilateral treaty on double tax agreements, and possibly further to a limited universal multilateral double tax treaty. It has also been shown that such a universal treaty would not be altogether different to the existing bilateral instruments, though with the further development of multilateral instruments, there may arise new areas of concern relating to the operation thereof which will need to be addressed.

On the other hand, to put in place a universal tax system to be adopted by all states appears to be a leap too far, owing mostly to issues of power and politics, but also to the very nature of international tax law, which relates particularly to the relationships between states and not how the domestic tax laws of those states operate.

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# **The tax and exchange control consequences of virtual currency transactions in South Africa**

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Research dissertation/ research paper presented for the approval of Senate in fulfillment of part of the requirements for the Masters in Law in Tax Law in approved courses and a minor dissertation/ research paper. The other part of the requirement for this qualification was the completion of a programme of courses. I hereby declare that I have read and understood the regulations governing the submission of Masters in Law in Tax Law dissertations/ research papers, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation/ research paper conforms to those regulations.

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## I. INTRODUCTION

### (a) Background

Cryptocurrencies such as Bitcoin have seen a large increase in usage since their emergence in the last ten years. Part of the success of virtual currencies is the general lack of regulation by any central authority or state entity, as well as a substantial level of anonymity.

Trading volumes on only one of South Africa's Bitcoin exchanges show that approximately 48 180 Bitcoin was traded on that exchange in 2016,<sup>1</sup> and when compared to 2015 figures of about 38 600,<sup>2</sup> it is clear that there is a growing pattern of usage in South Africa's economy.

However, neither the South African Revenue Service and the South African Reserve Bank have yet properly addressed how income from various transactions related to Bitcoin are to be treated for the purposes of income tax or exchange control – especially since it can act as a means of bypassing the exchange control regulations. This lack of specific provision may be due to confusion as to the nature of Bitcoin as property.

By contrast, the Davis Tax Committee believes that 'South African legislators would be wise to consider the potential impact of virtual currencies like Bitcoins on tax compliance and to monitor international developments to determine the most suitable approach for in South Africa' and that even though 'Exchange controls seem – at least in the short term – a major defence... statutory provisions will be needed in the long run.'<sup>3</sup>

### (b) Purpose and Scope

This dissertation aims to answer two questions, namely whether Bitcoin should be treated any differently for the purposes of South African income tax law, and whether there should be any changes made to the Exchange Control Regulations. In answering this question, one will need to examine how various other states have dealt with

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<sup>1</sup> Coindesk 'Bitcoin price index chart' available at <http://www.coindesk.com/price/> accessed on 4 January 2017.

<sup>2</sup> Ibid.

<sup>3</sup> At 56.

Bitcoin in these respects, and also determine how Bitcoin may better be categorized for the purposes of South African law – in particular, whether Bitcoin should be treated as a currency for the purposes of both the Income Tax Act and the Exchange Control Regulations. There is no consideration of Value-Added Tax for the purposes of this paper, though it is likely that there may be VAT implications involved in Bitcoin transactions.

**(c) Overview**

Part II of this dissertation looks at the nature of Bitcoin and other cryptocurrencies, how they work and what types of tax-bearing transactions they generate. Part III examines the response that the South African organs of state have provided to Bitcoin, and how Bitcoin transactions should then be treated, while Part IV compares that response to various other states. Finally, Part V looks to provide a solution to income tax issues, and Part VI attempts to investigate and answer the problems related to exchange control.

## II. VIRTUAL CURRENCIES AND BITCOIN EXPLAINED

Virtual currencies are defined by the European Banking Authority as:

‘a digital representation of value that is neither issued by a central bank or public authority nor necessarily attached to a FC, but is accepted by natural or legal persons as a means of exchange and can be transferred, stored or traded electronically.’<sup>4</sup>

The European Central Bank shares a similar definition, and states that further defining characteristics are that virtual currencies are issued and controlled by their creators, and used by members of a specific virtual community.<sup>5</sup>

Finally, for the purposes of South African law, while there is no definition of a virtual currency in any legislation, a statement issued by the National Treasury identifies them as a ‘unit of account that is digitally or electronically created and stored’, that ‘members of the virtual community agree to accept these units as a representation of value in the same way that currency is accepted’, and finally that ‘virtual currencies operate without the authority of central banks, and are therefore not regulated.’<sup>6</sup>

The various definitions thus share common characteristics, such that for the purposes of this dissertation, a virtual currency can be defined as a digital, intangible means of exchange that is not regulated by a central authority or government.

A cryptocurrency is a form of virtual currency that uses cryptography to ensure the security of the transactions using the virtual currency.<sup>7</sup> Perhaps one of the most well-known examples of a cryptocurrency is Bitcoin. On 31 December 2016, Bitcoin had a global market capitalization of approximately \$17 500 000 000, or close to R240 000 000 000 at the time,<sup>8</sup> which was about 18 times as much as the nearest virtual currency.<sup>9</sup> For the purposes of this dissertation, Bitcoin will be used as a stand-in for cryptocurrencies and, by extension, virtual currencies, even if there may be subtle variations between various different virtual currencies.

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<sup>4</sup> European Banking Authority *EBA Opinion on Virtual Currencies* (2014) at 11.

<sup>5</sup> European Central Bank *Virtual Currency Schemes* (2012) at 13.

<sup>6</sup> Department of National Treasury *User Alert: Monitoring of Virtual Currencies* (2014) at 1.

<sup>7</sup> Financial Action Task Force *Virtual Currencies: Key Definitions and Potential AML/CFT Risks* (2014) at 5.

<sup>8</sup> CoinmarketCap ‘Crypto-currency Market Capitalizations’ available at <http://coinmarketcap.com/> accessed on 4 January 2017.

