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WEEKLY COMMENT: FRIDAY 16 SEPTEMBER 2022

1. This week I complete my review of the taxation of cryptoassets (the term used by Inland Revenue to refer to virtual currencies) in New Zealand. I look at the information provided on Inland Revenue's website on working out income and expenses and record-keeping. In addition, while I have discussed non-fungible tokens in earlier *Weekly Comment* blogs, but I thought I would round off my review of cryptoassets by summarising some key points about NFTs obtained from an excellent recent PwC publication: *Non-Fungible Tokens (NFTs): Legal, tax and accounting considerations you need to know*.

Cryptoasset income

2. Inland Revenue notes that cryptoasset income might include income from:

   (a) Mining cryptoassets (such as block rewards and transaction fees, including income from a mining pool);

   (b) Staking cryptoassets or using a staking-as-a-service provider;

   (c) Lending cryptoassets to another person (including crypto 'interest');

   (d) Selling or exchanging cryptoassets (including mining rewards);

   (e) Getting paid in cryptoassets for goods or services provided.

3. Inland Revenue notes that usually these amounts are income in the income year they are received.

4. If cryptoassets are held as trading stock, income also includes the closing value of the trading stock, which is the value of the cryptoassets held as trading stock at the end of the income year.

Cryptoasset expenses

5. Inland Revenue notes that the type of expenses that can be claimed will depend on whether there is a cryptoasset business or not. Generally, the following expenses can be deducted from cryptoasset income:

   (a) The cost of the cryptoassets – i.e. the amount paid for the cryptoassets, including any transaction fees;

   (b) Depreciation of capital assets such as computer hardware or software;

(c) Interest charged on money borrowed to buy the cryptoassets (providing that the profit from their sale is taxable);

(d) Other expenses relating to the cryptoasset activity – for example, a miner could include electricity or rental costs.

6. If cryptoassets are held as trading stock, expenses will also include the opening value of trading stock, which will generally be the same as the closing value of trading stock at the end of the previous year. If it is the first year in business, there may not be any opening stock.

7. Timing of deductions:

   (a) Deductions are available in the income year the expense is incurred, which will generally be at the time a payment is made;

   (b) The cost of cryptoassets not held as trading stock can only be deducted when the cryptoassets are sold or exchanged.

The cost of cryptoassets

8. If the cost of cryptoassets cannot be separately identified on sale because multiple units of the same type were acquired at different times at different prices, the following methods can be used to allocate costs:

   (a) First-in first-out (FIFO); or

   (b) Weighted average cost (WAC).

9. The last-in-first-out (LIFO) method is not allowed. The same method must be used every year and records must be maintained of the method used.

10. Persons who are miners or who accept payment in cryptoassets can have income both when cryptoassets are acquired, as well as when they are sold. In such circumstances, the amount returned as proceeds on acquisition will become the deductible cost upon disposal.

11. If cryptoassets are held as trading stock, the cost of acquisition can be deducted, but trading stock held at year-end must be added back as income. The trading stock tax rules are not straightforward, and a more detailed explanation is beyond the scope of this summary review.

Calculating NZD value of cryptoassets

12. The NZD value of cryptoassets received as income will have to be determined using an appropriate conversion rate at the relevant date. Inland Revenue notes that this could apply when:

    (a) Receiving mining or staking rewards;

    (b) Exchanging cryptoassets for different cryptoassets; or

    (c) Receiving a payment in cryptoassets.

13. Inland Revenue notes that cryptoassets may have to be converted into a foreign currency before they can be converted into NZD.

14. Inland Revenue notes that conversion rates could be obtained from the following centralised repository sites:

    (a) CoinMarketCap;

    (b) Yahoo Finance: Cryptocurrencies.

15. Inland Revenue states that conversion rates can also be obtained from a reputable public exchange, such as one with comprehensive know-your-customer and anti-money-laundering procedures in place. Which exchange (or exchanges) is appropriate depends on the circumstances.

Cryptoasset records required to be kept

16. Records of cryptoassets will have to be kept to support the tax position adopted in tax returns. These may include:

    (a) The type of cryptoasset;

    (b) Date of the transaction;

    (c) Type of transaction (for example, received or disposed of);

    (d) Number of units;

    (e) Value of the transaction in New Zealand dollars;

    (f) Total units of each cryptoasset held at the beginning and end of the year;

    (g) Exchange records and bank statements;

    (h) Wallet addresses.

17. If cryptoasset exchanges are used, Inland Revenue advises that transaction history should be downloaded regularly, because the exchanges may only keep records for a short period, or the exchange may no longer exist when the tax return is prepared.

18. An online cryptoasset income tax calculator may help to meet record keeping obligations and work out tax. However, many of these calculators are provided by overseas software providers and it will be necessary to make sure that transactions are accounted for in a way that meets NZ tax law.

19. If the cryptoasset mining or staking activity is GST registered, GST records will have to be maintained.

Non-fungible tokens

20. As noted earlier, the material for this final section has been obtained from a PwC publication: *Non-Fungible Tokens (NFTs):Legal, tax and accounting considerations you need to know*.

21. Non-fungible tokens (NFTs) are unique and non-interchangeable digital assets stored on a blockchain. NFTs have been a huge boon to artists because they provide a means to receive royalties from initial sales as well as re-sales and their products are able on globally accessible marketplaces.

