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Dear Sir/Madam,

Treasury consultation on initial coin offerings (ICOs)

Thank you for the opportunity to provide a submission in relation to Treasury's consultation on the Australian regulatory and taxation landscape surrounding ICOs.

Our submission responds to Part 5 of the Treasury Issues Paper, which focusses on the tax treatment of ICOs and token holders (**Attachment 1**) and is an extension to our earlier lodged submission dated 5 June 2018 (**Attachment 2**).

Our significant involvement in this sector has evolved from a desire to understand the potential of distributed ledger technology (**DLT**) / blockchain technology. We hope that our efforts demonstrate our support for the potential of blockchain technology to create:

- network economies that bring efficiency gains (i.e. by reducing transaction costs) to each industry and our country;
- an instantaneous (or near instantaneous) means of valuing each network, and the transactions within these networks, where a token is involved; and
- opportunity for Australia to be a world-leader in the implementation of a technology, and token economies, that could fundamentally change:
  - the nature of our interactions with each other,
  - how businesses and industries derive value, and
  - how Australia's economic growth may be impacted vis-à-vis other countries that are "blockchain and crypto-friendly".

In our view, the attractiveness of Australia as a jurisdiction to undertake blockchain projects relies on there being clear tax principles for both ICOs and token holders. Whilst the tax treatment of an ICO is a headline issue for Australia that we need to get right in order to attract genuine and economically beneficial ICO activity, it is the token holders that are needed to support the network. The success of a blockchain relies on the health of its network economy, i.e. uptake and use of its network. Therefore, clarity on the tax treatment for token holders is necessary so that investment and activity on a network is not distorted or impeded by, for example, fear of onerous tax compliance and unclear tax consequences.

With that said, we consider it crucial for Australia to have a legal and tax framework that encourages the full spectrum blockchain projects which may or may not undertake an ICO and which is, to the maximum extent possible, future-proofed. In this regard, proposals around the tax treatment of ICOs and token holders should not be considered without reference to:

- the work being undertaken internationally by the OECD under Action 1 of the Base Erosion and Profit Shifting (**BEPS**) Project to address the tax challenges of the digital economy;
- the advent of decentralisation - particularly, decentralised organisations (**DOs**), decentralised autonomous organisations (**DAOs**), decentralised autonomous companies (**DACs**) and decentralised exchanges (**DEXs**);
- the significance of a digital Australian dollar (**DAD**), particularly to better enable interoperability between blockchains, whereby the DAD is given the status of Australian currency (rather than property which could give rise to onerous tax compliance obligations);
- the advent of anti-competitive behaviour as blockchain projects increase in number and/or scale, and any special tax provisions that may need to be introduced to deal with remedial action required;
- the role and tax treatment of airdrops; and
- the more recent phenomenon of the IEO (Initial Exchange Offering).[1]

For the above reasons, our key tax recommendations are:

(a) To the extent possible, shortly after the close of Treasury's consultation period, a clear announcement should be made about the length of time Treasury will take to consider submissions, to advise the Government, and the key matters upon which Treasury will advise the Government. Such matters may include:

(i) Alternatives to upfront taxation (income tax and GST) of ICO proceeds (on the bases set out in our earlier submission and/or following an early stage investment company-style format as set out in the PwC submission), particularly where a new regulatory regime for ICOs is introduced (as proposed by the Australian Digital Commerce Association, **ADCA**).

(ii) The introduction of a specific type of tax exempt entity that could be established as a Foundation for oversight and governance of the blockchain project.

(iii) The introduction of a statutory organisation to oversee Australian blockchain projects over a certain period (e.g. 3 years) and better understand the potential of the technology and projects to contribute to the Australian economy, similar to Monaco's recently legislated Blockchain Authority. This role, or a similar role, could be played by an organisation like ADCA.

(iv) Amendments to the definition of 'digital currency' for GST purposes.

(v) Legal definitions of types of tokens, specifying the attributes that give rise to different legal and tax consequences: Payment token, Utility token, Tokenised security, Stablecoin, Sovereign token.

[1] Refer: https://medium.com/traceto-io/what-is-an-initial-exchange-offering-ieo-245a7cf72f28

(vi) Introduction of a disclosure requirement for whitepapers to include a tax section (similar to a tax section in a prospectus or PDS) so that token holders can understand the general tax implications of acquiring and using the token at each phase of the blockchain project. This could be a precondition to participating in the regulatory regime proposed by ADCA and may require a ruling from the Commissioner of Taxation (**Commissioner**).

(vii) Retrospectivity of any law change.

(viii) Special provisions for multi-characteristic tokens and multi-tier tokens.

(ix) Special provisions for the taxation (or non-taxation) of a DAO and its participants.

(x) "Personal use" wallet election for individual token holders.

(xi) "De minimis" exemption for individual token holders.

(xii) Introduction of a token withholding tax for Australian resident digital currency exchanges.

(xiii) Amendments to definitions of assets defined by s 275-105 ITAA 1997 (investments eligible for deemed capital account treatment) and 'permitted investment' (s 115-290(4) ITAA 1997) to include tokens, for investment fund token holders.

(xiv) An "opt-in" taxing framework for token transactions, which has regard to the work being undertaken internationally by the OECD under Action 1 of the BEPS Project to address the tax challenges of the digital economy.

(b) To the extent possible, shortly after the close of Treasury's consultation period, the Commissioner should provide (some level of) certainty to the market for the period until Treasury is able to advise the Government and until any Government announcement is made, by making a commitment to provide:

(i) administratively binding statements on key issues regarding:

(A) the taxation of each type of ICO (payment, utility, tokenised security, stablecoin, sovereign; multi-characteristic and multi-tier token economies) for the issuer and for the token holders;

(B) the classification of digital currency exchanges as electronic distribution platforms and their potentially significant historic liability to GST on supplies of tokens that do not meet the definition of digital currency (e.g. stablecoins, utility tokens);

(C) the taxation of airdrops, largely from the issuer's perspective but also for recipients of airdropped cryptocurrency; and

(D) the application of the controlled foreign company (**CFC**) rules to ICOs conducted offshore as well as assets involved with, and income from, alternative consensus protocols like Proof of Stake (**PoS**) and Delegated Proof of Stake (**DPoS**) arrangements.

(ii) a clear statement of ATO internal procedure and timeframes for escalating and resolving highly technical issues.

Through consultation with ADCA and the Australian Taxation Office (**ATO**), we believe that guidance for ICOs and token holders can be prioritised and achieved in the near future. We would welcome the opportunity to participate in its development.

Hall & Wilcox look forward to discussing our submission with you and lending assistance as the consultation progresses. Please contact Joni Pirovich directly on (03) 9603 3615 to discuss.

Yours faithfully

Hall & Wilcox

ATTACHMENT 1

Detailed comments and recommendations

Part 5: Tax Treatment of ICOs

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

(c) The tax industry welcomes Treasury's consultation on the regulation around, particularly the tax treatment of, ICOs.

(d) The ICO market in general has wilted in the wake of mismanaged, non-compliant and fraudulent ICOs. Whilst such conduct has also muddied the water for genuine ICO activity in Australia, one of the largest impediments to conducting an ICO in Australia is either or both of the tax cost and the uncertainty of tax treatment. This aspect in particular is a leading cause for ICO teams to undertake an ICO offshore, or to consider a different token, or to not undertake an ICO at all.

(e) The Australian tax treatment of ICOs is unclear to ICO teams, the crypto-DLT community generally, and to tax advisors. This lack of clarity is an impediment for issuers in undertaking capital raising activities through ICOs.

(f) Set out below, are some of the reasons for the lack of clarity in current tax treatment and our associated recommendations to encourage a healthy and risk-managed ICO industry.

(g) Whilst we offer a few options for Treasury's consideration in our detailed comments, we ultimately prefer certainty and simplicity in an ICO regulatory regime. Certainty and simplicity would create favourable conditions for investment of capital into Australia, as well as the attraction of talent, as countries rapidly mobilise to consider appropriate regulations.

