Division Head
Financial System Division
The Treasury
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PARKES ACT 2600

By email: ICO@treasury.gov.au

28 February 2018

Dear Sir/Madam

Consultation: Initial Coin Offerings – Issues Paper

PwC welcomes the opportunity to make a submission to Treasury in relation to its consultation and review of the Australian regulatory and taxation landscape surrounding Initial Coin Offerings (**ICOs**).

Note that our submission uses the term **Token Raising** as we believe this is more appropriate for the market (and more clearly distinguishes token raises from initial public offerings).

While token raises have ebbed and flowed in terms of popularity, they can play a role as a liquidity source for start-ups that are focusing on blockchain technology. Often these start-ups are FinTechs - a strategically important growth prospect for the Australian economy. For this reason, where honest participants are seeking to use token raises to achieve initial funding for innovative ideas, we believe that the appropriate regulation of token raises, including clarity around their tax treatment, is vital.

Our comments and recommendations in response to this consultation are set out in the attached Appendix. You will note that we focus on taxation matters only and we understand that there are a number of other submissions that will address the commercial and industry matters raised in the Issues Paper.

Our key messages on taxation are as follows:

- The complexity of the taxation laws in Australia, combined with the higher tax rate, provides a practical deterrent to token issuers. Where token issuers engage with the Australian tax law, we have seen them find particular challenges in resolving the tax treatment for utility tokens. This has often led token issuers to prefer a security token raise, which brings further legal complexity. In several cases, token issuers have ultimately reverted to a capital raise. This turn of events suggests that Australian token issuers are not fully accessing the benefits of the token markets.

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- Upfront income taxation and GST on certain utility token raises (e.g. where a platform is already built and is operational, and the utility token is the revenue generating asset of the issuer) may be appropriate. However, this is not intuitive in circumstances where a token issuer raises funds for the purpose of building a platform, brand community or network (i.e. a capital asset), particularly where the build of the platform is highly innovative. In these cases, the activity - while not strictly an equity raise - has characteristics that may justify similar treatment under tax laws. Even if the tax law ultimately achieves this result, it is a costly and complex process to assess the relevant issues, exacerbated by the new technology involved and the absence of case law or ATO guidance.

- While there are some challenges for token holders, in terms of the tax treatment of tokens, we believe that these challenges are (for those most part) not distinct from those arising from transactions involving cryptocurrency more generally. We acknowledge the efforts that the ATO has undertaken in providing clarity on many of these matters. We encourage this process to continue (and perhaps expand to consider the tax treatment of tokens). We also encourage this process to be formalised through issuance of public rulings to accompany ATO website guidance.

- If Treasury agrees that token raises are a strategically important source of liquidity for the FinTech sector, and that they should not be discouraged, steps should be taken to consider *when* upfront taxation is relevant. Where it is found that the existing laws are unclear, or lacking, a streamlined tax regime could provide some clarity. We believe that the early stage innovation company regime provides a sound guideline for interacting with the start-up community in a way that is efficient, low cost, and transparent. Features of this regime could include:

    - Regime is only available to start-ups that fall below certain income thresholds.

    - Issuers should only have access where they have complied with relevant regulatory rules (whether this be existing guidance from ASIC and compliance with AML/KYC rules, or compliance with new regulations that are to be introduced).

    - The regime could provide a set of principles to assess whether taxation should be upfront or deferred, and perhaps would allow for deferral where the platform is truly innovative, is not yet established, and requires the token raise to fund the build. Industry should be consulted, together with the ATO, ASIC and other stakeholders to understand the factors that are relevant from a policy perspective, to encourage genuine FinTech innovation.

- ATO guidance could accompany the legislation and provide a roadmap to help issuers self-assess and prepare short form rulings.

- Further refinements could include a 100 points test, where issuers can self-assess if certain criteria are met. This would need to be discussed with stakeholders.

- Where the regime applies, depending on the token raise, it may be appropriate for the raise to be treated as if it were an equity raise (i.e. no upfront taxation) or for a tax deferral to apply until the platform becomes operational (similar to the treatment under accounting principles in respect of many platform builds).

PwC are also happy to discuss this submission in further detail. Please contact Sarah Hickey on 02 8266 1050 in the first instance.

Yours sincerely

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Appendix

Detailed comments and recommendations

We note that our comments and recommendations below are set out and arranged in accordance with the Key Questions contained in the relevant section of the Treasury Issues Paper, being Part 5 ("Tax treatment of ICOs").

Tax treatment of ICOs

Key questions

5.1. Does the current tax treatment pose any impediments for issuers in undertaking capital raising activities through ICOs? If so, how?

Yes. Our reasons for this response is outlined below and has regard to various practical and technical issues affecting the issuer, investors and the broader economy, and in the context of the nature of the token raise.

5.1.1. General observations and anecdotal evidence from the market

The types of activities that take place under a token raise are broader than "capital raising"

The question above implies that the objective of a token raise is only to raise capital. However, it is our experience that the reasons for the token raise might be varied, depending on whether the issuer is trying to:

- Raise capital to fund a new idea (usually related to blockchain).

