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Divisional Head
Individuals and Indirect Tax Division
The Treasury Langton Crescent
PARKES ACT 2600

Sent by email**:** digitalcurrency@treasury.gov.au

Dear Sir or Madam

Submission on Federal Government response to Australia's FinTech priorities: GST treatment of digital currency and encouraging venture capital investment in FinTech

PwC welcomes the opportunity to make a submission to Treasury in relation to the May 2016 Discussion Paper on the GST treatment of digital currency (**Discussion Paper**) and to comment on how the venture capital tax laws may be amended to encourage investment in FinTech.

We set out our submission below.

Summary

PwC is highly supportive of the Government's objective to encourage innovation in the Australian economy, particularly in the FinTech sector, by removing impediments to the development and use of digital currencies and related technology and providing incentives for early stage investments in FinTech.

In our view, the GST treatment of digital currencies should align with their function/s and character so as to ensure comparable GST treatment for digital currency and similar 'things' and to avoid unnecessary advantages and disadvantages for the use of digital currency.

Digital currencies are broadly recognised as functioning as a medium of exchange, a unit of account and a store of value. In this respect, digital currencies have the same functions as fiat currencies. Therefore, the GST treatment of digital currencies and fiat currencies should be the same. This should be given effect by:

- Including digital currency in item 9 in the table at regulation 40-5.09(3) of the *A New Tax System (Goods and Services Tax) Regulations 1999* (**GST Regulations**), in the same way that 'Australian currency' and 'the currency of a foreign country' are included at item 9; and

- Including digital currency in the definition of 'money' in section 195-1 of the *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**), in the same way that 'currency (whether of Australia or of any other country)' is included at paragraph (a) of the definition of 'money'.

However, digital currencies have a number of different characteristics to fiat currencies, including that they are not recognised as legal tender in any jurisdiction and are only in digital form and digitally traded. Also, digital currencies are constantly being developed, not all digital currencies have the same characteristics and the Government has stated that it does not intend to include all digital or 'virtual' currencies in scope of the new GST treatment.

Therefore, we recommend the following in defining digital currency for GST purposes:

- A principles based definition of 'digital currency' should be included in section 195-1 of the GST Act;

- The definition should focus on the functions and common characteristics of digital currencies that the Government intends to include in scope. The definition should be simple, precise and flexible so as to enable taxpayers to readily determine whether particular digital currencies fall in or out of the definition and to allow for developments in technology and digital currencies over time.

- Digital currencies that the Government does not intend to be in scope should be specifically excluded, including by reference to particular currencies, functions and characteristics.

Consideration will also need to be given to whether changes are required to accompanying provisions and regulations, including, for example, the financial supply items and the reduced input tax credit items in the GST Regulations.

We consider that amendment the GST Act and GST Regulations in this way will remove the double taxation impediment to the development and use of digital currencies in Australia and should at least put Australia on a level playing field with other jurisdictions from a GST / VAT perspective. To make Australia more competitive, we consider that other tax related measures should be looked at. In particular, we support the Government's proposal to extend the tax concession for investments into Early Stage Venture Capital Limited Partnerships to FinTech firms.

We set out our detailed responses to the questions raised in the Discussion Paper at Appendix A.

Yours faithfully

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Appendix A - Response to Discussion Paper

A) Identifying Digital Currencies

1. ***Should digital currencies be identified for GST purposes by defining them or listing them? If a combination or alternate approach should be used, please describe how it would work.***

In the Discussion Paper, Treasury notes that there are now over 600 digital currencies of a similar nature to Bitcoin, each with their own design, characteristics and distribution model, with more being constantly developed.

In light of this, we agree with Treasury's comments that identifying digital currency by reference to a prescribed list will result in an onerous administrative burden. This is because it would require, among other things, constant maintenance as new digital currencies emerge and as existing currencies adopt new supporting protocols.

As indicated by Treasury, such additional red-tape is likely to cause a significant time lag to get a new currency added to the prescribed list. Clearly, this would create a real barrier for new entrants, and established currencies would be placed at a competitive advantage.

We, therefore, suggest that identifying digital currency by reference to a list is not best aligned to the Government's objective to remove impediments to the development and use of digital currencies.

We consider that a principles-based approach should enable greater flexibility for new entrants, produce a more efficient outcome, reduce administration costs for the Australian Taxation Office (**ATO**), and should not impact the revenue base. We do, of course, recognise that this requires a precise definition which sufficiently addresses the characteristics of digital currency, whilst being broad enough to capture new technology and changes in supporting protocol. To be effective, we suggest that a principles-based approach needs to be coupled with ATO rulings and guidance which can be updated from time to time.