5.1.1 Reasons for lack of clarity in tax treatment of ICOs

(a) The lack of clarity in tax treatment (or in other words, the lack of clarity around how traditional tax principles apply to an ICO) could be because of any or all of the following:

Lack of public guidance or precedent

(b) Each iteration of guidance published on the ATO website, or within Taxation Rulings, has not dealt with the tax treatment of an ICO.

(c) There are no publicly available (albeit, sanitised) private binding rulings regarding the tax treatment of ICOs to refer to for general guidance.

(d) The privately incorporated companies that have ICO'd in Australia have not publicly disclosed the tax treatment of their ICO (e.g. PowerLedger, Havven, Canya, Horizon State), nor have their whitepapers referred to the general tax treatment of tokens for various types of token holders (e.g. Australian resident versus foreign resident, tokens held on capital account or revenue account).

(e) The online “atocommunity” forum allows taxpayers to post questions and have them answered by the ATO. There is one question about ICO taxation, to which the ATO has responded. The response refers the taxpayer to the general information on the ATO website regarding the taxation of cryptocurrencies and suggests the taxpayer contact the ATO early engagement team for more detailed information about managing the tax obligations of an ICO.[2]

(f) Due to the new and nuanced nature of ICOs, cryptocurrency and DLT, and the rapidly changing nature of this industry, the early engagement team (and private ruling team) are not currently equipped to escalate and resolve technically tough and contentious issues swiftly. Advice escalated to the Tax Council Network and Assistant Commissioners of Taxation for input and review is not generally bound by any service standard timeframe.

Lack of understanding of ICOs, cryptocurrencies and DLT

(g) Accountants and tax advisors are generally lacking in understanding about what an ICO involves, as well as cryptocurrencies and DLT.

Nuances of ICOs, cryptocurrencies and DLT challenging application of traditional tax principles

(h) Accountants and tax advisors that do have some understanding about ICOs, cryptocurrencies and DLT have not been able to practically, commercially and sometimes technically advise ICO teams (and token holders) on all aspects of the ICO for a number of reasons, including:

    (i) ICOs, cryptocurrencies and DLT are completely new areas to advise upon and are challenging the application of traditional tax principles. As a result, tax minds do differ as to what the tax outcomes should be, meaning that a number of alternatives (or, attempts at analogies to existing provisions) need to be fully canvassed in giving advice, which increases the complexity and cost of advice.

        (A) For example, tokens are generally created and held in the issuer’s wallet/s before being transferred to those who have participated in the ICO, which makes for a clearer case of traditional tax principles applying to the issuer. However, the tax law falls short where tokens are created and issued from a smart contract, governed by a separate foundation and network of participants, and where the smart contract also diverts ICO proceeds immediately to various wallet addresses (rather than through a central entity). Further discussion on these topics is set out below in relation to DOs, DAOs, and DACs.

    (ii) Given the level of fraudulent activity that has been connected with ICOs, there is a high risk of reputational damage associated with providing tax advice and/or a reasonably arguable position paper to ICO teams that are not conducting an ICO for genuine reasons. It can be difficult for smaller accounting firms and tax advisors in general to conduct proper due diligence on ICO teams before accepting the client engagement.

    (iii) ICO teams generally have had very limited budgets pre-ICO, which is when tax advice should be obtained - for both the benefit of the ICO team and

[2] Refer: https://community.ato.gov.au/t5/Cryptocurrency/ICO-taxation/td-p/5646

the token holders. As the ICO market matures, ICO teams are considering raising early stage capital via more traditional avenues (e.g. angel, seed) to fund costs for legal and tax advisors as well as technology and tokenomics specialists. However, particularly in general cases, ICO teams should not be impeded by uncertainty, expensive tax advice and/or an expensive and lengthy early engagement / private ruling process. Such factors are significant detractors to conducting an ICO in Australia.

(iv) Unlike an IPO, there is not a great level of certainty around ICO proceeds or a minimum spread of shareholders. As such, commitments to pay advisor fees with ICO proceeds are generally refused by tax advisors.

Comparisons to IPOs

(v) Rightly or wrongly, ICOs have been compared to IPOs whereby the initial public offering of shares does not result in a tax liability for the issuer. The features of an IPO that make it a non-taxable event include:

(A) IPO proceeds represent equity (in the form of shares) in the issuing entity. A shareholder has a contingent right to the return of that equity, as well as rights to dividends and to vote. In contrast, the terms and conditions for an ICO of a payment token (where they exist) generally do not permit the return or refund of ICO proceeds to the token holder.

(B) To the extent that an ICO relates to the offering of a tokenised security, it should be taxed equivalently to an IPO (and should also be subject to the relevant disclosure requirements).

(C) However, where the tokenised security has other characteristics that take it beyond a mere tokenised security, amendments to the income tax and GST rules should be considered, as set out below at items (k) to (m).

Sensationalist and click-bait media reporting

(i) Media reporting is signalling to the crypto-DLT community that there is, or may be, scope to argue that ICO proceeds should not be subject to tax, similar to an IPO.

ASIC interventions and relevance of specific, opt-in tax frameworks for MISs

(j) Some attempted ICOs have been prevented or interrupted by ASIC on the basis of ASIC's view that the proposed tokens constituted financial products, the offer of which should have complied with the Managed Investment Scheme (**MIS**) regime. Specific, opt-in, tax regimes exist for MISs, such as the Managed Investment Trust (**MIT**) regime and the Attribution Managed Investment Trust (**AMIT**) regime. More recently, the proposed opt-in Corporate Collective Investment Vehicle (**CCIV**) regime. To the extent that an ICO does proceed which complies with the MIS regime, expert tax advice and ATO engagement is likely required to determine if and how the tokenised security and digital blockchain network syncs with, or must be run parallel to, the legal and tax regimes.

(i) Note that German's first security token offering, Bitbond, approved by the German Federal Financial Supervisory Authority, was issued without intermediaries and without a centrally-held certificate.[3]

[3] Refer: https://thebitcoinnews.com/bitbond-bafin-approves-germanys-first-security-token-offering-sto/

Not 'one size fits all' tax treatment of ICO - tax differs based on type of token

(k) The Australian tax treatment of an ICO of a payment token may be different to the tax treatment of an ICO of a utility token, a tokenised security or a stablecoin or a sovereign token. ICOs of multi-characteristic or multi-tier token systems require extensive analysis. In short, there is no general or current single tax treatment of an ICO.

Multi-characteristic tokens are a new asset class not anticipated by the tax law

(l) As alluded to above, some tokens are multi-characteristic (e.g. have features of a utility token and a security token or tokenised security), which makes it difficult to determine appropriate taxation of a token or parts of a token initially, and for exchanges, upon the secondary trade of the token.

(m) We have distinguished the term 'security token' from 'tokenised security'. In this submission, the term 'security token' is used to describe tokens that may boast eventual utility features but actually be characterised as a security or other financial product and where the ICO team either was not aware of this or was non-compliant. Whereas the term 'tokenised security' refers to the cryptographic instance of a traditional security, the distribution of which has been compliant with relevant laws.

    (i) The following points draw out the tension between traditional tax rules (e.g. debt-equity rules and the GST exemptions for shares) and the nuances of multi-characteristic tokens.

    (ii) The debt-equity rules in Division 974 ITAA 1997 apply to characterise a financing arrangement from the perspective of the issuer and do not anticipate bifurcation of a debt interest or equity interest - although there is some consideration of debt/equity hybrid interests, these provisions are unhelpful for multi-characteristic tokens.

    (iii) The debt-equity characterisation is undertaken:

        (A) from the perspective of the issuer, to determine whether returns paid by the issuer are deductible (and to which interest withholding tax may apply) or frankable (and to which dividend withholding tax may apply); and

        (B) at the time the scheme comes into existence and when there is a material change to the scheme.