<sup>9</sup> Data extracted from [www.coinmarketcap.com/charts](http://www.coinmarketcap.com/charts)

Bitcoin was created in 2008, when a user of a cryptography mailing list, named Satoshi Nakamoto, uploaded a research paper detailing the plans for the cryptocurrency, as well as the code to put it into practice.<sup>10</sup> Other users then took up the reins and started using the system.<sup>11</sup> Bitcoin can be involved in a few types of transactions, as it can be used to buy and sell goods or services, be bought and sold itself on exchanges, or it can be ‘mined’. Although the system does follow certain rules, there is no regulating authority. While the system is not overly complex, it is possibly best explained through an example.

If buyer B wants to purchase a widget from seller S costing one Bitcoin, B will use software called a ‘wallet’ on his computer or other device, and transfer a bitcoin to S’ ‘address’.<sup>12</sup> An address can be equated to a bank account, and can be freely created by randomly generating a string of characters using a particular algorithm – ownership of the address is indicated by a private key, which is just a string of characters which one can store in their wallet.<sup>13</sup> After B has inputted the transaction in his wallet, the wallet will then send an encrypted message containing the details of the transaction to the ‘blockchain’.<sup>14</sup> The blockchain is a publically available file on a peer-to-peer network which acts as a ledger of all the transactions in which a Bitcoin is transferred from one user to another, and also contains the details of how much Bitcoin have been allocated to any given address.<sup>15</sup>

Before the transaction can be added to the blockchain, however, it is grouped with other, perhaps unrelated, Bitcoin transactions, in what is called a block.<sup>16</sup> The block is essentially encrypted, and people called ‘miners’ use computers to run algorithms designed to find a key called a nonce which serves as evidence that the transactions are legitimate.<sup>17</sup> Once the nonce has been found, the block is added to the blockchain and the transactions are completed – the Bitcoin passes from the buyer to the seller.<sup>18</sup> The process of finding the nonce is called ‘mining’, and the miner who

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<sup>10</sup> Tasca, Paolo *Digital Currencies: Principles, Trends, Opportunities, and Risks* (2015) at 9.

<sup>11</sup> *Ibid* at 31.

<sup>12</sup> *Ibid* at 12.

<sup>13</sup> *Ibid*.

<sup>14</sup> *Ibid*.

<sup>15</sup> *Ibid*.

<sup>16</sup> *Ibid*.

<sup>17</sup> *Ibid* at 14.

<sup>18</sup> *Ibid*.

found the nonce is awarded 25 Bitcoin.<sup>19</sup> It must be noted at this point that the mining process creates these 25 Bitcoin – the miner is not being paid by anyone in particular – and that this is how new Bitcoin enter the market.

Bitcoin can also be bought and sold using traditional currency. This occurs on so-called ‘exchanges’, which are operated by third-parties.<sup>20</sup> This is based on a willing-buyer, willing-seller model and the prices are determined by the exchangers, much like shares on a Stock Exchange. In other words, Bitcoin is not purchased directly from any central authority, but from other owners of Bitcoin. The value of a Bitcoin is therefore subject to variation and is dependent on supply and demand,<sup>21</sup> although it has risen from \$0.07 per Bitcoin on 31 July 2010 to approximately \$965.00 per Bitcoin on 31 December 2016,<sup>22</sup> which implies that it has mostly increased in value and is likely to continue doing so.

However, Bitcoin has been linked to use in criminal activities, including money laundering and trafficking.<sup>23</sup> It is for this reason that most governments are wary of its utility in any given economy.

### III. BITCOIN TAX LIABILITY IN SOUTH AFRICA

There is currently no specific provision in any legislation in South Africa related to the use or taxation of transactions related to virtual currency, or even how it is defined. An alert issued by National Treasury in September 2014 merely states that there are no specific provisions for virtual currencies such as Bitcoin, and that there are several dangers associated with the use thereof such as volatility and various illegal activities.<sup>24</sup> However, of vital importance is that the Treasury states that Bitcoin cannot be classified as legal tender as it is unregulated and is therefore only acceptable as a means of exchange when the participants both agree to it being used as a means of exchange. This implies that it is not accepted as a ‘currency’.

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<sup>19</sup> Ibid.

<sup>20</sup> European Central Bank op cit note 5 at 21.

<sup>21</sup> Ibid.

<sup>22</sup> Coindesk ‘Bitcoin price index chart’ available at <http://www.coindesk.com/price> accessed on 4 January 2017.

<sup>23</sup> Ibid at 25.

<sup>24</sup> Department of National Treasury *User Alert: Monitoring of Virtual Currencies* (2014).

This is confirmed by the South African Reserve Bank's position paper on virtual currencies, also published in 2014.<sup>25</sup> That paper labels Bitcoin as a 'Decentralised Convertible Virtual Currency' (DCVC), but states that it does not consider Bitcoin as 'legal tender', since it is not issued in terms of Section 17 of the South African Reserve Bank Act.<sup>2627</sup> In terms of that provision, legal tender can be defined as:

'a) a tender by the Bank itself, of a note of the Bank or of an outstanding note of another bank for which the Bank has assumed liability in terms of section 15 (3) (c) of the Currency and Banking Act or in terms of any agreement entered into with another bank before or after commencement of this Act; and

b) a tender by the Bank itself, of an undefaced and un mutilated coin which is lawfully in circulation in RSA and of current mass.'<sup>28</sup>

Since Treasury, as well as the South African Revenue Service and the South African Reserve Bank, do not accept Bitcoin as a currency, the question arises as to how it should be regarded when assessing one's tax liability.