It is worth noting that the Government has shifted towards a principles-based approach in other areas of the GST law in order to reduce administrative costs and provide increased certainty as to the correct GST treatment. A tested example of this relates to Div.81 of the GST Act. Prior to 1 July 2011, the Government had to determine twice a year which Government taxes, fees and charges were exempt from GST for the purposes of Div.81 of the GST Act. Given the significant list of taxes, fees and charges, this was an administrative burden. As such, the law was subsequently replaced with a principles-based legislative exemption.

2. ***Assuming digital currencies are to be defined for GST purposes, what criteria should be included? Should specific types of other currencies be explicitly excluded in the definition? Would all criteria be given equal weight?***

"Digital currency" is not a universally defined term and can been used to describe a range of virtual currencies, including cryptocurrencies (for example, Bitcoin and Ripple) and internet game currencies, and e-money (digital form of fiat currency).

The Financial Action Task Force, an intergovernmental body established by the G-7, of which Australia is a member, defined virtual currency as:

> *[A] digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction.*
>
> *It is not issued nor guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. 'real currency', 'real money', or 'national currency'), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country.*
>
> *It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. E-money is a digital transfer mechanism for fiat currency—i.e., it electronically transfers value that has legal tender status.*

Invariably, digital currencies may be defined by reference to their function and characteristics.

Treasury has identified Bitcoin and other similar digital currencies to be included in scope of the new GST treatment, but states that it does not intend to include all digital currencies, citing in-game currencies, loyalty scheme points, frequent flyer points and digital vouchers as examples of digital currencies to be excluded.

As stated above, we recommend a principles-based approach to defining "digital currency" for GST purposes, rather than identifying particular digital currencies. These principles should refer to the functions and characteristics of digital currencies that the Government intends to be in-scope of the new GST treatment. The definition should be simple, precise and flexible so as to enable taxpayers to readily determine whether particular digital currencies fall in or out of the definition and to allow for developments in technology and digital currencies over time.

In this regard, we consider that criteria listed at paragraph 33 of the Discussion Paper are all valid and make the following comments:

- Use of cryptography and de-centralised control - while all cryptocurrencies (digital currencies protected by cryptography) have no central administrative authority, there are a number of payment systems for real world transactions utilising a digital currency administered by a single authority (the payment system operator), such as Perfect Money and WebMoney. Consideration should be given as to whether such currencies are intended to be in-scope or excluded from the new GST treatment to determine whether these criteria are valid.

- Particular digital currencies that the Government does not intend to be within scope of the new GST treatment should be specifically excluded from the definition, including by reference to particular currencies, function and characteristics. This also applies to other financial instruments which may otherwise be inadvertently included in the definition of digital currency.

3. ***Regardless of how digital currencies are identified for GST purposes, should a decision maker have the capacity to exclude one or more of them under certain circumstances, such as if a currency was being used predominantly for illegal purposes?***

We agree, in principle, that some level of intervention is needed to mitigate the likelihood of digital currencies being used for illegal purposes.

However, it is not clear whether the desired outcome would be achieved through excluding certain digital currency from being treated as input taxed or as 'money' for GST purposes. This is for the following reasons:

- Fiat currency is currently used as a medium of exchange for illegal goods and services. Therefore, it seems illogical to have one rule for fiat currency and another rule for digital currency.

- We consider that the focus should be on the supply of the illegal goods or services rather than the means of exchange used to acquire those goods and services. From a GST perspective, this appears to have already been dealt with by the legislature as the definition of supply is not confined to 'lawful' supplies of goods and services.

- Defaulting to tax a digital currency that is already being used for illegal purposes has the potential to precipitate GST fraud. That is, there is a risk that participants intentionally fail to remit output GST on taxable supplies of digital currency. In this regard, we note that, in the *VAT Committee Working Paper No 854*, the EU Commission observed that taxing supplies of digital currency could, among other things, create a breeding ground for missing trader fraud (or carousel fraud).

4. ***Regardless of how digital currencies are identified for GST purposes, what can be done to ensure the provisions remain relevant as technology advances?***

We consider that avoiding reference to particular technologies, except as required to ensure only digital currencies that the Government intends to be within scope of the new GST treatment are included, is important to ensure the definition of digital currency remains relevant as technology advances.