    (iv) Similarly, the GST characterisation is undertaken at the time the supply is made. However, the GST provisions do cater for subsequent adjustments to be made in some circumstances. These provisions need to be explored more fully in a cryptocurrency context.

    (v) Unlike the case for a shareholder with (generally) unchanged voting, capital and dividend rights, there is difficulty in a corresponding and static characterisation of a token from the perspective of the token holder.

    (vi) For example, an individual may acquire a tokenised security with the sole intention of holding it as an investment (notwithstanding that the token has utility characteristics, and/or because the token has, or will have, utility characteristics which may inform the investor's sense of value of the token), to vote on governance issues of the blockchain project and receive returns. Within a few months, the individual's circumstances change such that the token is instead used for its utility, to access services provided through the blockchain platform. In such a scenario the following questions arise for the issuer (noting that further questions arise for the token holder which are considered at section 5.2):

(A) Whether the token should be characterised as an equity interest, despite the (current or anticipated) utility characteristics, such that ICO proceeds are not taxable?

(B) Whether the token should be considered an input taxed financial supply (of a security), despite the (current or anticipated) utility characteristics?

(C) Upon the token holder using the token for its utility, whether the issuer should (and whether the issuer could, under existing laws) become liable to income tax and GST? If so, should the value of the income and supply, and thus the income tax and GST, be based on the value of the token at the ICO time or when the token is used?

(D) In an opposite scenario where income tax and GST apply to the ICO proceeds, should income tax and GST be returnable to the issuer (and GST returnable to the token holder) if the utility characteristics never eventuate?

(E) Whether the investor's intentions for participating in the ICO should (and whether they could, under existing laws) be taken into account in determining the initial income tax and GST treatment of the ICO proceeds? For example, if an investor makes a statement of intention, when expressing interest to participate in the ICO, that the token is to be purchased solely for use on the network once built, then the issuer should be liable to income tax and GST.

- We note Hammer's caution about relying on a token holder's intention to determine characterisations and tax treatment from the issuer's perspective, as the token holder's intention can change for a number of reasons including market dynamics.[4]

- We note the approach adopted by the US and Israel, for example, where tokens that do not have a current use when issued or acquired are treated as securities and for the token holder are acquired for investment purposes.

- We also note that the US has left open the possibility that with the passage of sufficient time and after the tokens have achieved sufficient practice use, the tokens may lose their status as 'securities' and be considered utility tokens that are not subject to securities laws.[5]

(n) Also, as alluded to above, some DLT projects create multi-tiered token economies. Where an entry-level token is required to grant access to another tier of token and so forth, the tax characterisation of each tier of token and transactions between tiers is unclear for a number of reasons including:

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[4] Refer R. Hammer: https://medium.com/orbs-network/utility-vs-security-an-argument-for-defining-a-new-asset-class-for-the-token-and-crypto-economy-ad740df89398.

[5] Ibid.

(i) whether the characteristics of each tier should be considered related schemes for the purposes of the debt-equity rules, or if each tier could retain its own tax characterisation; and

(ii) practical difficulties of keeping appropriate records of the Australian currency value of tier-to-tier transactions.

Confusion about Australian tax residency rules and attractiveness of overseas legal and tax ICO treatment

(o) There is confusion in the crypto-DLT industry about application of Australian tax residency rules, the controlled foreign entity provisions and conducting an ICO offshore. Especially because of the global nature of ICO teams and their advisors.

(p) 'Crypto-friendly' jurisdictions like Malta and Gibraltar appear to have more certain and attractive legal and tax regimes than Australia.

Availability of more favourable ICO tax structures are unclear

(q) Some ICO teams and tax advisors have explored other avenues to reduce the overall tax bill, including:

(i) use of a not-for-profit structure; and

(ii) partnerships or joint ventures with universities, to take advantage of the income tax exemption granted to such education institutions.

(r) As far as we are aware, these avenues have stalled for a number of reasons including the complexity of tax advice and approvals required, without reliable prospects of the structure being free from scrutiny from the Commissioner of Taxation (**Commissioner**).

Issues with the current tax treatment of an ICO of a payment token

(s) In a simple case of a payment token offered at ICO and without the whitepaper specifying how ICO proceeds will be used, it would seem appropriate that all ICO proceeds represent income and should be subject to tax.

(t) However, we have set out our assumptions around the current tax treatment of an ICO of a payment token to demonstrate some of the issues that require clarification and/or alternate tax policy.

(u) In the absence of clarity, the crypto-DLT community generally consider it disadvantageous to conduct an ICO in Australia (relative to other more favourable jurisdictions) because of the general view that ICO proceeds will be taxed at 30% and fear of GST also being applicable. In tax terms, this assumes:

(i) The issuing entity is a company, subject to (what has been) the prevailing corporate tax rate (30%).

(ii) The ICO proceeds constitute ordinary income of carrying on a business or income from a profit-making scheme or a capital gain, each of which constitute assessable income of the company.

(iii) Each income year (generally 1 July to 30 June), the company is liable to pay income tax on its taxable income (assessable income less deductions).

(iv) Generally, an ICO occurs very early in the life of the DLT project, meaning that the assessable ICO proceeds far exceed the deductible expenses incurred for the income year.

(v) Assuming the issuing entity is in a taxable income position, the R&D Tax Incentive may be available to offset some of the tax payable. However, the R&D Tax Incentive is calculated as a function of expenses incurred and may require an amount to be included in assessable income were a ‘feedstock adjustment’ is triggered. That is, broadly, where expenses incurred on R&D activities produce marketable products. The main R&D expenses are likely to be wages paid to the development team. If the ICO proceeds are considered to be ‘feedstock revenue’, then the feedstock adjustment may negate the benefit of preparing an R&D claim. As a result, innovative payment token projects may not benefit from the R&D Tax Incentive which is in place to foster and encourage novel projects in Australia.

(vi) Assuming the translation rules apply, the ICO proceeds should be translated to Australian currency on the day the cryptocurrency proceeds become beneficially owned by the issuer.

(A) The special translation rules appear in Sub-division 960-C ITAA 1997, which is titled, ‘Foreign currency’; however, Items 6 and 11 of sub-s 960-50(6) refer only to ‘amounts’ that should be translated to Australian currency. We presume the Commissioner would rely on these provisions to assert that an issuer is required to translate the ICO proceeds received in cryptocurrency to Australian currency at the exchange rate applicable at the ICO time notwithstanding that:

(I) the word, ‘amounts’, appears within the context of a Sub-division focussed on ‘foreign currency’; and

(II) the Commissioner’s view that cryptocurrency with similar characteristics to bitcoin is not a foreign currency.

(B) As the assessable amount of ICO proceeds is valued in Australian currency, the ICO team practically needs to immediately dispose of 30% of the ICO proceeds to be able to meet the anticipated tax bill. Depending on the size of the ICO, this sell order volume is likely to be difficult for an Australian exchange to service. Realistically, such a one-off sell order does not occur for a number of reasons, and smaller portions are liquidated over a period of time. This scenario exposes the issuer to exchange rate risk, which is difficult to hedge or mitigate.

(v) In summary, the confluence of all the above factors, particularly the perceived large tax bill amidst an uncertain application of traditional tax principles and Australia’s seemingly tentative appetite to host ICOs, does not instil confidence in the crypto-DLT community to undertake capital raising activities through an ICO in Australia.

5.1.2 Recommendations

(a) Given the two clear paradigms -- a coloured past and a hopeful future -- we recommend that Treasury / the Commissioner clearly acknowledge how past ICOs will be dealt with from an Australian tax perspective regardless of whether new ICO and cryptocurrency tax policy is introduced.

(i) A clear announcement regarding the tax treatment of past ICO's could send a positive message to the crypto-DLT community and help build confidence around genuine ICO activity in Australia.

(ii) A clear announcement by the Commissioner would be especially meaningful if more than a few months pass before the Treasury consultation progresses and/or before Government is able to announce what a new tax policy might involve.