The likely answer is that when conducting trade using Bitcoin as a means of exchange, the value of the Bitcoin received constitutes taxable income in the hands of the recipient. This would take the form of a barter transaction, as one is trading the goods or services for a Bitcoin, an intangible asset that has a value and is capable of being converted into cash.

According to the Income Tax Act,<sup>29</sup> income tax is payable on income, which is defined as the gross income of the taxpayer less deductions.<sup>30</sup> The definition of gross income includes 'the total amount, in cash or otherwise, received by or accrued to or in favour of such resident' which is not of a capital nature.<sup>31</sup> Since Bitcoin is apparently not considered cash, the value thereof would still be considered gross income as it falls under the 'or otherwise' component. It is unlikely in the instance that one trades with Bitcoin that it would be considered capital, as they are using it as a means of exchange in a scheme of profit-making.

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<sup>25</sup> South African Reserve Bank *Position Paper on Virtual Currencies* (2014).

<sup>26</sup> Act 90 of 1989.

<sup>27</sup> South African Reserve Bank op cit note 25 at 4.

<sup>28</sup> *Supra* (note 26) at s17(2).

<sup>29</sup> Act 58 of 1962.

<sup>30</sup> *Ibid* at s1.

<sup>31</sup> *Ibid*.

Similarly, if one consistently buys and sells Bitcoin on an exchange with a view to making a short-term profit, it would be considered gross income. In this case, it is not the Bitcoin itself that is the amount received, but the amount in cash for which it is sold. One might question whether, in the instance that a taxpayer buys some Bitcoin on an exchange with the view to using them to make purchases, and then after some time sells any superfluous Bitcoin at a profit, has received income that is of a revenue nature. This would obviously depend on the circumstances, but the paramount test with regards to classifying receipts as capital or revenue is that of intention.<sup>32</sup> If the taxpayer had no intention to speculate in the value of Bitcoin, but was merely curious about using Bitcoin as a means of exchange, and has furthermore only spent Bitcoin in trading and not received any, then it cannot be said that he engaged on a scheme of profit-making. The amount for which the surplus Bitcoin was received would then be of a capital nature.

However, it is possible that a court might look at the *ratio* in *African Life Investments (Pty) Ltd v SIR*<sup>33</sup> to suggest that the profit- or loss-making involved in exchanging traditional currency for Bitcoin is not merely incidental to trading in Bitcoin itself – that it is a necessary, secondary component of doing so, and that the receipts from the exchange therefore constitute revenue.

Finally, one might consider the Bitcoin received by miners from successfully mining a block of transactions. These must ultimately constitute gross income for the purposes of the Income Tax Act, as they are amounts received otherwise than in cash and cannot be considered capital. This could be either because they constitute ‘any amount, including any voluntary award, received or accrued in respect of services rendered’ as stipulated in paragraph (c) in the definition of gross income in the Income Tax Act, the service being the mining process, or because they are received as a result of an intended scheme of profit-making.

Bitcoin might be considered trading stock for the purposes of the Income Tax Act, which defines trading stock as:

‘(a) [including]-

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<sup>32</sup> *CIR v Stott* 1928 AD 252 at 256.

<sup>33</sup> 1969 (4) SA 259 (A).

(i) anything produced, manufactured, constructed, assembled, purchased or in any other manner acquired by a taxpayer for the purposes of manufacture, sale or exchange by the taxpayer or on behalf of the taxpayer;<sup>34</sup>

It does appear that Bitcoin fits into this definition. It is either purchased, or at least acquired by a taxpayer – mining of Bitcoin may not necessarily be production, manufacture or construction, as these connote a physical creation, whereas the mining process is completely abstract and results in a digital code, but there is an acquisition of that code at the end of the process – and it is usually obtained for the purposes of exchange or sale.

Where Bitcoin does constitute trading stock, Section 22 of the Income Tax Act would apply and the cost price of all Bitcoin held by the taxpayer would have to be added to their gross income at the end of the year of assessment. This may be hard to determine when the Bitcoin is bought at different prices, especially considering the volatile nature thereof.

One might note that the definition of trading stock specifically excludes foreign currency option contracts and forward exchange contracts as each is defined in Section 24I(1) of the Act. Foreign currency option contract and forward exchange contracts both relate to foreign currencies, and since Bitcoin is apparently not even considered a currency for the purposes of the Act, need not be considered at this point.

In terms of the Exchange Control Regulations,<sup>35</sup> since Bitcoin or any virtual currency is not deemed a currency by the South African Reserve Bank, the provisions related to the transfer of foreign currency out of the Republic does not apply. This means that one could purchase Bitcoin on a South African Exchange, using South African Rand, and sell it on an exchange in a foreign jurisdiction – using the currency thereof. This also entails that one does not need to buy Bitcoin from only an approved dealer in terms of Regulation 2. The Reserve Bank has noted that this could constitute an issue, as it means that money can leave the country without being reported.<sup>36</sup>

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<sup>34</sup> Supra (note 29) at s1.

<sup>35</sup> Exchange Control Regulations, 1961.

<sup>36</sup> South African Reserve Bank op cit note 25 at 11.

#### IV. COMPARATIVE ANALYSIS OF TREATMENT IN FOREIGN JURISDICTIONS

Since South Africa has no specific legislation, and rather sparse policy in relation to virtual currencies, it might be prudent to analyze how other jurisdictions have dealt with the trend. The jurisdictions chosen for this comparative analysis are Australia, Canada and the United States of America.