In addition, the definition of digital currency could be included in the GST Regulations to better enable it to be amended if necessary. We also consider that published guidance from the ATO could be used to clarify the definition if required.

B) Addressing 'Double Taxation'

The Discussion Paper proposes two options to resolve the so called 'double taxation' of digital currency in Australia. We understand the options to be as follows:

- Option 1 - amend the table at reg. 40-5.09(3) such that it includes digital currency.

- Option 2 - amend the definition of "money" in s. 195-1 of the GST Act such that it includes digital currency, and amend the table at reg. 40-5.09(3) such that it includes digital currency (potentially Item 9).

5. ***Should digital currencies be given input-taxed treatment or be treated equivalently to 'money' for GST purposes, noting the limited differences in outcome and the likely compliance burdens and timeframes for implementation?***

We consider that both of the options put forward have the effect of achieving the Government's objective to address the 'double taxation' of digital currencies under the GST Act as described in the Discussion Paper.

However, having regard to the Government's broader objective to encourage innovation in FinTech by removing impediments, we consider that Option 2 - i.e. to treat digital currencies as equivalent to 'money' for GST purposes - is preferable. This is for the following reasons:

- Digital currency functions in the same way as fiat currency, namely as a medium of exchange, a unit of account and a store of value. Therefore, digital currency and fiat currency should have the same GST treatment. Treating digital currency as a commodity or other financial instrument would be inconsistent with its function and use.

- 'Money' is defined for GST purposes for the purposes of excluding the use of fiat currency and other comparable payment methods as a medium of exchange (ie as consideration for a supply) from being a supply for GST purposes (in section 9-10(4) of the GST Act). Comparable methods excluded include fiat currency transferred in digital form (payment by way of crediting or debiting an account). Given that digital currency functions as a medium of exchange in the same way as fiat currency, it should also be treated as 'money' for the purposes of this exclusion.

- Treating digital currency in the same way as fiat currency (including within the definition of 'money') should ensure that the Australian GST treatment is consistent with the EU. In the EU, the European Court of Justice has held that the trading of Bitcoin for fiat is VAT exempt (GST input taxed) on the basis that is akin to transactions in currency, bank notes and coins used as legal tender (see the Court of Justice of the European Union's judgment in *Hedqvist* (C-264/14)). It is also worth noting that the Advocate General's (**AG**) opinion in *Hedqvist* provides that digital currency and fiat currency when used as a medium of exchange (ie as a means of payment) should be treated the same. Specifically, at para. 15, the AG notes that:

> *"**that which applies for legal tender should also apply for other means of payment with no other function than to serve as such**. Even though such pure means of payment are not guaranteed and supervised by law, for VAT purposes they perform the same function as legal tender and as such must, in accordance with the principle of fiscal neutrality….be treated in the same way"* (our emphasis).

- Treating digital currency as an input taxed financial supply item, but not as money - i.e. Option 1 - means that financial supplies can arise between merchant and customer when digital currency is used to purchase goods and services. This arises because both the transfer and acquisition of a financial supply item is treated as input taxed. Therefore, both the merchant and the customer must determine the extent to which they are entitled to claim input tax credits on any related acquisitions and may suffer an irrecoverable GST cost if input tax credits are blocked - see 'Response 6 below'.

- The compliance and administrative burden of treating digital currency as 'money' would require few (if any) changes to existing business systems and processes. However, treating digital currency as input taxed, but not as money will require any merchant that accepts it as payment to at least determine if it breaches the GST financial acquisition threshold (**FAT**) and if so, determine any input tax credit denial. In addition, input taxed financial supplies of digital currency will need to be captured and reported. This will unnecessarily impose additional burdens on affected taxpayers' business systems and processes.

We acknowledge that expanding the definition of "money" in the GST Act may take longer to achieve as it would require amendments to be made to the GST Act. However, in our view, it is more important to ensure that the most appropriate solution is implemented.

6. *Are there specific examples of different outcomes between the options that would result in one option being favoured? How frequently would these circumstances arise for relevant businesses?*

Paragraph 47.1 of the Discussion Paper states that:

> *" input taxed treatment of digital currency, when compared to treatment as 'money', only results in a different outcome where the digital currency is used by a business to pay for other goods and services."*

We note that different outcomes exist because of the fact that input taxed supplies can arise in relation to the 'acquisition' of a financial interest, and this will create additional compliance burdens and potentially significant irrecoverable GST costs.