(iii) Such an announcement may even have the effect of bringing ICO teams back on shore, accompanied by the ICO proceeds.

(b) In terms of future tax policy, to attract genuine ICO activity, Australia should make a clear announcement about the proposed tax treatment of ICOs, including general tax implications for token holders.

(c) Such an announcement might involve the following legislative and/or administrative measures:

(i) Legally define, and/or make an administratively binding statement for, the types of token categories:[6]

(A) Payment token: Tokens that are used as a means to transfer value and are not connected to any specific venture.

(B) Utility token: Tokens that are intended to grant access or usage rights in a service or product offered by a specific project.

(C) Tokenised security: Tokens that are intended to have the characteristics of a security or other financial product.

(D) Stablecoin: Tokens that offer price stability. There are a number of types of stablecoins which differ based on whether the cryptocurrency is collateralised and if so, what the cryptocurrency is collateralised with. Some examples are fiat-collateralised, crypto-collateralised or non-collateralised using algorithmic controls.

(E) Sovereign token: Tokens that are given national recognition as legal tender (e.g. Venezuela's petro token). This category could also capture legally recognised cryptocurrencies issued at the supranational (e.g. European Union), state or local/city (e.g. Dubai's Emcash) levels of government.

(ii) To the extent of any law change, clearly state whether the law will have retrospective effect.

(iii) To the extent that traditional tax principles will continue to apply without any contemplation of law change and/or new tax rules, an administratively binding statement should be made by the Commissioner setting out how each type of ICO (payment, utility, tokenised security, stablecoin, sovereign; multi-characteristic and multi-tier token economies) should be taxed.

(A) For multi-characteristic tokens, options that should be considered include:

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[6] We have adopted the definitions of payment token, utility token and tokenised security from the Interim Report released by the Israeli Securities Authority Committee for the Examination and Regulation of ICOs, as summarised by R. Hammer at https://medium.com/orbs-network/utility-vs-security-an-argument-for-defining-a-new-asset-class-for-the-token-and-crypto-economy-ad740df89398

(I) characterisation based on the primary use of the token from the perspective of the issuer;

(II) bifurcation of the token; and

(III) adjustments to initial basis of taxation where subsequent behaviour of token holder alters initial characterisation.

(iv) The ICO market moves quickly and would benefit from a clear statement of ATO internal procedure and timeframes for escalating and resolving highly technical issues.

(v) Legally specify, and/or make an administratively binding statement, that where the acquisition, use and/or trading of a small amount of cryptocurrency is for the purpose of learning about ICOs, cryptocurrencies and DLT, then the acquisition cost should be immediately deductible as a form of self-education expense with no further tracking required for tax purposes. This measure should be considered in parallel with the 'personal use' wallet election proposed below at Section 5.2.

(A) There may be some industries (supply chain, health, ID) that are more impacted by DLT than others but taxpayers should be permitted to experiment with, and learn about, the technology without fear of having to seek complex tax advice. The purpose of this measure is to educate Australian taxpayers to ensure their access to, and understanding of, DLT and to support the growth of the crypto-DLT community in Australia.

(B) In addition, where an issuing entity opts to provide an amount of cryptocurrency to a "learn and earn" pool,[7] the Australian currency value of the cryptocurrency should be clearly deductible to the issuer as a marketing expense.

(C) Proper consideration should be given to the meaning of 'small amount' and appropriate record keeping requirements. A lifetime acquisition value of A$600 may be sufficient, and perhaps even unnecessary if "learn and earn" becomes a mainstream offering or if the 'personal use' wallet election is more appropriate for such activity.

(D) We note the current US proposal to introduce a US$600 de minimis exemption for purchases made with cryptocurrency.[8]

(vi) Legally require the ICO to be registered, including the names and addresses of each team member and advisor so that adequate due diligence can be conducted in respect of the ICO team.

(d) Legally specify, and/or make an administratively binding statement, that where the whitepaper sets out how the ICO proceeds of taxable tokens (i.e. payment token, utility token, stablecoin and potentially multi-characteristic tokens) will be used, or if the ADCA proposed regulatory regime is complied with, then either (in order of preference):

(i) **Exemption or deferral of upfront tax** as set out in straw man format in the PwC submission.

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[7] See, for example, Ox providing an allocation of launch tokens to Coinbase: https://www.coindesk.com/coinbase-will-soon-reward-you-for-studying-cryptocurrencies

[8] Refer: https://www.coindesk.com/us-lawmakers-file-bill-to-exempt-cryptocurrencies-from-securities-laws

(ii) **Deferral of tax,** by the introduction of a timing rule that allows tax to be paid over the life of the blockchain project with a cap of 5 years (a reverse section 40-880 approach); and/or

(iii) **Tax refunds**, by the re-introduction of a loss carry-back regime for blockchain projects that raise funds via an ICO, whereby tax is required to be paid in the ICO year but can be returned to the issuer as a refundable tax offset in future years (capped or uncapped) upon development milestones being achieved; and/or

(iv) **Clarity around capital/revenue treatment of tokens, and where proceeds to be taxed on capital account**, the retrospective allocation of development costs to the CGT cost base of the tokens; and/or

(v) **Future-proof taxing regime**, by, for example, the integration of tax collection with the blockchain project, whereby the amount of tax payable (in Australian currency) is deposited into an escrow account and released to the issuer and/or the ATO upon certain conditions being met (i.e. development milestones, passage of time, etc).

(e) Increased ATO presence at crypto-DLT community events to create a more inviting and easy dialogue for discussing novel tax concepts. For example, events are regularly held at Stone & Chalk in Melbourne and Sydney.

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

(a) Whilst the Commissioner has published detailed guidance on the taxation of cryptocurrencies on the ATO website and in Taxation Rulings published in 2014, the guidance is can be impractical for token holders to apply. Despite the impracticalities, the guidance is generally appropriate for the limited scenarios that have been covered in the guidance. However, a number of scenarios are not covered.

(b) To illustrate some of the impracticalities and tensions for token holders, we have set out some high level issues (and associated recommendations) for the following categories of token holders:

(i) Australian resident individuals

(ii) Foreign residents

(iii) Cryptocurrency funds (or funds that have some investments in cryptocurrency)

(iv) Australian resident companies

(v) Australian-controlled foreign companies (i.e. CFCs)

(vi) Australian resident cryptocurrency exchanges

(c) As cryptocurrency exchanges become appropriately licensed to offer tokenised securities for trade on their platforms, we might see institutions and investment funds begin to seek exposure to the tokenised security asset class and other token categories. A number of tax issues for individual token holders become relevant to clarify for investment funds which must outline the general tax consequences of the fund's investment activities to its investors.

5.2.1 Australian resident individuals

(a) Some of the impracticalities and tensions for Australian resident individuals dealing in cryptocurrency include:

(i) High compliance cost and effort, particularly for crypto-to-crypto transactions - Generally, individuals involved in cryptocurrency dealings consider the record-keeping requirements onerous and impractical. This is especially so because of the lack of information generally produced (by the ICO team, exchange, or other counterparty if one exists) at the time of the cryptocurrency transaction. Individuals are also not assisted by the lack of accounting and reporting/tracking tools available to record the details of cryptocurrency transactions that are relevant for tax purposes. In more detail:

(A) The Commissioner's view is that crypto-to-crypto transactions involve the disposal of property (i.e. taxable event) and the acquisition of property.

(B) The practical complexities of requiring individuals to keep appropriate records of crypto-to-crypto transactions are resulting in individuals opting not to report because "it is too hard".

(C) The Commissioner has not communicated to the public, which avenues the ATO is able to obtain information about an individual's cryptocurrency transactions. In addition, individuals do not fully appreciate the breadth of the Commissioner's powers to obtain information, to issue amended assessments, and impose penalties and interest based on the information available to the Commissioner.