- Build a network or community of support for a platform (where it is either non-operational, or is operational but depends on a network of supporters in order to meet its potential).

- Secure actual participants on already operational platform.

Equally, the nature of the token issued can vary greatly. At one end of the spectrum, an issuer might issue a security-like token which meets the definition of tax law equity. At the other end of the spectrum, the token may have no immediate attributes unless/until the platform is actually deployed. A token may be equity, trading stock, a CGT asset and/or a GST digital currency, or it could fall outside all these categories.

The **intention** and the **nature of token** should both be relevant to determining the tax treatment of a token raise. However, under current law, the latter point tends to drive the tax technical analysis and in some cases, leads to anomalous results, which we discuss further below.

There is a need for regulator and adviser caution, however this should not preclude honest participants from being able to access the benefits of the token market

At the outset, we acknowledge that there are challenges with cryptocurrency, particularly in relation to “sham” token raisings and a lack of regulation in the market more generally. Such practices should not be tolerated by regulators or advisers and there is a need for them both to work together to understand how the legal and tax system should respond to such challenges. We agree that this should be a priority in any tax or legal reform to the token raising market.

Our experiences across the market suggest that there are many participants that are genuinely seeking to comply with their obligations when aiming to access the token market as a new and innovative source of funding and/or brand support for their projects. We believe that a system that provides certainty for those taxpayers is crucial, provided that the system does not come at the cost of protecting potential investors or participants in a token raise.

Anecdotal evidence on token issuers' response to the complexity of Australian tax laws generally

The level of uncertainty in the Australian market means that the tax issues relating to token raises require significant resources and expenditure to resolve. Equally, these are new issues for the ATO to tackle and the answers are not intuitive, meaning that there is little guidance other than that the revenue/capital rules apply, and the raise “may” be taxable. For this reason, in many cases these “headline” tax complexities *of themselves* deter token issuers from considering Australia as a potential location for a token raise.

Token issuers are often unaware of the complexity of the Australian tax laws (in particular, the revenue/capital distinction) and may not consider this until the token design is complete (or the token has been issued). Anecdotally, token issuers that do consider this as part of their design process tend to either seek to raise outside Australia, or select a security token because it is the most straightforward.

Where corporate token issuers move outside Australia, they remain subject to risk, in that the ATO's revised view on central management and control might mean that an offshore issuer is *still* an Australian tax resident. For this reason, Australian founders that wish to retain control and direction of their company are unlikely to be able to raise from an offshore entity, without that entity being an Australian tax resident. Founders then acknowledge that, if the token raise needs to be conducted from

Australia, a straightforward avenue is required where the income tax outcomes are known, and no GST should arise.

Disappointingly, where token issuers have chosen to stay in Australia and seek a security token raising, we have seen several issuers choose not to proceed with the raise, due to other challenges with security tokens (e.g. level of ASIC consultation and uncertain aspects of many Corporations Act requirements relating to digital shares). That is, the level of tax uncertainty "funnels" the *token design* towards a security, and then the level of corporations law uncertainty "funnels" the security *token raise* back into a capital raising.

We believe this chain of events is concerning because it means that potential token issuers are pushed back into seeking the same sources of funding that they could achieve outside of a token raise. In practice, the opportunity that a token raise offers (including access to different pools of liquidity, the opportunity to build a network of users quickly/efficiently) is not actually realised by many Australian companies.

Anecdotal evidence on the impacts of token raises being taxable or potentially taxable upfront

Another challenge for token issuers when considering whether to undertake a raise from Australia, given the uncertainties noted above, relates to the amount that should be set aside to pay tax. Many issuers will have a cap on the amount that they seek to raise, set by reference to the costs or plan for their operations. Equally, issuers ask questions about *how* they pay their cash tax at the relevant due dates, where most of the token proceeds are received in cryptocurrency. These two challenges are discussed below.

Token holders often do not know **the quantum of pre-tax funds** they need to raise, because they are uncertain of the portion that needs to be set aside to meet cash tax liabilities. This is particularly difficult to manage where the token raise is subject to GST, because an Australian issuer may not be subject to GST to the extent that tokens are issued to overseas holders, but may be subject to GST where Australian issuers participate in the token raise. (As Treasury is aware, the concept of "digital currency" does not apply to most utility tokens, hence is not an appropriate carve out). Until the raise happens, it is challenging to predict the funds that need to be set aside for the tax liability because the investor base is so dispersed, and the likely location of key investors is unknown. While the token issuer might consider passing on the economic burden of the GST to Australian investors, this would disincentivise those potential investors from participating and would ironically put Australian issuers at a *disadvantage* in securing Australian participants.