##### (a) Australia

The Australian Tax Office have issued a guidance paper organising transactions in Bitcoin into three broad categories – the use of Bitcoin for personal transactions, the use of Bitcoin in business, and exchange transactions.<sup>37</sup>

There is no tax attached to receipts of Bitcoin for personal use – in other words, those receipts related to the use of Bitcoin by an individual to pay for goods and services that they need for their everyday life.<sup>38</sup> While it is hard to imagine how an individual that pays for services may receive Bitcoin, the guidance paper mentions that these receipts may take the form of capital gains on the exchange of Bitcoin.<sup>39</sup> The proviso to this provision is that the individual may not sell Bitcoin with a cost price of more than 10 000 Australian dollars in any given year of assessment.<sup>40</sup> It will thus be considered a personal use asset for the purposes of Australian tax law.<sup>41</sup>

Transactions sounding in Bitcoin which are conducted for the purposes of business are treated as barter transactions, and the recipient of the Bitcoin must record the details of the transaction, including the address of the other party.<sup>42</sup> The receipt is to be accounted for in its fair-market value, not the actual amount of Bitcoin received.<sup>43</sup> Hence, Australia does not treat Bitcoin as any form of currency, but rather as a non-cash consideration.<sup>44</sup>

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<sup>37</sup> Australian Tax Office 'Tax treatment of crypto-currencies in Australia – specifically Bitcoin' available at <https://www.ato.gov.au/General/Gen/Tax-treatment-of-crypto-currencies-in-Australia---specifically-bitcoin/> accessed on 11 September 2016.

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

<sup>42</sup> Ibid.

<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

The mining of Bitcoin is also seen as a transaction relating to the business of the taxpayer.<sup>45</sup> Although no reason is provided for this categorization, it may be justified in that the mining of Bitcoin requires a substantial investment in hardware that has high computing ability so as to be able to run the algorithms required.<sup>46</sup> In other words, a miner would likely not do it simply as a hobby – they would more than likely do it for profit, especially since they would be competing with other miners.

Finally, in terms of exchange transactions, the running of an exchange will likely produce proceeds in the form of transaction fees. These will constitute taxable income.<sup>47</sup>

In relation to the purchase and sale of Bitcoin, returns would only be taxable if the process was a business undertaking – in other words, that the business of the taxpayer is the purchase and sale of Bitcoin on a frequent basis with the intention of making consistent profits, or if the transactions formed part of the business of the taxpayer.<sup>48</sup> Long term investors would only pay capital gains tax in respect of profits, provided that investment is not their business.

The guidance paper is merely a general document provided to taxpayers as a guideline for the conducting of their affairs, and does not form legislation. Hence, the ATO is not bound by the document.<sup>49</sup>

## **(b) Canada**

The Canada Revenue Agency (CRA) takes a very similar, but far less detailed approach to the Australian Tax Office.<sup>50</sup> Again, there is no specific legislation providing for Bitcoin, but a ‘fact sheet’ published in 2013 states that the trading of goods and services using Bitcoin are dealt with as bartering transactions.<sup>51</sup> Interestingly, receipts from the sale of Bitcoin on an exchange are partially likened to those from the sale of equities.<sup>52</sup> A further difference is that Bitcoin mining activities

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<sup>45</sup> Ibid.

<sup>46</sup> Tasca op cit note 10 at 24.

<sup>47</sup> Australian Tax Office op cit note 37.

<sup>48</sup> Ibid.

<sup>49</sup> Ibid.

<sup>50</sup> Canadian Revenue Agency ‘What you should know about digital currency’ available at <http://www.cra-arc.gc.ca/nwsrm/fctshs/2013/m11/fs131105-eng.html> accessed on 12 September 2016.

<sup>51</sup> Ibid.

<sup>52</sup> Ibid.

can amount to a hobby in terms of the Canadian approach, and so proceeds from mining may be considered a capital amount in those cases.<sup>53</sup>

Since the CRA treats some transactions as bartering, it stands to reason that it does not see Bitcoin as a currency. The position of the Bank of Canada in 2014 was that Bitcoin cannot constitute currency as it ‘fall[s] short of today’s definition of “money.”’<sup>54</sup> This definition of ‘money’ is that it must act as a means of exchange, a unit of account and a store of value.<sup>55</sup> As a means of exchange, according to the Bank of Canada, too few vendors accepted Bitcoin in 2014 and hence did not have wide enough usage.<sup>56</sup> As a unit of account, the Bank of Canada noted that those vendors which did accept Bitcoin as a means of payment would simply quote prices in Canadian Dollars and convert the price to Bitcoin when the transaction was performed.<sup>57</sup> Finally, the position was that the value of Bitcoin was too volatile, and thus it could not be a reliable store of value.<sup>58</sup>

Of further note is that a discussion paper was released in November 2016 discussing the possibility of the creation of digital currencies by central banks based on Bitcoin and other existing digital currencies.<sup>59</sup> The outcome of that paper was that there was some merit in taking the discussion forward and examining various questions related to the effectiveness of such a system.<sup>60</sup> However, this is not to suggest that the Bank of Canada has changed its position in respect of Bitcoin.

Fournier and Lennard argue that the Bank of Canada’s position with regards to Bitcoin and its relation to this definition of money is unsound, since it appears to be based purely on prevailing conditions and patterns of usage at the time of the statement, and also focused only on the place of Bitcoin in the Canadian economy.<sup>61</sup> Since Bitcoin was relatively new at the time, it may have been unfair to base the

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<sup>53</sup> Ibid.

<sup>54</sup> Bank of Canada ‘Decentralised E-money (Bitcoin)’ available at <http://www.bankofcanada.ca/wp-content/uploads/2014/04/Decentralize-E-Money.pdf> accessed on 12 September 2016, at 1.

<sup>55</sup> Ibid at 2.

<sup>56</sup> Ibid.

<sup>57</sup> Ibid.