(ii) Difficulty applying personal use exemption - Individuals may acquire payment tokens and/or stablecoins to hold and use in a similar way to holding and using cash in a bank account. Similarly, individuals may acquire utility tokens because they wish to support the project and anticipate using the token once the functionality is developed.

(A) The Commissioner has stated that the longer cryptocurrency is held, the more likely it looks like an investment (held on capital account). To an extent, the Commissioner's view is appropriate however should not narrow and unduly limit the personal use exemption for longer term holding of cryptocurrencies where an individual genuinely wishes to store and use cryptocurrencies as if it were cash in a bank account.

(B) The Commissioner's views regarding the tax treatment of tokens other than bitcoin have not been publicly stated.

(C) The Commissioner has stated that it will not consider private ruling requests with questions around the application of the personal use asset exemption unless the cryptocurrency has been disposed. This does not promote confidence in the market to support utility token projects.

(D) Implicit from the ATO web guidance, it would appear the Commissioner's view in relation to utility tokens is that if the functionality does not exist at the time of acquisition, the token has been purchased as a speculative, investment asset (on capital account). There is little or no certainty that the utility will eventuate so the token will be treated as speculative until it is certain or reasonably certain that the utility will eventuate. There is a lack of precedent at this early time, for utility eventuating and the token being used for its utility in Australia.

(E) Private rulings posing questions around the application of the personal use asset exemption have been on foot for almost a year. The new and nuanced nature of cryptocurrencies and blockchain technology means that the application of traditional tax principles is not always straightforward. As a result, processing times for deciding upon private binding ruling requests have been very lengthy and costly for taxpayers trying to do the right thing. Taxpayers are currently in significant unrealised loss positions for opting to defer disposing of cryptocurrency until obtaining ATO certainty via the PBR process.

(F) The tax treatment of cryptocurrencies that do not have similar characteristics to bitcoin, such as stablecoins and utility tokens, is unclear.

(iii) Whether foreign currency taxation rules apply to sovereign tokens - It would seem appropriate that a sovereign token - a cryptocurrency issued by a government, such as the Petro token by Venezuela - should be treated as a currency and foreign currency for Australian income tax purposes. However, with the Government of the city of Dubai launching its own cryptocurrency, Emcash, rather than a cryptocurrency being issued at

UAE level, further thought should be given to the appropriateness of our foreign currency taxation rules for individuals making large but personal transfers using sovereign tokens.

(iv) Losses arising from profit making schemes - Insufficient guidance has been provided by the Commissioner in relation to:

(A) an individual's ability to claim losses incurred on certain isolated transactions entered into with the purpose of making a profit; and

(B) how to distinguish an isolated profit-making scheme from a single investment on capital account.

If a single cryptocurrency transaction is considered as undertaken as a profit-making scheme, the loss would be on revenue account; if an investment, the loss would be on capital account. From a policy perspective, the distinction needs to be clarified because there will likely be a significant number of taxpayers that invested at the market peak in late 2017/early 2018 and are sitting on realised or unrealised losses, who are likely to reasonably claim a tax revenue loss rather than a capital loss.

(b) Hard forks / chain splits - The Commissioner's guidance is favourable to taxpayers in that new cryptocurrency received as a result of a chain split is not considered, in the Commissioner's view, to give rise to the derivation of ordinary income or a capital gain. Instead, the capital gain must be calculated at the time the new cryptocurrency is disposed of, where the Commissioner considers the cost base of the new cryptocurrency is zero.

(i) The technical basis for the Commissioner's view is not explained and is published as guidance on the ATO website, which is not administratively binding upon the Commissioner.

(ii) Tax minds consider that the tax law does fall short in the case of a hard fork / chain split and that the tax law could be interpreted to result in double tax. In the event the Commissioner "u-turns" from existing web guidance, taxpayers are left exposed. For example, attempting to determine the tax treatment of a hard fork / chain split by analogising with the tax treatment of share splits, demergers, bonus shares may appear to be logical analogies. However, these tax rules that were written without anticipation of the nature and nuances of DLT, cryptocurrencies and ICOs do fall short and in some cases anomalies do arise where the tax technical outcome is not consistent with what is generally the intention of the tax law (e.g. no double taxation).

(iii) Guidance published in the UK by the HMRC states that a cost base apportionment occurs whereby part of the initial investment in the original cryptocurrency is apportioned to the new cryptocurrency. In addition, as long as taxpayers follow a reasonably fair approach for apportioning the cost base, it is likely the HMRC will accept the taxpayer's valuation of the apportionment.[9]

(c) Airdrops - A more detailed discussion of airdrops is set out at Section 5.3. In short, individuals may not be aware that they have received airdropped cryptocurrency and the tax treatment of the receipt of airdropped cryptocurrency is unclear.

[9] Refer: https://bettingbitcoin.io/cryptocurrency-uk-tax-treatments/#forks

(i) For example, if an individual discovered their ownership of an airdropped cryptocurrency after lodging the relevant year tax return, would the individual:

(A) be required to amend the prior year tax return to disclose an amount of income; or

(B) not be required to amend on the basis that the tax treatment of airdropped cryptocurrencies should accord with the Commissioner's views regarding new cryptocurrency received from a chain split?

(d) Wash trading unfortunately does occur in the crypto-DLT community, whereby a trader will sell tokens to themselves in order to create a fake market and increase the value of the token. Identification of such activity is not obvious though forensic procedures have been carried out by the Blockchain Transparency Institute with concerning results.[10] From a tax perspective, wash sale arrangements outside of the cryptocurrency context attract the operation of the general anti-avoidance provision because the arrangements are undertaken to realise a capital loss to offset a capital gain although the wash sale does not result in a significant change in the taxpayer's exposure in the asset.[11] The Commissioner should be alive to the wash trading issue if and when reviewing an individual's cryptocurrency transactions as part of information obtained from a third party, data matching protocol, or during a review/audit of the taxpayer.

5.2.2 Recommendations

(a) Introduce a 'personal use' election that can be made by an individual in relation to a cryptocurrency wallet or particular cryptocurrencies. The election would reduce onerous cryptocurrency reporting for high-volume, low-value transactions which would most likely include utility tokens, stablecoins and payment tokens.

(i) The election could be modelled from the 'limited balance exemption' for qualifying foreign exchange accounts on the basis that the policy rationale behind the limited balance exemption – to reduce the complexity and cost of compliance for low-value taxpayers – is equally applicable to many taxpayers holding cryptocurrency wallets.

(ii) A summary of how the limited balance exemption operates is provided below.

(A) Sub-division 775-D ITAA97 provides a 'limited balance exemption' to taxpayers with qualifying forex accounts. The exemption removes the need for taxpayers to record the A$ denominated tax recognition time value of all account debts, and then trace them to the value of each deposit or withdrawal – a complicated and costly exercise. The exemption therefore aims to reduce the significant compliance costs for low-value, high-transaction-volume forex accounts.

(B) The exemption enables taxpayers to elect in writing that forex gains or losses made in relation to forex realisation events 2 and 4 (ceasing to have a right to receive, or obligation to pay, foreign currency) be disregarded where the combined balance of all accounts covered by that election is not more than the foreign currency equivalent of A$250,000 (**limited balance**).

[10] Refer: https://cryptodigestnews.com/cryptocurrency-exchanges-engaging-in-high-level-wash-trading-to-fake-trade-volumes-d5e9c5e5a0ca
[11] Refer TR 2008/1 and Taxpayer Alert TA 2008/7 at https://www.ato.gov.au/law/view/document?DocID=TPA/TA20087/NAT/ATO/00001

(C) The foreign currency equivalent is calculated based on the foreign currency's average exchange rate prevailing for the third month preceding the start of the relevant income year. This approach is 'designed to minimise compliance costs by removing the need to continually monitor, during an income year, the A$-translated balance of the account by reference to a fluctuating exchange rate'.[12] However, the limit is measured on a continuous basis: an account may cease to satisfy the limited balance exemption if at any time it exceeds the limited balance.