If funds are raised in cryptocurrency rather than in the token currency, there is also a need to liquidate cryptocurrency to AUD to meet tax liabilities. Generally, if the funds are raised in ETH or BTC, there would be a relatively liquid market to participate in, and the liquidation of a large amount of ETH/BTC at tax payment date would not necessarily have market impacts. However, exchange rate risk sits with the token issuer. That may encourage the token issuer to seek fiat currency as well as cryptocurrency as part of the token raise, or they may need to manage the tax liabilities by slowly liquidating cryptocurrency to fiat currency over a period of time. While these challenges are manageable, they add to the already complex tax landscape. As Treasury might imagine, explaining all of these complexities to an Australian founder can generate a response that an Australian issuance seems “too hard”.

Strategically important sectors of the economy are impacted

It is important to put the above comments in the context of the “users” of token raises, to understand the sectors of the economy that might be impacted by the uncertainties.

We have observed that the primary issuers of token raises are start-up businesses who, due to the innovative and/or technology-backed nature of their businesses, aim to obtain alternative forms of finance. Where blockchain technology is fundamental to the idea that is being posited, a token raise is an alternative source of funding and provides access to a blockchain-literate audience, that is more attuned to the feasibility of the issuer’s idea, and the opportunity it presents. In some cases, a token raise offers such exponential value over a traditional capital raise, particularly in terms of developing a community of supporters for a project, a network of early adopters, or simply customers.

For most start-ups, timing is fundamental to their success and absent a more certain tax legislative framework and appropriate guidance for reference, such businesses are experiencing considerable strain and delays on the implementation of innovative projects in Australia.

Anecdotally, many of the impacted businesses are Fintechs, because blockchain - as a mechanism for transferring value (almost instantaneously) - has natural application to the financial services sector.

This outcome is concerning, given Australia’s focus on encouraging FinTech.

The current tax treatment of token issuances is unclear, compounded by the wide range of tokens

Our response is primarily focused on token issuers, as we are of the view that the existing tax legislative framework adequately deals with the current tax implications for token holders.

We also believe that providing clarity to token issuers can improve the position of token holders. This is because where token issuers are confident about the tax laws that apply to them, and how the tokens should be characterised for tax purposes, relevant disclosure documentation can include additional guidance that may be helpful to token holders. At the moment, there is very little in many White Papers in relation to taxation, other than a caution that token holders “seek tax advice”.

As noted above, the most common yet complex issue in relation to a token raise is the nature of the token raised. The presence of a wide range of token categories (including some which may have a hybrid of characteristics from different token types) creates a challenge not only for the industry and token issuers, but also experienced tax practitioners. While there are longstanding common law principles that can (in theory) be applied to the token issuance, the principles are of themselves challenging, i.e. revenue/capital, and this is compounded by the fact that there is no readily available precedent which applies to (say) a utility token raise. Equally, the ATO's guidance on crowdfunding - which in some cases leads to a position that the fundraiser is not carrying on a business until the funds are raised - seems difficult to apply to a token issuer, given the level of planning required for a token raise.

Under current law, the **nature** of the token is taken as **instructive** on the intention of the token issuer. It is therefore a shortcut method of identifying the appropriate tax treatment in a range of circumstances.

Further details on these issues are considered in section 5.1.2 below.

We believe that the tax technical challenges in applying the existing legislative concepts and provisions to a token raise - once the token has been classified - can be broadly broken down into two parts: (i) upfront tax impact; and (ii) ongoing tax implications. An overview of the relevant tax considerations is summarised at section 5.1.3 below. We believe that the position for token holders is manageable, particularly if the position for token issuers is clarified, and suggest that this is the focus of Treasury's work (see section 5.2).

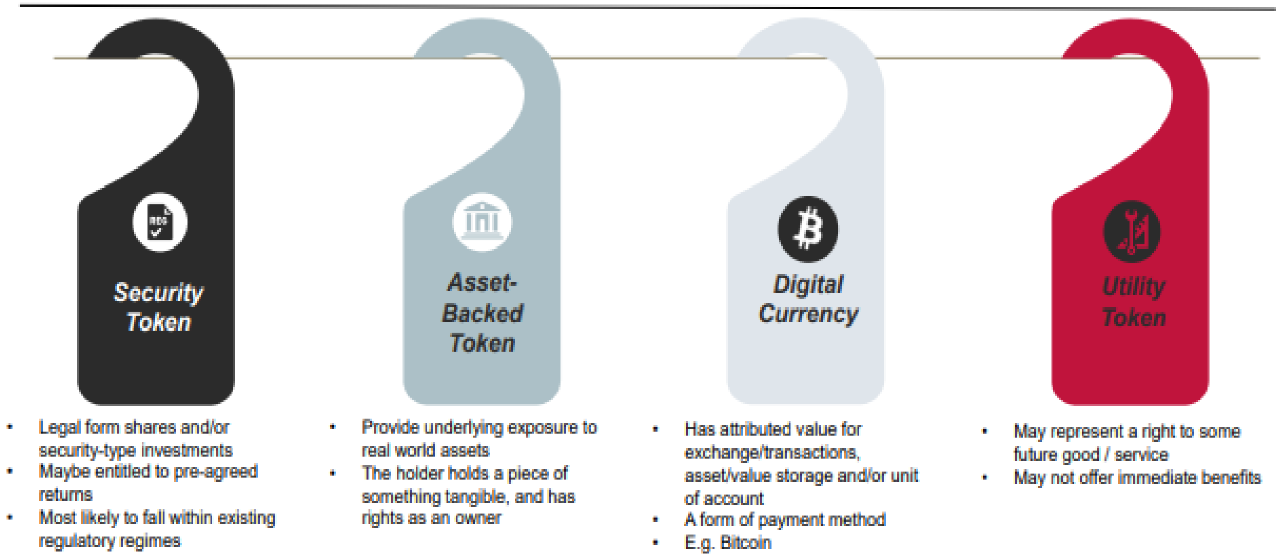
In section 5.3, we make recommendations in regards to some changes to the existing legislative framework and guidance in addressing the practical and technical issues noted. We challenge the view that the nature of the token should alone govern the tax outcomes that arise, particularly for utility tokens.