<sup>58</sup> Ibid.

<sup>59</sup> Fung, BSC and H Halaburda ‘Bank of Canada Staff Discussion Paper: Central Bank Digital Currencies: A Framework for Assessing Why and How’ available at <http://www.bankofcanada.ca/2016/11/staff-discussion-paper-2016-22/> accessed on 7 January 2017.

<sup>60</sup> Ibid at 18.

<sup>61</sup> Fournier, Olivier and John J. Lennard ‘Rebooting Money: The Canadian Tax Treatment of Bitcoin and Other Cryptocurrencies’ (2014) *Canadian Tax Foundation 2014 Conference Report* 11:1-27 at 11:7.

categorisation on usage statistics when it should have been based on the substance of the definition provided.<sup>62</sup> An example that is used is that of the Euro – it is not used as a means of exchange or a unit of account in Canada, even if it is in Europe.<sup>63</sup> According to the Bank’s logic, this would mean that it is not a currency for the purposes of Canadian tax law.

The argument of Fournier and Lennard is that the definition of ‘money’ should be distinguished from that of ‘currency’, since while there can certainly be overlap, this does not mean that they are interchangeable terms.<sup>64</sup> For them, the term ‘currency’ has three potential meanings, being a system of money or monetary units, the specific objects identified as money (such as bank notes or coins) that act as a means of exchange, or something that represents money transmissible free of claims from previous owners.<sup>65</sup> It is claimed that Bitcoins fulfill all of these potential meanings and should be considered as currency.<sup>66</sup>

### **(c) United States**

The position of the IRS is that while Bitcoin may operate in many countries as ‘real currency’ does, it does not carry the status of legal tender anywhere.<sup>67</sup> It accepts that Bitcoin can operate as a means of exchange, a unit of account and as a store of value.<sup>68</sup> Nonetheless, the IRS treats Bitcoin as property,<sup>69</sup> and most transactions are treated much like the treatment described in relation to Australia and Canada above.

There have been some American court decisions in relation to the status of Bitcoin in the US, although none of them have been in relation to tax law. However, they do prove informative as to how it has become difficult to categorise virtual currencies.

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<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

<sup>64</sup> Ibid at 11:8.

<sup>65</sup> Ibid at 11:10.

<sup>66</sup> Ibid at 11:12.

<sup>67</sup> Internal Revenue Service Notice 2014-21.

<sup>68</sup> Ibid.

<sup>69</sup> Ibid at 2.

For example, in *Securities and Exchange Commission v Trendon T. Shavers and Bitcoin Savings and Trust*,<sup>70</sup> the District Court had to determine whether Bitcoin amounted to ‘money’. This case related to securities fraud, in that the defendant established a ‘Ponzi scheme whereby he would take possession of Bitcoin ostensibly to be invested on behalf of his investors, who were offered high returns, but instead merely made payments to some of the investors using the Bitcoin given to him.’<sup>71</sup>

The argument of the defendant was that this could not fall under securities fraud because Bitcoin didn’t constitute money, and hence did not fall within the ambit of securities legislation.<sup>72</sup>

The court disagreed, rejecting the argument that in order for something to constitute money it would have to be accepted as legal tender, which the IRS had already stated was not the case.<sup>73</sup> Instead, the court held that in order for something to constitute money, it must meet the requirements of being a means of exchange, a unit of account and a store of value.<sup>74</sup> It held that Bitcoin did meet these requirements and was hence money.<sup>75</sup> It must be noted that there is a distinction between currency and money under some US legislation,<sup>76</sup> but it may further be noted that the requirements applied by the court are the same general requirements which the Bank of Canada applied to their definition of money and the justification for Bitcoin not constituting currency under Canadian tax law.

The second proviso to the finding of the court is that it does not overrule the IRS’ categorization of Bitcoin for the purposes of tax law. The court states that ‘the IRS Notice did not make any determinations about whether bitcoins are money or not, only that for federal tax purposes, bitcoins are to be treated as property.’<sup>77</sup>

In September 2015, the Commodities Futures Trading Commission (CFTC), an American commission that oversees the trading of commodities, ordered Coinflip Inc.

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<sup>70</sup> *Securities and Exchange Commission v Trendon T. Shavers and Bitcoin Savings and Trust* E.D. unreported case no 4:13-CV-416 available at <http://www.law.du.edu/documents/corporate-governance/securities-matters/shavers/SEC-v-Shavers-No-4-13-CV-416-E-D-Tex-Sept-18-2014.pdf>, accessed 10 October 2016.

<sup>71</sup> *Ibid* at 3.

<sup>72</sup> *Ibid* at 8.

<sup>73</sup> Internal Revenue Service *op cit* note 67.

<sup>74</sup> *Supra* (note 70) at 12.

<sup>75</sup> *Ibid*.

<sup>76</sup> *Ibid*.

<sup>77</sup> *Ibid*.

to cease operation of its Derivabit platform, a platform for the trading of Bitcoin options by third party buyers and sellers.<sup>78</sup> This was because it was not registered as a ‘swap execution facility or designated contract market’.<sup>79</sup> The CFTC justified its jurisdiction over the matter by claiming that the options were backed by Bitcoin, and that Bitcoin constituted a commodity as defined in Section 1a(9) of the Commodity Exchange Act,<sup>80</sup> specifically that it was included under ‘all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.’<sup>81</sup>

That part of the definition is the catch-all, as the rest of the definition is a long list of specific goods which are natural produce, such as wheat, cotton, and rice.<sup>82</sup> The only exception is that it also includes ‘motion picture box office receipts’. It seems rather odd to place an intangible string of code in such a list. It is notable that this definition does not include oil, gold, coal or other mineral resource.