Under Option 1, any GST registered business that accepts digital currency as a means of payment for goods and services would be making two supplies for GST purposes - namely, the supply of the goods and services (which would be taxed in the usual way), and an input taxed supply of the acquisition of digital currency.

This, therefore, results in an input taxed supply being made in relation to every transaction made by a merchant where digital currency is used as means of payment. This was the very reason why the exclusion of 'money' from being a supply was inserted into the GST law.

The existence of input taxed supplies arising from every transaction will require the merchant to undertake an analysis of whether it breaches the FAT and has the potential to create an irrecoverable GST cost for merchants by virtue of any blocked input tax credits on related acquisitions. This is, of course, subject to whether the merchant breaches the FAT, and the extent acquisitions are treated as relating to the acquisition of digital currency or qualify for reduced input tax credits (**RITC**). However, the requirement to analyse and monitor compliance should not be dismissed and the potential complexity of apportioning acquisitions should not be underestimated, particularly in light of current jurisprudence. For example, how should overhead acquisitions be split between the supply of the good or service and the acquisition-supply of the digital currency?

For these reasons, we submit that Option 1 is not a feasible solution.

7. ***What effect does each of the options have on the regulatory burdens and compliance costs of different market participants (for example, consumers, merchants and digital currency traders/intermediaries)?***

Consumers acquiring goods and services with digital currency

We consider that the regulatory and compliance impost should be relatively small for the end consumer under either option - particularly, when compared to the so called 'double taxation' which arises under the current (taxable) treatment.

It is worth noting that there may be some cost flow through to end consumers by merchants seeking to cover their increased costs due to the ineligibility to recover input tax credits.

Merchants accepting digital currency

As noted above at 'Response 6', treatment under Option 1 also has the effect of bringing into the scope of GST digital currency used as a means of payment for goods and services, and this can add to the compliance and administrative burden for merchants.

Trading in digital currency for fiat currency

Both options will impact the regulatory burdens and compliance costs for entities which buy and sell digital currency as principal. However, we do not consider that this is an additional (or unusual) burden above that which already applies to entities that buy and sell fiat currency as principal.

It is worth noting that, as a result of the relative anonymity associated with transactions using distributed ledger technology, a potential issue arises in relation to determining the location of a counterparty to a transaction for the purposes of applying the GST-free export provisions contained in s.38-190 of the GST Act (noting that GST-free treatment would have a favourable impact on the GST recovery).

We therefore suggest that consideration is given to whether clarification needs to be sought with respect to what acceptable proxies can be used to identify location, so that the GST-free rules can be properly engaged. If the GST-free provisions cannot be properly engaged, this has the potential to result in embedded tax being passed on to consumers.

Facilitating transactions in digital currency

Both options should not impact directly upon entities which provide services that facilitate transactions in digital currency. This is on the basis that such services would generally be taxable, as is the case for services which facilitate transactions in fiat currency.

In our view, the two fundamental issues which require consideration are as follows:

- Input taxed treatment exists for accounts provided by an ADI. This is effectively a digital unit of account for fiat currency and enables digital transfers of fiat currency. Therefore, consideration should be given to whether similar input taxed treatment should exist for accounts (or digital wallets) provided in relation to digital currency; and

- To what extent do the Regulations need to be amended to capture outsourced services which should be eligible for RITCs, noting that certain services which relate to fiat currency qualify as reduced credit acquisitions. We have provided comments on this below at 'Response 8'.

8. *Are additional reduced credit acquisitions required to be specified in the GST Regulations to allow access to RITCs for the digital currency industry? If so, what types of acquisitions would they include?*

We have set out below some of the 'outsourced' services which exist in the digital currency ecosystem and we have provided some initial observation on how they may fit within the current reduced credit acquisition regime (provided that they are supplied for a fee).

Acquisition	**Potential Item**	**Comments**
Analytics overlay service	Item 2 - *Transaction banking and cash management services*	Broadly, the blockchain or distributed ledger is a database which is typically public for cryptocurrencies. Entities (such as meta data aggregators) can extract, process and, repackage transactional information contained in the blockchain or distributed ledger and provide it as a service to customers (including non-digital currency users). The acquisition of this type of service could be viewed as similar to the 'processing services' identified in Item 2 of the table. However, we note that Item 2 relates to processing services for "account providers", so it may not currently cover entities which receive these services in the course of making supplies of digital