5.1.2. Classification of tokens is helpful to assessing tax outcomes, but difficult when applied to utility tokens

Certain types of tokens fit within existing tax frameworks, however the design opportunities for utility tokens are so broad that the tax outcomes are not easily identified or applied

There are broadly four main categories of tokens: utility, security, asset-backed and digital currency. However, we believe that tokens exist on a **spectrum** and that some tokens, particularly utility tokens, vary considerably in character. In the diagram below, we plot the types of tokens in terms of tax certainty (from highest to lowest) that we can attribute to their issuance.

Figure 1 - Types of tokens



Security tokens are clearly equity for tax purposes. Asset-backed tokens may offer a right to an underlying asset that is held on bare trust by the token issuer. Digital currencies are effectively cash-like. While not underestimating the nuance and tax issues that might arise for each of these categories, we believe that the issues are manageable under the existing tax laws.

However, the challenge arises for utility tokens, which bundle together a range of potential tokens (leaving aside hybrid tokens):

- Tokens that provide access to a platform which has already been built;
- Tokens that provide access to a platform that may be built in the future;
- Tokens that may provide access to one platform or service initially, but may convert to something else entirely where a certain (contingent) future event happens.

The **intention** behind a token raise is reasonably apparent with a security token, asset-backed token, or digital currency, so the token forms a natural proxy for the appropriate tax treatment. For example:

- A security token is clearly aimed at providing an equity interest in the issuer.

- An asset-backed token is clearly aimed at providing the token holder with digital access to a particular asset, which is effectively held on trust by the token issuer.

- A digital currency is usually acting as a lubricant for the blockchain protocol that is being operated, and has no value or attributes rather than to be exchanged for another digital currency. This extends beyond Bitcoin or other cryptocurrencies and may extend to tokens such as gaming tokens (which could otherwise be defined as utility tokens being used on an operating, functional platform), which are assigned a particular value and used as a proxy for cash.

In contrast, the intention behind a utility token is often more difficult to ascertain. This is because the use of the utility token might be contingent on a future event happening. The utility token might give a right to assets that do not yet exist (e.g. a crowdfunding). Further, actual “utility” of the utility token might be entirely dependent on network effects or the existence of a brand community surrounding the blockchain protocol. While some of these challenges can also exist for asset-backed tokens and digital currencies, the sheer magnitude of design possibilities means that utility tokens defy a “one size fits all logic”.

To date, the ATO has provided some high level guidance in relation to the taxation of cryptocurrency, however, this guidance mainly focuses on cryptocurrency trading rather than the tax implications of token raises. Furthermore, the limitation of the guidance to Bitcoin and other cryptocurrencies or digital currencies that have the same characteristics as Bitcoin means that such guidance is of little direct relevance and application for token raises of other token types outside of digital currencies. Admittedly, there is market confusion about the application of some ATO guidance to Bitcoin and Ethereum as if they are the same type of token, when in fact Ethereum is a utility token. These might be resolved if one were to accept that, once a utility token reaches a particular level of scale, the ATO classifies it as a digital currency and the tax outcomes that would otherwise arise from this characterisation flow through.

As will be discussed later on, we believe there is merit in adopting a particular approach for utility tokens, in order to streamline the process for token issuers that seek clarity on the tax treatment of a raise.

The tax issues arising in respect of utility tokens are complex, and often the cost of resolving this tax treatment is too high for a token issuer to contemplate

To explain the challenges with the classification of utility tokens in further detail, we note some of the issues that we have encountered when advising on these issues. We note that we see these issues arising in tandem, i.e. the token issuer will often need to work through more than one of these issues at the same time:

- Does the simple fact of a token raising suggest a company is carrying on a business, because it requires a considerable degree of organisation and planning? Is this always appropriate where the business's success hinges on the funds that are raised via the token raise?