Hence, while the position in respect of American tax authorities is that Bitcoin is deemed to simply be property, various other bodies have shown how it can be construed in other ways. It is submitted that this illustrates the difficulty in attempting to fit Bitcoin into existing definitions of classes of assets.

In conclusion, however, it appears that some form of consensus has arisen from the various tax authorities on how virtual currencies can be dealt with, and this creates strong prospects for future regulation by legislative bodies.

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<sup>78</sup> *Commodity Futures Trading Commission v Coinflip Inc. d/b/a Derivabit, and Fransico Riordan* CFTC unreported case no 15-29 available at <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinflipror09172015.pdf> accessed 10 October 2016.

<sup>79</sup> *Ibid* at 2.

<sup>80</sup> Commodity Exchange Act 1936.

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid*.

## V. BITCOIN AS ‘CURRENCY’ FOR THE PURPOSE OF THE INCOME TAX ACT

In order to determine whether Bitcoin should be treated any differently for the purposes of income tax, one has to question how it would be categorised in terms of the Income Tax Act. There are a few options if Bitcoin were to be deemed to fit into one of the existing asset classes – equities, commodities or currency.

Bitcoin does share some characteristics with shares - at least publicly traded shares. They are traded on exchanges open to the public, and hold value. However, the owner of a Bitcoin does not hold any participation rights in any company by virtue of that ownership; nor does a Bitcoin carry any rights to a dividend. Hence, shares as a class would most likely not be suited for Bitcoin, especially since, as per the Income Tax Act, a share is defined as any unit into which the proprietary interest of a company is divided.<sup>83</sup>

Commodities are not defined in the Income Tax Act. Thus, one would use the ordinary meaning of the word. According to the Oxford English Dictionary, a commodity is ‘a raw material or primary agricultural product that can be bought and sold, such as copper or coffee’. It is hard to imagine that one would classify a Bitcoin as a raw material. It is not used to be developed into a secondary product.

If Bitcoin were to be considered a currency for the purposes of the Income Tax Act, it would have to be considered that a ‘currency’ on its own is not defined in the Act. Instead, Section 24I provides definitions for ‘foreign currency’ and ‘local currency’.

Section 24I(1) states that a foreign currency is any currency that is not a local currency, while the definition of local currency itself is lengthy and has multiple permutations. However, it can be simplified such that the local currency is the ‘currency of the Republic’ where the taxpayer is a resident that is not a headquarter company with income attributable to a permanent establishment outside the Republic, or where the taxpayer is a non-resident permanent establishment within the Republic. In all other instances, the local currency is deemed to be the functional currency of the taxpayer.

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<sup>83</sup> Supra (note 29) at s1.

The currency of the Republic is not defined as a concept in the Income Tax Act. Rather, one would have to turn to the South African Reserve Bank Act,<sup>84</sup> Section 15 of which states that the monetary unit of the Republic is the Rand. Since Bitcoin is not the Rand, it is not a local currency. Since a foreign currency is any ‘currency’ which is not a local currency, and the simple term ‘currency’ remains undefined, Bitcoin may still fit within the ambit of foreign currency. Therefore, one would have to investigate the meaning which should be attributed to currency for the purposes of South African tax law.

The Oxford English Dictionary defines a currency as a system of money in general use in a particular country. While it is understood that Bitcoin is not in general use in the country, it is fairly new and has seen consistent growth. If one were to assume that it is in sufficiently significant usage – in other words, it is not just used by a small community in a remote area of the country, but is slowly being adopted throughout the country and the world – then this portion can be overlooked temporarily.

The greater question is whether it is a system of money. Again, money is not defined for the purposes of the Income Tax Act. One would again look to the ordinary meaning of the word. As per the Oxford English Dictionary, money is ‘a current medium of exchange in the form of coins and banknotes; coins and banknotes collectively’ or ‘the assets, property, and resources owned by someone or something; wealth’.<sup>85</sup> The first definition is not of much assistance. It appears to refer to money in its physical cash form, which does not take account of electronic transactions using traditional currency. Equally, the second definition refers to wealth, assets and property. However, this is not sufficient, as to suggest that Bitcoin is money because it is an asset is the same as suggesting that land is money because it is an asset. It is problematic logically.

One might turn to the definition attributed to ‘money’ by the Bank of Canada, which is that it is a means of exchange, a store of value and a unit of account.<sup>86</sup> This definition is an economic term which is derived from the work of William Stanley

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<sup>84</sup> Supra (note 26)

<sup>85</sup> Oxford English Dictionary, available at <https://en.oxforddictionaries.com/definition/money> accessed on 12 October 2016.

<sup>86</sup> Bank of Canada op cit note 54.

Jevons, a 19<sup>th</sup> century British economist, who stated that there were four functions of money, being the three in question and the additional function of being a standard of value.<sup>87</sup> The additional function appears to have been abrogated by disuse since the functions were first outlined in 1875.

A means or medium of exchange is something which is commonly used to exchange for any another thing.<sup>88</sup> It is arguable that what gives the medium its assigned value is its ability to be used as in other exchanges because of a social contract that it will be so used. For example, Bitcoin would be without value if it was not accepted as a medium of exchange. The South African Rand would have no real value if it was not the currency of the Republic by virtue of legislation. If, for example, the entire population decided that the means of exchange were to change from Rands to bottle-caps, and it was accepted as such, bottle-caps would become much more sought after and hence valuable.

For this reason, the second function, being a store of value, is derived from the first – a value is attributed to the medium of exchange so as to make transactions meaningful without the medium of exchange having some intrinsic value. Bitcoin currently has a value determined on the supply and demand thereof. There is no intrinsic value in a Bitcoin. It cannot be used by itself to produce anything, cannot be used in the manufacturing of anything else.