		currency.
Payment system operator service	Item 6 - *Payment and fund transfers services*	Transferring Bitcoins from one account to another involves getting the distributed network of competing Bitcoin miners to record the transaction on the blockchain. Miners are currently rewarded with Bitcoins for creating the block and also by way of transaction fees. As block rewards diminish, there will be a shift towards the transaction fees to provide the economic incentive for the miners. It is possible that these services would fall within the scope of a fee charged by an operator of a payment system; however, we suggest that the term "payment systems" would need to include, for example, a block chain or distributed ledger.
Wallet management service	Item 8 - *Payment and fund transfers services*	A digital currency participant may choose to acquire outsourced account management services via a wallet provider. This service relates to the processing of digital currency transactions on behalf of customer accounts. We would suggest that this acquisition could fall within Item 8; however, we suggest that the term "payment systems" would need to include, for example, a block chain or distributed ledger.

We recommend that Treasury seeks confirmation from the ATO as to whether the following types of services would qualify as reduced credit acquisitions, and whether they consider that any amendments to Regulations are required.

9. ***Under input taxed treatment or treatment as 'money' for digital currencies, would Australia regain sufficient international competitiveness, compared to other jurisdictions?***

The *Productivity Commission Inquiry Report into Business Set-up, Transfer and Closure* dated 30 September 2015 contained the following observation under the section entitled *"Appropriate GST treatment could reduce barriers to digital currency businesses in Australia"*:

> *"As digital currency users can easily shift to overseas suppliers, the current classification of digital currencies as intangible property for GST purposes places Australian based businesses at a disadvantage to overseas competitors where sales tax is not charged on the supply of digital currency. Bitcoin Foundation and Bitcoin Association of Australia further note that the GST treatment of crypto-currencies is hindering its adoption in Australia and, that it is 'aware of a number of Australian based bitcoin businesses moving operations offshore to remain competitive in a global market for the supply of bitcoin"*

> *"Following the ATO ruling in late 2014, the Australian start-up CoinJar relocated to the United Kingdom, noting that the ATO ruling on GST made it uncompetitive against non-Australian rivals (CoinJar Pty Ltd 2014). In the United Kingdom, crypto-currencies were reclassified from gift vouchers to money for tax purposes and are now not subject to value added tax (HM Revenue & Customs 2014)."*

Given the ease with which digital currency users can switch jurisdictions, it is critical that Australia's approach to the GST treatment of digital currencies is competitive in order to realise the Government's objectives.

We consider that the shift from taxing digital currency by treating it as 'money' under Option 2 will help ensure that Australia is on a level playing field with other jurisdictions which have the same treatment (particularly, the EU) and more competitive than other jurisdictions which tax the use of digital currencies.

To make Australia more competitive, we consider that other incentives, like the Government's proposal to extend the tax concession for investments into Early Stage Venture Capital Limited Partnerships to FinTech firms, need to be considered. We have provided some comments on this measure below.

Encouraging venture capital investment in FinTech

PwC supports the Government's intention to extend the availability of venture capital tax concessions to investments in FinTech. In order to ensure that the tax concessions are available for the right Fintech startup businesses engaging in "insurance" and "finance" related activities, we suggest legislative amendments be made to narrow the scope of "ineligible activities" under sections 118-425(13) and 118-427(14) of the *Income Tax Assessment Act 1997* (**ITAA 1997**).

One suggestion would be to insert an additional provision that allows "insurance" and "finance" related activities to not be treated as "ineligible activities" in circumstances where the investee company or unit trust satisfies the "innovation" criteria required of an early stage innovation company (under the newly enacted section 360-40(1)(e) of the ITAA 1997).

The innovation limb under section 360-40(1)(e) of the ITAA 1997 can be satisfied either by applying the principle-based innovation test or by reference to having at least 100 points under section 360-45 of the ITAA 1997 (which sets out certain objective innovation criteria). By having regard to the innovation criteria recently introduced for the early stage tax incentive, the proposed amendment to the scope of "ineligible activities" would operate to ensure investments into truly innovative FinTech businesses are able to access the venture capital tax concessions.

Whilst we would prefer the legislative certainty of the above option, an alternative (albeit one that provides less certainty) is for Innovation Australia to provide guidelines (either by way of public rulings pursuant to the newly enacted section 362-5 of the Tax Administration Act 1953 or, at the very least, administrative practice statements) outlining how it would go about assessing whether an activity is an "ineligible activity".

Falling short of legislative certainty, the provision of such guidelines would provide a degree of clarity for investors in terms of the criteria that Innovation Australia is expected to apply in determining whether a certain Fintech investment could qualify as an “eligible venture capital investment”.