- Does the utility token reflect a right that is similar to a reward-based crowdfunding? If so, is the tax treatment of the token proceeds determined by the principles in *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 (i.e. taxable unless refundable)? How does that apply in circumstances where the "reward" is not guaranteed and is highly contingent (including where there is a degree of innovative risk in the idea being posed)?

- What if the terms of the utility token are so vague that no legal right is conferred? Is it still capable of being a highly contingent asset (i.e. a CGT asset) or is it simply a tax "nothing"? (Note that this complexity in some part arises because White Papers are not regulated and may be unclear on what is being offered to the token holder, so in some ways suggests a regulatory challenge).

- What should drive the tax character of the token where it can or may be exchanged for another token in the future? As there are no look through rules (cf. options etc), would multiple taxing points arise for the issuer in relation to the issuance of one token?

- Where a utility token raise is an irrefutable, once-off event because the blockchain technology will not allow further tokens to be minted, can tokens be characterised as "trading stock" for the issuer? While some attributes of trading stock are existent, the genuine infrequency of the event (which is somewhat unprecedented) challenges traditional views of this concept.

There is also an underlying question of whether any of the above should fundamentally matter where the **intention** of the issuer was to raise funds or build a community or network, as these are fundamentally "capital" rather than revenue activities. As Treasury may be aware, the outcomes of many of the above questions default to a "revenue" or "revenue-like" treatment for the token (discussed further below).

Treasury might consider implementing a streamlined regime to provide certainty on the treatment of utility tokens. We believe that ATO guidance in relation to other forms of tokens could provide clarity

It is quite possible that further guidance would be suitable for resolving the tax treatment of token raises other than utility tokens. However, we believe that a hybrid approach involving legislative reform together with a streamlined ruling process is a more pragmatic solution. We believe that this solution has true merit with regard to utility tokens but could provide broader clarity for start-ups.

We discuss this further in our response to Question 5.3 of the Discussion Paper.

For the other types of tokens, we suggest that the ATO should consider providing practical examples and base criteria, for example through an administrative procedure. Where appropriate, several examples of existing tokens that would fall under the categories below should be listed in the guidance. For example:

- *Security tokens* – which represent legal form shares and/or security type investment and holders may be entitled to a pre-agreed return, e.g. dividends.
- *Asset-backed tokens* – which provide the holder with underlying exposure to assets such as gold, diamonds, securities, cash and real estate, and the holder has rights as an owner.
- *Digital currencies* - tokens with no attributes other than a currency ***and potentially*** tokens that were once utility tokens but that have now reached a high degree of liquidity.

Through consultation with ADCA and the ATO, we believe that this guidance could be prioritised and achieved in the near future. We would welcome the opportunity to participate in its development.

5.1.3. Technical issues arising from ICOs – upfront and ongoing implications

(a) Upfront tax impact

A key commercial impediment for issuers in relation to a token raise is the potential for the raise to be subject to upfront taxation on revenue account or as trading stock. Where token raises are on capital account, further - and sometimes complex - CGT considerations also result. These can result in the token raise also being taxable upfront, with tax being deferred until a later stage, or not payable at all.

From a practical perspective, there is little communication on tax implications of a token raise. Where that communication is given, it would be likely to disincentivise participants from choosing to invest in an Australian token raise

From our experience, most if not all of the White Papers issued on token raises have not factored in appropriate tax considerations for the issuer, including a funds waterfall that includes a calculation of the token proceeds (if any) that will be subject to tax. In some ways, this is because tax is a nice problem to have, as it only arises if the token raise has been successful.

As such, the overall tax impact (including any upfront tax implications) is generally not communicated to potential token holders. As noted earlier in our submission, because GST impacts of the token raise may not be known until the amount of Australian participants is confirmed, it is also difficult to communicate the impact with any certainty. Clearly, the possibility of upfront tax on a particular token raise (including both income tax and potentially GST - discussed below) may deter potential token holders and diminish the overall attractiveness of the project, given that a significant portion of the funds contributed may not be invested into the project itself from the outset.

Token holders that are choosing between investing in a project offered by an Australian issuer versus a project issued out of a tax haven or a lower taxed country (e.g. Malta, UK, etc), may choose that their dollar "goes further" towards assisting a start-up where it is invested outside Australia. Upfront taxation, if applicable, puts Australian token issuers at a competitive disadvantage, particularly given that our corporate tax rate is one of the highest globally.

Upfront taxation is problematic for utility token raises

From an income tax perspective, from our experience most token raises involving plain vanilla security tokens (the characteristics of which are akin to traditional shares) are not taxable, whereas asset backed tokens and digital currency tokens are more likely to be taxable. We believe that these outcomes can be reached intuitively under the existing law and do not discuss them further.