Finally, the function of acting as a unit of account means that because of widespread use, people start to measure the value of goods in accordance with the value of money, and it becomes a unit for record-keeping purposes.<sup>89</sup> This function is referred to by Jevons as being the ‘common measure of value’, but appears to have displaced by the term ‘unit of account’ in later years.<sup>90</sup> Nevertheless, the setting of prices of goods in terms of the value of Bitcoin is possible, so it appears that Bitcoin does perform this function.

Thus, Bitcoin appears to fulfil the three basic functions of money and is capable of being considered money in economic terms. The question remains whether this makes it currency. Returning to the Oxford Dictionary’s definition of ‘currency’,

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<sup>87</sup> Jevons, William Stanley ‘Money and the Mechanism of Exchange’ (1875).

<sup>88</sup> Ibid at 13.

<sup>89</sup> Ibid.

<sup>90</sup> Cf. Bank of Canada op cit note 54 at 12.

being a system of money in general use in a particular country, one would have to argue that Bitcoin could be a currency by this definition, since it is a system of money that. However, it is not in general usage yet. Nevertheless, on the basis that it is possible to consider it currency, however unlikely currently, one can continue with the analysis of its place in South African tax law for the benefit of any future developments

Returning to the definitions of local and foreign currency in terms of the Income Tax Act, one would have to determine which Bitcoin may fit into. Since Bitcoin is not the local currency, which by legislation is the South African Rand as discussed above,<sup>91</sup> it can be a foreign currency, which is any currency other than the local currency. It must be noted that in both instances, these definitions operate only in relation to exchange items, which is:

‘an amount in a foreign currency-

- (a) which constitutes any unit of currency acquired and not disposed of by that person;
- (b) owing by or to that person in respect of a debt incurred by or payable to such person;
- (c) owed by or to that person in respect of a forward exchange contract; or
- (d) where that person has the right or contingent obligation to buy or sell that amount in terms of a foreign currency option contract.<sup>92</sup>

The definition of either form of currency therefore has a narrow context, in that it is only applicable for the purposes of the application of Section 24I. However, there is some relevance to Section 24I, since if it is accepted that Bitcoin can constitute a foreign currency for the purposes of at least this provision in the Act, then it applies in place of Section 22, which dealt with trading stock.<sup>93</sup>

Hence, instead of applying Section 22 and including the cost price of the Bitcoin in one’s income at the end of the year of assessment – and the concomitant deduction at the beginning of the year of assessment – one would apply Section 24I(3), which states that:

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<sup>91</sup> Supra (note 83).

<sup>92</sup> Ibid.

<sup>93</sup> Ibid at s24I(6).

‘(3) In determining the taxable income of any person contemplated in subsection (2), there shall be included in or deducted from the income, as the case may be, of that person-

(a) any exchange difference in respect of an exchange item of or in relation to that person, subject to subsection (10A);...

An exchange difference is defined in the Act as:

‘the foreign exchange gain or foreign exchange loss in respect of an exchange item during any year of assessment determined by multiplying such exchange item by the difference between-

(a) the ruling exchange rate on transaction date in respect of such exchange item during that year of assessment, and-

(i) the ruling exchange rate at which such exchange item is realised during that year of assessment; or

(ii) the ruling exchange rate at which such exchange item is translated at the end of that year of assessment; or

(b) the ruling exchange rate at which such exchange item was translated at the end of the immediately preceding year of assessment or at which it would have been translated had this section been applicable at the end of that immediately preceding year of assessment, and-

(i) the ruling exchange rate at which such exchange item is realised during that year of assessment; or

(ii) the ruling exchange rate at which such exchange item is translated at the end of that year of assessment;’<sup>94</sup>

Finally, the definition of the ruling exchange rate depends on the nature of the exchange item, but for the purposes of a unit of currency, it is determined as:

‘on-

(i) transaction date, the spot rate on that date;

(ii) the date it is translated, the spot rate on that date; or

(iii) the date it is realised, the spot rate on that date: ...’<sup>95</sup>

Therefore, a taxpayer would include in their taxable income the difference in value of the exchange item as a result of currency value fluctuations between the beginning of the year of assessment and the end of the year, or alternatively the time

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<sup>94</sup> Ibid at S24I(1).

<sup>95</sup> Ibid.

that it was realised. Since Bitcoin is subject to fluctuations in value, if it was deemed a foreign currency, it would then have to be taken into account.

However, one might consider whether there is any net effect as a result of the change from the operation of Section 22 and Section 24I. Ultimately, it appears to have a very similar impact on the taxable income of the taxpayer. Recognising Bitcoin as a foreign currency for the purposes of the operation of a single provision, perhaps unnecessarily so, may simply create further issues when this deeming is relied on for the purposes of other legislation.

Rather, and in conclusion, it may be prudent to leave Bitcoin ‘unclassified’ for the purposes of the Income Tax Act, at least for the time being, until some event occurs which justifies its being specifically provided for.

