Cryptocurrency Investments for SMSFs

Cryptocurrency is a term used to describe digital assets used as a medium of exchange. The records of ownership are stored in electronic ledgers where cryptography is used to secure both transaction records and transfers of ownership. There are many types of cryptocurrency already available and new ones being created that utilise different blockchain technology. Blockchain is a continuously growing, list of records that are linked and secured with cryptography.

Returns on cryptocurrency are derived by capital growth on selling the currency as they do not earn income directly. The value is derived by demand and supply of the currency which is largely based on investor perceptions and the underlying technology involved. They are considered to be high risk investments as their values are based largely on investor perception and the volatility affects the returns achieved.

There are a growing number of cryptocurrencies available, so demand and supply is constantly evolving as the market develops. As digital assets they have decentralised control and operate independently of central authorities, banks, or governments. They are part of an unregulated market.

They are not prohibited for SMSFs; and trustees that want to control and maximise their investment returns/retirement benefits can invest in cryptocurrencies as long as they consider the issues noted in this document. We will outline how cryptocurrency is stored electronically, classification for tax purposes, SMSF compliance issues to be aware of and the documentation requirements for SMSFs to satisfy the annual audit requirements.

Storage

Cryptocurrency is bought and sold on an exchange and then stored within a digital 'wallet'. The wallet software enables investors to store, send and receive digital assets. A wallet has both a private and public key associated with it. The public key is a long sequence of letters and numbers which is the wallet address. A private key is essentially like a PIN which enable investors to access and use their cryptocurrency.

An exchange wallet is a custodial account as the exchange holds the private key. Wallets can be hot or cold. A hot wallet is connected to the internet whereas a cold wallet is run offline and has less risk of being compromised.

Wallet information needs to be documented and stored securely so it can be passed onto other trustees or beneficiaries in the event of incapacity or death of a member. If not documented, it may not be accessible ever again. SMSF trustees should document that precautions have been taken to secure this information and ultimately the benefits of the fund.

Classification

Despite its' name, cryptocurrency is not a currency and is acquired for investment purposes and treated as a capital gains tax asset under Australian tax law. Therefore, it is important that trustees keep appropriate records to calculate their capital gains and losses. In the SMSF financial statements and annual return it is also important that cryptocurrency is classified appropriately. The SMSF annual return has a specific field under 'Other investments' to report the value as of 30 June each year.

It is also worth noting for GST registered SMSFs, that where not carrying on a business, there are no GST consequences to consider in buying or selling digital currency.

Compliance issues

Any investment for an SMSF must be allowed under the trust deed and investment strategy; must be registered with the correct SMSF ownership details and must comply with any investment restrictions under the SIS act and regulations. As cryptocurrency is an evolving category of investments, there are also other compliance issues to consider specifically for SMSF investors.

- Trust deed requirements – Trustees need to ensure the governing rules of the fund allow them to invest in cryptocurrency.

- Investment strategy requirements – Trustees need to ensure that the investment strategy allows for digital assets or update their strategy if required. They need to consider the return will come from growth in the value and they need to consider the risks in relation to both the value and the security of the chosen method of storage.

- Separation of assets – The trustees should keep SMSF assets separate from their personal assets. The wallet and exchange account should be in the name of the SMSF trustee as trustee for the SMSF. This can be problematic for custodially held exchange wallets. It is also important that trustees use the SMSF's bank accounts to directly buy and sell cryptocurrency.

- Sole purpose test – The trustees need to maintain the SMSF for the sole purpose of retirement benefits for members or their dependants if they pass away before retirement. The trustees should not receive a direct or indirect financial benefit from the investment decisions they make and should not receive any personal benefits related to an investment in cryptocurrency.

- Related party acquisitions – The trustees cannot accept cryptocurrency as either a transfer from a related party or a contribution as it would be deemed as an acquisition from a related party which is prohibited. Cryptocurrency does not satisfy any of the exemptions under section 66 of the SIS Act for related party acquisitions.

- Charges over assets of the fund – The trustees cannot create a charge over the SMSF's assets by hedging their cryptocurrency investments. There are no exceptions under the law for this.

- Valuations – Trustees must ensure that investments in cryptocurrency are reported at fair market value obtained from a reputable exchange. For 30th June valuations, the ATO accept the 30 June closing value published on the website of a cryptocurrency exchange that reports historical cryptocurrency values.

- Pensions and lump sum payments – Trustees can use cryptocurrency to make an in-specie lump sum out of the fund where they meet a condition of release. However, a lump sum will not count towards the minimum pension requirements as pension payments must be made in cash.

Documentation

Where all of the above requirements can be satisfied, it is essential that the documentation can be provided to substantiate the transactions and investment for audit purposes. To pass the annual audit the following documentation is required depending on how the cryptocurrency is held:

- Exchange/broker/custodial wallet holdings

  - Holding confirmation – A holding statement from the exchange as at 30 June of the relevant year is required to confirm the holding balance. It must also confirm the SMSF is the legal owner of the account
    - o OR Where a holding statement from the exchange is not available a signed declaration can be provided to confirm the type of cryptocurrency, units held, market value, exchange used and confirmation it is legally owned by the SMSF.
  - Transaction history – A full year transaction history is required for each exchange account.

- Direct/non-exchange/off-exchange holdings

  - Holding confirmation – To confirm holdings the unique wallet address of each holding needs to be provided for direct confirmation. The wallet address generally shows live holdings so a reconciliation back to the 30 June balance is required.
  - Ownership declaration – A signed declaration is required on an annual basis for any wallet not held on an exchange. This needs to confirm the full wallet address and state that the wallet is owned by the SMSF and used wholly and exclusively by the SMSF. For cold storage of cryptocurrency the storage location of the device is also required to be stated in the declaration.
  - Transaction history – The wallet address will show the full transaction history.

The compliance issues associated with investments in cryptocurrency within an SMSF must be considered before any investment is made. It is also essential to consider how the cryptocurrency will be acquired and stored; and whether the associated documentation will be available to satisfy the audit requirements each financial year.

Please note this fact sheet is for educational purposes only and Cryptocurrency investments are not currently allowed under the Xpress Super service offering.