The challenge lies with utility tokens which - as noted above - take on many shapes and forms. In many cases - even though something of *potential value* (i.e. the token) is being issued, that value may not be realised for some time. When the market invests in that item of value and it is not a share, there is an argument that they are "investing" in a quasi-equity sense (i.e. the investor believes the value will go up and seek to participate in the profits of the **idea** rather than the underlying business). This is because the idea's value is driven by network participation, brand community and profile. What is more relevant here is the issuer's intention, which may be to raise capital without issuing shares (and tap into a different liquidity pool), build a brand community or build a network of support.

We agree that where the issuer's intention is to issue an asset with a specified value (e.g. a gaming token or asset-backed token), or to provide access rights to an existing platform, the outcome under current tax law is intuitively revenue treatment. There are clearly trading stock and/or *Arthur Murray* attributes in these circumstances. However, this does not apply intuitively to utility tokens that are contingent on future events happening, in order for those tokens to be usable. This is particularly the case where the funds received from the token raise are to be spent on building the network **for the benefit and future use of token holders** rather than simply for the token issuer to profit.

The revenue/capital question here draws on the principles in *GP International Pipecoaters v Federal Commissioner of Taxation* (1987) 19 ATR 84, and a long line of supporting case law. Equally, case law relating to the tax treatment of government grants and bounties may be relevant. Unfortunately for issuers, in our experience it has been very difficult to apply these laws with certainty to a utility token raise. Equally, given the lack of ATO guidance, a private ruling from the ATO is the recommended course of action. While there may ultimately be some guidance in the future, the nature of the issues, combined with the complexity of the rulings process, may mean that some that token issuers disengage from the problem.

Further, even if a token raise is on capital account, questions such as whether CGT event A1 or D1 arise. If the token issuance gives rise to a right for the token holder, upfront taxation may ensue in any event. This seems counterintuitive where the right is highly contingent (e.g. where it relates to a platform that has not yet been built, and particularly where there is a degree of innovation required for the project to succeed).

In contrast, with a security token issuance, there are clear pathways in the tax law that prevent the token proceeds from being taxable. As the proceeds of an equity issuance are expressly contemplated under the capital gains tax rules, and an equity raising is seen as a clearly capital transaction, it is far more intuitive to reach a non-taxable outcome. As mentioned earlier in the conversation, even where the intention of token raises may be quite similar, the **nature of the token** appears to determine the outcome.

We have no objection to this where the nature of the token is revenue-like (e.g. where the relevant platform is using the token in a currency format, e.g. a gaming token, or where the token provides an immediate right to use the platform). However, this is often not the case because the token raise relates to a future blockchain ecosystem. These situations - which are often the ones involving the most innovation and entrepreneurial risk - are ironically the situations that are at risk of upfront taxation.

GST is an additional burden

We have noted above the practical issues that arise where GST applies to token proceeds.

While the digital currency rules, or rules relating to financial supplies, may exclude some token issuances, these rules are less likely to apply to utility tokens.

The potential GST cost, as well as the administrative burden of meeting the GST obligations (e.g. preparation of tax invoice, GST registration, lodgements, etc) represent further impediments to the issuers that are seeking to undertake a utility token raise. While this may only be relevant to the extent that there are Australian token holders, it disincentivises token issuers from offering to Australians and locating their token raise in Australia. It is also another factor that can prompt token issuers to consider a security token as an alternative, thereby funneling the token raise back towards more traditional forms of fundraising, and eroding the full opportunities in the token market.

(b) Ongoing tax implications

Similar to the upfront tax analysis, any ongoing tax implications (income tax and GST) for an issuer are also likely to factor into the ultimate success and viability of an token issuance in Australia.

From an income tax perspective, the potential for double taxation on the disposal of cryptocurrency poses a significant challenge for token issuers. For example, most if not all token issuers are likely to keep a portion (usually around 20-30%) of the tokens to provide coverage for ongoing operating costs. There are instances where a token issuer will raise funds in a fiat currency (e.g. AUD or USD), however from our experience in most cases, the funds raised are likely to be in forms of more prominent cryptocurrencies (e.g. Bitcoin, ETH, Litecoin etc), because these are the predominant currencies of the token market.

When operating expenses arise, a token issuer may liquidate the tokens on crypto-exchanges to convert the tokens to fiat currency - this raises two complications from a tax perspective. Firstly, double taxation may arise if the tokens raised are taxed upon receipt (e.g. where the tokens are considered to be held on revenue account or as trading stock in the hands of the issuer) and again on the subsequent conversion to fiat currency (based on the ATO's guidance on the taxation of cryptocurrency). This tax inefficiency poses as a significant financial impediment to issuers, because they are likely to receive most of their funds in cryptocurrency rather than fiat currency. Secondly, given the different categories of tokens that may be issued (as discussed earlier), the ambiguity around their tax treatment is further exacerbated for issuers upon the disposal of these "treasury" tokens upon the conversion to fiat currencies.