## VI. THE EXCHANGE CONTROL REGULATIONS

The Exchange Control Regulations are created in terms of Section 9 of the Currency and Exchanges Act.<sup>96</sup> Part of the purpose for which the Regulations were created was to protect the value of the South African Rand by preventing the flows of large amounts of capital.<sup>97</sup> In modern times, this has become more important as the ease of transmission of currency increases. In the words of Moseneke DCJ in *South African Reserve Bank v Shuttleworth*:<sup>98</sup>

‘Currency moves with lightning speed. Money has long ceased to be a hand-held commodity or physical article of trade for exchange purposes. The internet and electronic communications enable it to be moved from and between locations and jurisdictions almost instantly. Hence the need for special regulation.’<sup>99</sup>

Part of the design of Bitcoin is its ease of transmission. The use of digital wallets to send keys to addresses means that intangible objects of significant value may pass hands with a few mouse clicks, without that transaction having to pass through any approval by an organ of state. In the words of one of the Bitcoin community websites operating in South Africa, this is part of the attraction of using Bitcoin:

‘bitcoin allows for the first time ever, any human being anywhere on the planet, to be able to send and receive any amount of money, with anyone else on the planet, without having to ask for permission from any bank, corporation, or government. This can be done almost instantly, for virtually no cost, regardless of the amount of money.’<sup>100</sup>

The Position Paper issued by the South African Reserve Bank recognises that since it is not recognised as a currency for the purposes of the Regulations, the Regulations do not apply to Bitcoin.<sup>101</sup>

Regardless of the pronouncement, one might still consider if Bitcoin could be a foreign currency in terms of the Regulations. A foreign currency is defined differently in the Regulations, this time as:

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<sup>96</sup> Act 9 of 1933.

<sup>97</sup> South African Reserve Bank op cit note 29 at 10.

<sup>98</sup> [2015] ZACC 17

<sup>99</sup> Ibid at para [70].

<sup>100</sup> BitcoinZar ‘Bitcoin South Africa’ available at [www.bitcoinzar.co.za](http://www.bitcoinzar.co.za) accessed on 12 September 2016.

<sup>101</sup> Supra (note 29) at 11.

‘any currency which is not legal tender in the Republic, and includes any bill of exchange, letter of credit, money order, postal order, promissory note, traveller's cheque or any other instrument for the payment of currency payable in a currency unit which is not legal tender in the Republic;’<sup>102</sup>

Of importance in that definition is that it is any currency ‘that is not legal tender’. One might recall that in terms of SARB’s own position paper, it does not consider Bitcoin as legal tender because it is not issued by the Reserve Bank.<sup>103</sup> Therefore, in order for Bitcoin to be affected by the Regulations, it would simply have to be seen as a currency – again not itself defined by the Regulations. Based on the previous discussion of currency, it is possible to perceive Bitcoin as being considered a currency in the future. In that case, some provisions of the Regulations would apply to it.

Firstly, Regulation 2 would apply in that only authorised dealers may sell Bitcoin. This would mean the effective shutdown of most exchanges with third party buyers and sellers, replaced with ‘Bitcoin banks’ authorised to sell Bitcoin directly to users. Buyers would also be required to collect information on each purchase. This would be in stark contrast to the levels of anonymity typically associated with Bitcoin.

Secondly, Regulation 3 would prevent restrict the export of Bitcoin into foreign jurisdictions. For example, Regulation 3(1) states that:

‘Subject to any exemption which may be granted by the Treasury or a person authorised by the Treasury, no person shall, without permission granted by the Treasury or a person authorised by the Treasury and in accordance with such conditions as the Treasury or such authorised person may impose –

(a) take or send out of the Republic any bank notes, gold, securities or foreign currency, or transfer any securities from the Republic elsewhere;...’

One would therefore not be able to sell one’s bitcoin on a foreign Bitcoin exchange, as this would amount to taking it out of the country. One may also not be able to purchase goods in another country via an online transaction from within the Republic.

Regulation 3 states further that:

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<sup>102</sup> Supra (note 36) reg 1.

<sup>103</sup> South African Reserve Bank op cit note 29.

‘(3) Every person who is about to leave the Republic and every person in any port or other place recognised as a place of departure from the Republic, who is requested to do so by the appropriate officer shall -

(a) declare whether or not he has with him any bank notes, gold, securities or foreign currency; and

(b) produce any bank notes, gold, securities or foreign currency which he has with him;...’

It is questionable whether this would mean that transporting a computer on which a wallet is installed out of the country must declare the Bitcoin in their position and produce it, since that is intangible data stored on a peer-to-peer network on multiple nodes around the world. The question arises as to whether the owner actually has the Bitcoin ‘with him’. This is not likely true. It would akin to being the owner of money sounding in a foreign currency stored in a foreign bank account – the money is not ‘with’ the person at any given time until it is withdrawn and the physical notes are in their hands or wallet.

If it is accepted that Bitcoin is a foreign currency for the purpose of the Regulations, it appears that the operation thereof may defeat some of the objects of Bitcoin, that it is an efficient, anonymous means of exchange that is done without interference from any government. Whether this is necessary to prevent unchecked outflows of capital is a concern for the Reserve Bank and other organs of state.

An alternative solution would be to create a new class of ‘virtual currencies’ to which the Regulations may have limited application. For example, to have to produce Bitcoin on exiting the country seems a wasteful venture. On the other hand, having Bitcoin exchanges be required to register with the Reserve Bank, and to collect information on transactions may be of some benefit to the Reserve Bank and SARS without raising too much alarm with law-abiding taxpayers.

## **VII. CONCLUSION**

In conclusion, it has been shown that while Bitcoin shares similarities with currencies, and while it does require further thought from the legislature, for the time being it is not necessary for any changes to be made for the purposes of its treatment in income tax law. If it were to be treated any differently, the legislature would do well to not fit it into the definition of currency for the purposes of the Income Tax Act, but rather

establish it as a *sui generis* class to avoid conflict with the existing framework related to currencies and foreign currencies, even if it would be partially based thereon.

For the purposes of the Exchange Control Regulations, there is need for change to prevent the circumvention of the provisions thereof. However, specific provision would need to be made to avoid defeating the object of using Bitcoin and thus encourage the illicit flow of money through other means. Careful consideration would have to be given to the implementation of further regulation that balances control and market growth.

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