(D) To provide some tolerance for temporary breaches of the limited balance, a buffer provision enables taxpayers to hold the foreign currency equivalent of up to A$500,000, for not more than two 15-day periods in any income year, without losing the exemption (**buffer balance**). If accounts exceed the buffer balance for longer than 15 days at a time, or on more than two occasions in one income year, the exemption will be lost until the breach is rectified.

(b) To the extent of any law change dealing with the application of the personal use asset exemption, a clear statement should be made that the old law has been replaced by the new law which does not express the same ideas as the old law.[13] The effect of such a statement would allow taxpayers that have received unfavourable private rulings to apply the new law without being inhibited by the private ruling.

(c) Further consideration needs to be given to the tax treatment of utility tokens, for the development of a genuine and economically beneficial utility token economy. Otherwise individuals are dis-incentivised to acquire a utility token early in its development due to contradictory tax outcomes:

(i) taxed to a capital gain (potentially with a 50% discount) on disposal of the token, even if it is ultimately used for its utility; and

(ii) where the issuer is presumably liable to income tax on ICO proceeds as well as to collect and remit GST on the supply of a utility token on the basis that a utility token either doesn't fit within the definitions of 'digital currency' or 'security' and represents the potential future provision of what would constitute a taxable supply for consideration.

(d) A clear framework for taxpayers to more easily self-assess the tax treatment of a hard fork / chain split, noting that there are at least two types: contentious and non-contentious. The tax outcomes are likely to differ between each scenario.

5.2.3 Foreign residents

(a) Foreign residents are subject to Australian tax on their Australian source income. However, the determination of whether income from cryptocurrency transactions has an Australian source is unclear and could differ based on the type of token.

(b) For example, where a foreign resident invests in and/or disposes of a tokenised security representing interests in Australian real property via an Australian cryptocurrency exchange, a question arises as to whether any gain on disposal of the token constitutes Australian source income.

5.2.4 Recommendation

[12] Explanatory Memorandum to *New Business Tax System (Taxation of Financial Arrangements) Bill (No 1) 2003* at [2.299].
[13] Refer TR 2006/11 at [51] to [53]: https://www.ato.gov.au/law/view/document?DocID=TXR/TR200611/NAT/ATO/00001&PiT=99991231235958

(c) The practical difficulties around collection of tax payable by foreign residents on Australian source gains would mean that the tax collection liability should be imposed on the Australian cryptocurrency exchange. Absent the exchange being able to calculate the gain or loss, a withholding tax could be applied, the administration of which is consistent with the existing withholding tax regime.

(d) Alternatively, or in addition, the opt-in tax framework for cryptocurrency transactions, discussed below, could be considered in this context.

5.2.5 Cryptocurrency funds (or funds that have some investments in cryptocurrency)

(a) Investment funds established in Australia are able to take advantage of the MIT regime, the AMIT regime, the listed investment company (**LIC**), and more recently the proposed CCIV regime.

(b) It is difficult for cryptocurrency funds, or already established funds that wish to gain exposure to cryptocurrency asset classes, to take advantage of these regimes for a number of reasons, including:

(i) A MITs eligibility to make the capital account election relies on the MIT holding certain types of investments. The capital account election allows a trustee of a MIT to choose to apply the CGT provisions for the taxation of gains and losses on disposal of certain investments.[14] Investments eligible for deemed capital account treatment are defined by section 275-105 ITAA 1997:

(1) an asset is covered by this section if it is any of the following:

*a) a *share in a company (including a share in a *foreign hybrid company);*
*b) a *non-share equity interest in a company;*
c) a unit in a unit trust;
d) land (including an interest in land);
*e) a right or option to *acquire or *dispose of an asset of a kind mentioned in paragraph (a), (b), (c) or (d).*

(2) However, the asset is not covered by this section if it is any of the following:

*a) a *Division 230 financial arrangement;*
*b) a *debt interest.*

(ii) Other than perhaps tokenised securities, there is not a category of asset that covers cryptocurrency.

(iii) Outside of the MIT rules and within traditional taxation of trust rules, there is no limitation on the type of investments in which a trust can invest. However, a revenue versus capital analysis would likely be necessary for each disposal of cryptocurrency investments held by the trust.

(iv) There is uncertainty about the availability of Sub-division 115-D tax relief if a LIC structure is used to invest in various cryptocurrencies. This is largely because Sub-division 115-D was introduced before cryptocurrencies came into existence and the legislation, particularly the definition of ‘permitted investments’, does not easily apply to this new type of investment.

[14] s 275-100 ITAA 1997.

(v) 'Permitted investments' are defined by section 115-290(4) ITAA 1997:

The permitted investments are:

*a) *shares, units, options, rights or similar interests to the extent permitted by subsections (5), (6), (7) and (8); or*
b) financial instruments (such as loans, debts, debentures, bonds, promissory notes, futures contracts, forward contracts, currency swap contracts and a right or option in respect of a share, security, loan or contract); or
*c) an asset whose main use by the company in the course of carrying on its *business is to *derive interest, an annuity, rent, royalties or foreign exchange gains unless:*
   *i. the asset is an intangible asset and has been substantially developed, altered or improved by the company so that its *market value has been substantially enhanced; or*
   ii. its main use for deriving rent was only temporary; or
d) goodwill.

(vi) 'Rights' is a broad term and not defined by the ITAA 1997 or the ITAA 1936. Guidance published by the ATO generally associates rights or options with entitlements to acquire shares or units.[15] However, a legal right could be interpreted more broadly to capture the rights associated with holding cryptocurrency.

(vii) 'Financial instruments' is also a broad term and not defined by the ITAA 1997 or ITAA 1936. The Australian Accounting Standards Board (AASB) defines a financial instrument as, 'any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.'[16] The key requirement for a financial instrument being corresponding rights between parties.

(viii) By their nature, most cryptocurrencies, particularly payment tokens, do not create corresponding rights between investors and the blockchain and mining network. Due to the decentralised nature of the underlying blockchain and mining network, no single entity or collective of entities holds, or has been deemed to hold, a corresponding financial liability or equity instrument in relation to an investor's cryptocurrency holding. At least for accounting purposes, it appears unlikely that payment tokens could be classified as a financial instrument and more likely that these cryptocurrencies should be classified as intangible assets.[17] In addition, the types of financial instruments listed in paragraph 115-290(4)(b) indicate that corresponding rights are a requisite feature.

5.2.6 Recommendation

(c) For the funds and financial services industry to lend its weight and support to the growth of genuine and economically beneficial token projects, legislative amendments should be made to include cryptocurrency as a covered asset for the MIT capital account election and as a 'permitted investment' for the LIC regime to apply, where appropriate.

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[15] ATO, CGT, "Shares, units and similar investments - Acquiring rights or options": https://www.ato.gov.au/General/Capital-gains-tax/Shares,-units-and-similar-investments/Rights-and-options-to-acquire-shares-or-units/Acquiring-rights-or-options/
[16] AASB 132 at [11]: http://www.aasb.gov.au/admin/file/content105/c9/AASB132_07-04_COMPapr07_07-07.pdf
[17] IFRS news - Cracking the cryptocurrency code; or what is a 'bitcoin' anyway, PwC: https://www.pwc.lu/en/ifrs/docs/pwc-ifrs-march17.pdf

(d) It may not be appropriate to cover all types of tokens as a covered asset or permitted investment and these scenarios should be considered in greater detail. For example, Delegated Proof of Stake arrangements where the fund manager could be in a position to control a lot of votes without consulting investors. In addition, there could be a solid case for funds to provide investment to utility token projects that are more like speculative investments before the utility functionality is built and available - once the utility eventuates however, it might not make sense to have a fund holding utility tokens though this should be considered further.

5.2.7 Australian resident companies

(a) A number of tax issues identified for Australian resident individual token holders also apply to Australian resident companies.