Even if some of these challenges are the "norm" and apply to cryptocurrencies more generally, we believe that there are important GST challenges for token issuers. As tokens are exchanged on the secondary market, there is a risk that a transfer of a token between two Australians is subject to GST. While there may be de minimus rules that prevent GST from applying, these will not always apply, particularly for platforms that are intending to reach critical mass by inviting corporate participants. Token holders may find it difficult to identify who they are buying from/selling to, so that the GST implications cannot easily be resolved. However, for the token issuer, the knowledge of dormant GST risk may deter them from using a token that is going to be subject to GST. Again, security tokens are an easy fix.

There are other operational tax matters for token issuers to consider, depending on the nature of the token. We expect that many of these issues have not yet been raised with the ATO through rulings, so there may have been limited opportunities for guidance to be considered. We outline below some of those issues:

Issues	Details
Withholding tax implications on certain tokens with a right of return	Application of relevant withholding tax provisions where a particular token carries a right of return for the holder (in particular where the holders are of a different tax residency status compared to the issuer). Royalty withholding tax and its application to utility tokens should be considered.
Interaction with the TOFA rules	It is currently unclear when a token would be a 'financial arrangement' for the purposes of the Taxation of Financial Arrangement (**TOFA**) provisions under Division 230 of the ITAA 1997. In addition, the applicability of the TOFA rules to certain asset-backed tokens should be clarified as this will impact how any income should be recognised. For example, for an asset-backed token with exposure and a real claim to underlying commodity type assets, one view may be that the tax implications of holding such tokens should be driven by the nature of the underlying asset.
*Controlled Foreign Company (**CFC**) rules*	Where an ICO entity in a foreign jurisdiction is controlled by an Australian parent, there is need to consider the application of Australia's CFC rules. In such instances, the income derived by the non-resident ICO company will need to be considered under the active income test set out under Division 8 of the ITAA 1936. Given the ambiguity on token characterisation (as discussed above) and the resultant tax implications thereon, that characterisation is likely to inform the nature of the type of income derived by the non-resident ICO entity, including the division between active and passive income for the purposes of the CFC rules.

*Decentralised Autonomous Organisation (**DAOs**)*	DAOs are increasingly part of the blockchain space. Broadly, DAO is a form of 'organisation' formed through smart contracts and governed by consensus of token holders (i.e. not controlled by any particular entity or person). As a DAO does not have a 'physical form', nor a legal identity, it is a challenge to apply existing tax laws to tokens issued by a DAO. In particular, if the DAO is not a legal person, the application of some CGT rules (e.g. rules that have reference to disposals by a "person" or rights issued by a "person") are challenging. This is very important to resolve as it impacts fundamental issues such as the market value substitution rules, and when and how (and possibly if) a CGT event can happen. While we believe this is not immediately impacting token raises into Australia, we believe it is a matter that Treasury should be considering in order to future-proof any reform.

5.2. Is the tax treatment of tokens appropriate for token holders?

As treatment aligns to the taxation of cryptocurrency more broadly, we believe that it is appropriate

We have not identified material challenges with the tax treatment for token holders, aside from the tax challenges that exist in relation to cryptocurrency more generally. We do note the operational complexity with GST on secondary transfers of tokens, discussed above, but of course this would impact on larger entities and may not be as relevant to individual investors.

We note that for token holders, the tax treatment from holding tokens can generally be ascertained by determining whether the tokens are considered to be held on capital or revenue account, or as trading stock.

Notwithstanding our view that the existing legislative framework is sufficient for token holders, we note that certain specific cryptocurrency related transactions require further clarifications for persons that are engaging in cryptocurrency transactions more broadly. There are some fundamental challenges with how the existing laws apply to cryptocurrency generally, and that these warrant separate attention from Treasury. However, it is outside the scope of this question to respond in detail, on this broader matter.

We note that other submissions (including that of Hall & Wilcox) detail many of these issues. Some examples that we have come across include:

- Tax treatment of forking, chain splits and airdrops. While there is some ATO guidance on this matter, it is not consistent with overseas guidance (e.g. recent HRMC guidance[1]).

- Application of CGT rules where cryptocurrency is received from a DAO, particularly as to whether the DAO is a person (or deemed to be a person) so that these rules operate effectively.

- Source of cryptocurrency that is issued by an Australian issuer - are there circumstances in which non-residents trading in that cryptocurrency should be taxable in Australia?

We also note that most ATO guidance to date is in website guidance format - i.e. it is not legally binding on the Commissioner of Taxation. We encourage the work that the Commissioner has undertaken on these matters to date, as well as any future guidance, be reflected into a binding public tax ruling to provide certainty to taxpayers.

5.3. Is there a need for changes to be made to the current tax treatment? If yes, what is the justification for these changes?

As highlighted in the introduction of the Consultation Paper, "Australia's ambition is to be a global leader in technology and financial innovation that will contribute to productivity and economic growth, as well as the efficiency and inclusiveness of the financial system over the long term". We agree with Treasury's sentiments and believe that a supportive and clear tax system is an essential building block in this policy.