22. NFTs are most commonly distributed on the Ethereum network but are increasingly seen on other platforms. NFTs can be acquired by:

    (a) Minting an NFT directly on a blockchain;

    (b) Purchasing an NFT in an auction;

    (c) Purchasing an NFT on marketplaces such as OpenSea, SuperRare, Nifty Gateway, MakersPlace and Async Art, which take commission for the sale of NFTs similar to traditional auction houses.

23. NFTs represent a significant change to the business models for creative content industries. Through the use of NFTs, because blockchain technology is utilised, royalties can potentially be easily tracked and paid directly to the artist indefinitely.

24. PwC notes that a blockchain's Decentralised Finance ("DeFi") offers owners ways to monetise assets without selling them:

    (a) Fractionalisation allows digital assets to be substituted by a pool of tokens that can be traded on the secondary market, thereby allowing people to participate with a smaller outlay than would otherwise be required (similar to a share split by a company);

    (b) Collateralisation allows NFTs, which represent the digital ownership of assets, to be used as security for loans, with the added benefit of transparency meaning the same asset cannot be collateralised twice; and

    (c) Creator rewards allows creators to benefit from re-sales on the secondary market, rather than only from initial sales.

25. PwC describes the "NFT ecosystem" as including:

    (a) **Collectibles:** Either virtual or physical objects traded on a public blockchain environment can be readily valued and, therefore, more easily traded;

    (b) **Gaming:** Game creators can offer NFTs, which serve as digital certificates of achievements or ownership, which can be traded through in-game or open markets;

    (c) **Physical art:** Blockchain transparency allows purchasers to trace transactions of NFTs associated with a specific piece of art to the original creator to verify ownership, and smart contracts linked to NFTs can include clauses with royalties to be paid to the original creator from every transaction;

    (d) **Sports:** Teams can issue virtual highlights as NFTs or create player digital cards with varying degrees of rarity which can become collectibles or could be used in fantasy games in future;

    (e) **Cultural artefacts and history:** NFTs can be used to trade historical moments in music, fashion, sport and politics;

    (f) **Real estate:** The proof of ownership concept through NFT minting can also be applied to physical assets such as land, buildings and jewellery, where blockchain records can replace title deeds and issued tokens can be traded in an open market on a blockchain;

(g) **Music/digital art:** Musicians could sell traditional albums, unique bonus tracks or tickets as NFTs, and proceeds do not have to be shared with record labels or music agents, the original creator can keep getting paid out of the proceeds of secondary sales, and could engage with the current owner through continuing to provide post-sale content;

(h) **Tickets/access authorisation:** Tickets can be minted and created using unique NFTs and different functionalities could be programmed on these NFTs, for example, the value of tickets can be programmed to vary in accordance with demand;

(i) **Education and research:** Tokenisation of certificates can prove the authenticity of documents to third parties without the need to contact the issuer, and literary property could be protected through NFTs improving the value of research activity.

26. Contractual terms are an important aspect of buying and selling NFTs:

(a) It can be contractually agreed to sell and NFT "naked", without intellectual property rights to the underlying work attached, and contractual terms can be drafted to allow a division between rights retained by the seller (or marketplace) and rights transferred – for example, rights attached to an underlying artwork could remain the sole property of the owner, but the owner could be restricted from exploiting the artwork subsequently for commercial purposes;

(b) Consideration to be received by the NFT creator from sales in the secondary market could be determined in advance and embedded within the smart contract.

NFTs Tax considerations

27. A creator of a digital intangible asset could:

(a) Pay an NFT marketplace a fee in cryptoassets for minting and listing the digital intangible asset;

(b) Sell the NFT to a buyer, who pays in cryptoassets and also pays a commission to the NFT marketplace.

28. A secondary buyer of an NFT could buy the NFT from the original buyer and:

(a) Pay the NFT marketplace a commission; and

(b) Pay the creator a reward in cryptoassets (automatically paid into the creator's wallet).

29. The creator has two income streams – being the original sale proceeds, and the subsequent rewards on secondary sales. The creator will be subject to tax on worldwide income in the country of residence, and may also be subject to tax in the country of source (i.e. where the buyer is located) if the reward is classified as a royalty subject to withholding tax.

30. For income tax purposes in New Zealand, as discussed in *Weekly Comment* 19 August 2022:

(a) NFTs are not regarded as financial arrangements and the financial arrangements rules will not apply;

(b) If NFTs are acquired for personal use and enjoyment, there will be no tax implications of a subsequent sale;

(c) Gains from selling NFTs will be taxable if:

(i) Sold as part of a business of creating, buying or selling NFTs; or

(ii) The NFTs were acquired for the purpose of sale.

31. Inland Revenue has stated that a taxpayer would need to provide clear and compelling evidence about their purpose for acquiring NFTs at the time they were bought, to support the treatment of gains on sale as being non-taxable.

32. Where NFTs are paid for using other cryptoassets, the exchange of the cryptoassets for NFTs could itself be a taxable transaction.

33. The question of whether withholding tax applies and the implications of a relevant double tax agreement are issues that would need to be considered. In New Zealand, there have, so far, been no laws discussed that may impose withholding tax in such circumstances.

34. For GST purposes, as also noted in *Weekly Comment* 19 August 2022, supplies of NFTs will be subject to GST if supplied by a registered person. Sales of NFTs by a registered person to non-residents will be zero-rated.

35. Tax rules have recently been proposed in the latest tax bill to charge GST on platform sales of accommodation (Airbnb) and transport (Uber), but at present there are no tax rules proposed to cover platform sales of NFTs through digital marketplaces.

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