(b) As a future-proofing comment, targeted to Australian resident companies, the impact of potentially anti-competitive behaviour and actions to remedy anti-competitive behaviour should be in Treasury's sight.[18]

(c) To promote greater corporate uptake of token raises and participation in token economies, the revenue/capital distinction is important for Australian resident companies to have confidence in investing, especially when strategically investing early, in token raises or token economies. Traditional tax principles may be sufficient but this issue should be considered further.

(d) In the event that a company's involvement with a blockchain project were to become critical to compete in a particular industry, competitors may need to become part of the blockchain network and/or acquire the particular token. Where competition rules are introduced (or existing rules applied) to require disposal of tokens and/or dilution of involvement in a network, tax laws should be ready to deal with such scenarios.

5.2.8 Recommendation

(e) We recommend that Treasury have regard to the impact of anti-competitive behaviour as blockchain projects increase in number and/or scale, and any special tax provisions that may need to be introduced to deal with remedial action required.

5.2.9 Australian-controlled foreign companies (i.e. CFCs)

(a) The CFC rules were introduced before, and without anticipation of, cryptocurrencies and blockchain technology.

(b) In general terms, income of the CFC is only attributed if the CFC fails the 'active income test'. One of the main conditions to pass the active income test is that the tainted income ratio is less than 5%. Put another way, and again in a broad sense, provided the gross tainted turnover of the CFC in a given year is less than 5% of its total turnover, then the CFC rules won't attribute income to the Australian resident investors.

(c) The concept of tainted turnover is broad and covers:

(i) passive income, such as dividends, interest, rent and royalties. It also includes, relevantly, income from the carrying on of a business of trading in 'tainted assets' and gains from the disposal of tainted assets. 'Tainted

[18] For a useful analysis of blockchain and anti-competition risks, albeit not an Australian-specific analysis, see: (Jones Day), "Blockchains and Antitrust: New Technology, Same Old Risks?" (August 2018) at https://www.lexology.com/library/detail.aspx?g=224a6bb7-d78c-4d07-af58-cb3b05615637&utm_source=Lexology+Daily+Newsfeed&utm_medium=HTML+email&utm_campaign=Lexology+subscriber+daily+feed&utm_content=Lexology+Daily+Newsfeed+2018-08-06&utm_term=

assets' are defined to exclude assets that are considered trading stock or an asset used solely in carrying on a business;

(ii) tainted sales income and tainted services income.

(d) Where the CFC rules apply in respect of cryptocurrency dealings conducted through an offshore company, Australian tax may apply to any 'tainted income' on a notional accruals basis before a distribution or dividend is paid. For example, if the cryptocurrency investments are considered tainted assets and/or if income or gains from those investments is considered passive income, the CFC may fail the active income test and cause income to be assessable in Australia regardless whether a distribution or dividend is paid from the CFC.

(e) The interpretation of 'tainted assets' and 'passive income' cause some tension in the cryptocurrency context. To illustrate, we set out an example based on a simple Proof of Stake project.

(f) For a simple Proof of Stake project, we have assumed that:

(i) the CFC will acquire at least the amount of cryptocurrency required to be eligible to participate in Proof of Stake as a 'forger';

(ii) the CFC will put an amount of cryptocurrency 'at stake' so that it can validate transactions - i.e. cryptocurrency deposited/locked into an escrow account;

(iii) the CFC is entitled to returns paid in cryptocurrency based on the amount of cryptocurrency 'at stake';

(iv) the CFC may acquire more cryptocurrency for the purpose of putting more 'at stake' to increase the CFC's 'wealth' and chances of being selected to validate transactions; and

(v) if fraudulent transactions are validated, the CFC will lose the cryptocurrency 'at stake' and lose its right to participate as a forger.

(g) It is possible that cryptocurrency acquired for the purpose of putting it at stake could constitute a tainted asset as a loan, or a share, or a similar financial instrument to a loan or share, with any gains made on disposal giving rise to passive income.

(h) However, cryptocurrency at stake is unlike a loan or share in that cryptocurrency staked carries more responsibility than that of a mere lender or mere shareholder. Cryptocurrency staked is wholly at risk with no right to recovery if lost, whereas a lender generally has a legal right to recovery of the amount loaned and a shareholder generally has a last-ranking right to recovery in the event of a company's insolvency.

(i) Cryptocurrency will be lost as a result of fraudulent transactions being validated. The staker should have control over whether fraudulent transactions are validated or not. By virtue of this control and level of responsibility, we consider that the act of staking cryptocurrency and being involved in verifying transactions should constitute the carrying on of a business of staking cryptocurrency with the view of receiving cryptocurrency returns from that activity.

(j) Cryptocurrency at stake that is lost as a result of fraudulent transactions being validated should constitute an asset used solely in carrying on one of the CFC's businesses - i.e. staking cryptocurrency with the view of receiving cryptocurrency returns from that activity. Whilst the cryptocurrency staked is used in carrying on the business of staking, we consider it more likely that the loss amount should constitute a capital loss rather than a revenue loss because a periodic return is expected from the cryptocurrency staked. A CFC can only carry forward a capital loss to be offset against future capital gains, subject to satisfaction of the loss integrity tests.

(k) To the extent that the CFC's Proof of Stake activities are considered insufficient to constitute the carrying on of a business, there is residual risk that the cryptocurrency staked could constitute a similar financial instrument to categories of tainted assets such as loans or shares which are capable of being merely acquired from Australia but are acquired via an offshore company for the benefit of a more advantageous tax regime.

5.2.10 Recommendation

(l) Legally define, or make administratively binding statement, to clarify the application of the CFC rules to ICOs conducted offshore and assets involved with, and income from, alternative consensus protocols like Proof of Stake (**PoS**) and Delegated Proof of Stake (**DPoS**) arrangements.

5.2.11 Australian resident cryptocurrency exchanges

(a) Assuming the Australian resident cryptocurrency exchanges constitute 'electronic distribution platforms' (**EDPs**) for GST purposes, they may have been obliged to collect and remit GST upon tokens traded on their exchange, which do not fall within the exemption for 'digital currency', since the introduction of the EDP rules.

5.2.12 Recommendation

(b) The Commissioner should make administratively binding statement, to clarify:

(i) the classification of digital currency exchanges as EDPs; and

(ii) whether exchanges' potentially significant historic liability to GST on supplies of tokens that do not meet the definition of digital currency (e.g. stablecoins, utility tokens) will be the subject of ATO compliance resources and GST assessments.

(c) Treasury to consider the impacts of retrospective legislative amendments to the either or both of the definitions of EDP and 'digital currency' for GST purposes.

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?

(a) Whilst not an immediate or near term issue, we consider it crucial for Australia to have a legal and tax framework that encourages the full spectrum blockchain projects which may or may not ICO.

(b) In particular, there should be clarity around the tax treatment of DAO projects and consensus protocols that distribute the governance of a network (e.g. PoS and DPoS) that are more energy-efficient and appropriate than Proof of Work (hereafter referred to as 'alternate consensus protocols').

(c) The interaction between ICOs and airdrops is also important, as is the relevance of the work being undertaken by the OECD as part of BEPS Action 1: Addressing the tax challenges of the digital economy.

5.3.1 DAOs

(a) Some of the key attributes of DAO projects are considered below, to illustrate how Australia's traditional tax principles, and our international tax framework, are falling short.

(b) Due to the short consultation period, a full analysis of DOs, DAOs and DACs has not been prepared but we recommend Treasury give further thought to each scenario as part of setting the Australian policy landscape.

(c) As already emphasised in this submission, terminology is important. Vitalik Buterin provides a good summary of DOs, DAOs, and DACs, which we have adopted for the purposes of articulating issues with the potential tax treatment of DAOs.[19]

(d) To date, the Commissioner has not publicly stated a view regarding the tax treatment of a DAO and network of participants.