For the reasons we have outlined above, the liquidity offered by the token markets differs from other sources of funds available to innovative businesses (most particularly, start ups). The market has particular attractiveness to FinTechs given its blockchain underpinning. While there have been significant challenges with the market, it is feasible for token raises to be carried out in a manner that meets AML/KYC requirements, complies with legal regulations, and offers transparency to token holders.

Where token raises can be carried out in a compliant manner, we believe there is merit in having a simple process for resolving the tax treatment of a raise. The objectives of this process should be:

- Certainty for the token issuer and the ATO, in respect of GST and income tax.

[1] https://www.gov.uk/government/publications/tax-on-cryptoassets/cryptoassets-for-individuals

- Certainty for the token holder (which flows from the above).
- Low cost (noting the constraints on start-up businesses).
- Where possible, expedited (i.e. not taking several months to resolve).
- Transparency between the token issuer and the ATO.

Legislative change that draws from the ESIC rules could provide certainty

An example of a streamlined system that has proven helpful to the start-up sector is the Early Stage Innovation Company (**ESIC**) concession. The ESIC concession applies either a principles-based test, or a points-based test, to determine whether a company might be an early stage investor. Where the principles based test is applied, the ESIC rules encourage resolution of the issue through a tax ruling with the ATO.

In a token raising context, a similar channel could be used to provide clarity as to the tax treatment of the token (i.e. whether the token raise is taxable upfront, and the nature of the token for GST purposes). As there are situations where this will already be obvious (e.g. security tokens), the system may not be used in all circumstances. A straw man for this system might be as follows:

Step 1 - Threshold matters

The system should apply to start-up businesses, or businesses whose turnover falls below particular thresholds. The ESIC rules already offer some examples of how this might be achieved.

The system should then have carve outs so that it does not apply where the tax outcomes of the arrangement are already clear. In our view, this should be the case where:

- The token is an equity interest, such that the tax outcomes are clear already.
- The token already clearly fits within the GST definition of digital currency. Where this is the case, we imagine that the ATO might take the view that a token raise is taxable upfront (however this is a matter that the ATO has not provided guidance on to date).
- The token is asset-backed and simply provides a right to an underlying asset (although in this case, clarity from the ATO on whether the asset is deemed as held on bare trust would be helpful, as it would allow issuers to look through the token raise to consider the underlying asset).

The system should only be accessible to the extent that the token issuer has complied with all regulatory laws imposed on that particular token raise. This accommodates the need to ensure that even if an issuer is undertaking a utility token raise, they consider corporations laws and AML/KYC requirements. We note that the Australian Digital Commerce Association has proposed a new regulatory regime for token raises. If such regulatory reform emerges from the Treasury consultation, it would appear logical to link the entitlement to tax concessions to compliance with the new regulations.

Step 2 - Principles based approach

Where the thresholds are met, the issuer most likely has a utility token of some form, or a hybrid token. The treatment of the token raise as on revenue/capital account could be guided by a set of specific principles that have regard to the intention of the issuance, and the stage of the business.

Principles should be developed in consultation with industry, but could include no taxation (or deferred revenue recognition - see comments below) where some or all of these factors exist:

- The genuine purpose of the raise is to access liquidity, or to build a network or community.

- The token relates to development of a blockchain platform, and the platform is not in existence yet and/or cannot be funded to full functionality without the token proceeds.

- The token raise proceeds are to be used wholly or predominantly (specific tests may be required here) to fund the development of the blockchain platform.

It is expected that the ATO would issue guidance on its views regarding each element, which could be used by taxpayers to construct private binding ruling requests.

Step 3 - 100 points test

Alternatively, and where Treasury feels confident that this aligns to policy, Treasury might allow for taxpayers to use a 100 points test to secure capital or deferred revenue recognition treatment.

For example, points could be awarded for:

- Confirmation that the token raise is a once-off (hard cap), so that it cannot recur.

- Confirmation that the proposed token has no utility at this time, unless/until the platform is built.

- Innovators that have received grants or funding that are related to the development of a blockchain platform (similar to the ESIC rules around Accelerating Commercialisation Grants).

We would suggest that the viability of such a test be discussed with Treasury, innovators, ADCA, ASIC and the ATO. We also note that a principles-based test could be implemented without the 100 point test.

Step 4 - Outcomes for the token issuer

If the principles-based test is satisfied, the outcome of this may be no taxation (i.e. an outcome that would align with tax treatment of an equity raise) or deferred revenue recognition (i.e. aligning the recognition of income from the tokens with the realisation of that income on the blockchain platform).

We understand that for accounting purposes, often deferred revenue recognition arises in any event. Therefore it may not be an additional impost for token issuers to “match” tax and accounting treatment. A key benefit of this is the enhancement of the commercial attractiveness of the token raise, as well as the upfront financial position of the issuer to utilise and concentrate the funds raised on the project.

Conclusion

We acknowledge that token issuances are a challenging area for regulators more broadly. We welcome the opportunity to provide submissions on this matter, and encourage the continued development of the ideas in this paper. We would be pleased to be involved in future consultation on these matters.