(e) Based on our preliminary analysis, there could be an interpretation of Australia's tax rules which would be extremely prohibitive to DAO projects and participants in Australia. That is, the risk that the Commissioner could assess participants as partners in a tax law partnership, subject to joint and several liability for the debts of the partnership - in particular, tax debts. Even if one participant is subject to Australian tax, the Commissioner may be able to pursue each participant until the tax debt is met.

(f) The following key features of a DAO, extracted from BlockchainHub, challenge the application of traditional tax principles:

   (i) A DAO '…is an entity that lives on the internet and exists autonomously, but also heavily relies on hiring individuals to perform certain tasks that the automation itself cannot do.

   (ii) In order to exist a DAO needs some kind of internal property that is valuable in some way, and it has the ability to use that property as a mechanism for rewarding certain activities.

   (iii) The funding takes place directly upon creation of the organisation.

   (iv) DAOs do not have a hierarchical structure, nor executives or management.

[19] Refer: https://blog.ethereum.org/2014/05/06/daos-dacs-das-and-more-an-incomplete-terminology-guide/

(v) Once deployed the entity is independent of its creators and cannot be influenced by outside forces.

(vi) DAOs are open source, thus transparent and incorruptible.

Governance and voting

(vii) In order to withdraw or move funds from a DAO, a majority of its stakeholders (this percentage could be specified in the code of the DAO) must agree on the decision.

(viii) If bugs are found in the code, they could not be corrected until a voting procedure has taken place and the majority of voters agreed on it.

(ix) A DAO cannot build a product, write code or develop hardware. It needs a contractor to accomplish its goals. Contractors get appointed via voting of token holders.

(x) Proposals are the primary way for making decisions in a DAO. To avoid people overloading the network with proposals, a DAO could require a monetary deposit to prevent people from spamming the network.

(xi) After submitting a proposal, voting takes place. DAOs allow people to exchange economic value with anyone in the world, like investing, money raising, lending, borrowing, without the need of an intermediary, just be trusting the code.

5.3.2 Recommendations

(g) Legislate, or administratively binding guidance that no general law partnership or tax law partnership should arise which would otherwise result in joint and several liability to tax on all distributions made to network participants.

5.3.3 Alternate consensus protocols

(a) To date, the Commissioner has not publicly stated a view regarding the tax treatment of alternate consensus protocols. The tax treatment of assets involved and income earned via engagement with alternate consensus protocols is a critical issue for the interpretation of the attributable income provisions within the CFC rules considered in detail above.

5.3.4 Airdrops

(b) There is a broader question around why an ICO -- i.e. raising funds from the public at large (i.e. retail investors) to support a very early stage blockchain technology venture -- should warrant specific consideration and legal and tax policy. Throughout this submission there are a number of justifications, but in particular the nature of blockchain technology, or distributed ledger technology, means that it thrives upon network effects and user participation. ICOs are not just useful for raising funds but are important to promote the project to a wider user base. Developing a community around the blockchain project and use of the token propels network effects and the ultimate value of participating in the network. An appropriate legal and tax framework should uphold these purposes.

(c) Importantly, an ICO provides an initial market value of the cryptocurrency for willing buyers.

(d) However, airdrops achieve the latter, promotional purpose, without the legal complexity of raising funds at the same time. Airdrops can be defined as:[20]

> *…the process whereby a cryptocurrency enterprise distributes cryptocurrency tokens to the wallets of some users free of charge.*

(a) The tax treatment of airdrops, from the perspective of the issuer, is also unclear and/or tax advantageous and potentially subject to challenge by the Commissioner. For example, an issuer may self-assess the value of the airdropped cryptocurrency as an allowable deduction to realise a tax revenue loss in Year 1. Subject to loss integrity tests, the issuer may then utilise the loss in Year 2 in which they conduct an ICO and for which the ICO proceeds are assessable.

(b) The lack of clarity and/or tax risk around the tax treatment of airdrops is fuelled in large part by difficulties of valuing the airdropped cryptocurrency, determining costs attributable to the free distribution of cryptocurrency and the capital or revenue nature of that cost.

    (i) We note that from the token holders' perspective, absent an ICO to set at least an initial market value of the cryptocurrency, recipients of free cryptocurrency are likely to find it difficult to determine the market value (if any, at the time of receipt) of the asset received for tax reporting purposes.

5.3.5 Recommendation

(c) Any proposals around the tax treatment of ICOs should not be considered in isolation of the tax treatment of airdrops (from the issuer's perspective) to avoid abuses of the tax law.

5.3.6 Relevance of Action 1 of the OECD's BEPS Project: Addressing the tax challenges of the digital economy

(a) We highly recommend that Treasury have regard to the work being undertaken internationally to address the tax challenges of the digital economy for the following reasons:

    (i) Blockchain-based businesses generally rely on network effects to improve the network's value as well as the token's value. As such, blockchain-based businesses are likely to be caught within measures that may be proposed by the OECD, which are focussed on the taxation of user created value and network effects. Any measure that is not cognisant of the OECD work may be short-lived policy.

    (ii) Tax administrations are struggling, and may continue to struggle, to obtain meaningful data about cryptocurrency transactions, especially privacy coins, as well as transactions conducted on decentralised exchanges, DOs, DAOs and DACs. The ATO has traditionally been able to rely on information access powers and data matching protocols to obtain data necessary to conduct matching exercises. From these exercises, the ATO is able to identify non-reporting or misreporting of information in tax returns and better target the use of compliance resources to collect unpaid tax. Whilst some forensic techniques are being used globally to attempt to identify unreported and taxable cryptocurrency transactions, the levels of success now and into the future are unknown and therefore unreliable.

5.3.7 Recommendations

[20] Refer: https://hackernoon.com/what-are-airdrops-in-crypto-world-6ce97d5bb17b

(b) With the above reasons in mind, Treasury might consider whether the benefits of an opt-in tax framework outweigh the costs of data matching procedures and after-the-fact tax collection efforts. The opt-in framework might apply to any or all of exchanges offering crypto-to-crypto pairs, multi-tiered token economies and other scenarios deemed appropriate.

(c) An opt-in framework could require the development team to "opt in" by incorporating a tax collection function into the protocol layer or smart contract code and having that tax function promptly reviewed and approved by the ATO.

(d) In particular, an opt in framework might:
   (i) effectively "switch off" traditional income tax and GST rules that might otherwise apply to cryptocurrency transactions, which can be unclear and relatively onerous to apply - especially for multi-characteristic tokens and multi-tier token economies;
   (ii) create an efficient taxing mechanism, whereby either the protocol layer or a smart contract would collect the designated percentage of tax on each cryptocurrency transaction and either pool tax funds in a holding account before being remitted to the ATO or automatically remit the tax funds to the ATO;
   (iii) promote Australia as a more simple and certain regulatory jurisdiction in which to operate blockchain-based businesses and token economies;
   (iv) signal to the global crypto-DLT community that Australia anticipates the pervasiveness of blockchain technology and is at the forefront of simple, certain and appropriate tax policy;
   (v) alleviate pressure on revenue authorities to forensically analyse blockchain data to attempt to identify unreported and taxable cryptocurrency transactions;
   (vi) demonstrate Australia's awareness that particular types of tokens (e.g. payment, stablecoin, utility) should be used to promote network effects, rather than held as a speculative asset, and thus compliance with tax laws should promote high volume / frequent use and low tax compliance rather than high tax compliance that distorts and reduces use.

(e) Blockchain-based businesses could provide fertile ground to test the viability of an alternative, opt-in, basis of taxation, particularly for the new concept of taxation of user-created value. In the absence of international consensus until at least 2020, Treasury should consider the merits of introducing an opt-in taxing framework for blockchain-based businesses. Such a framework should not be net detrimental to the existing tax regime, nor any other ICO tax policy measures, because of the opt-in nature of the framework.

(f) The "personal use" wallet designation discussed above could also form part of the opt-in framework.

Background to Action 1 of the OECD's BEPS Project

(g) On 2 October 2018, Treasury released its Discussion Paper, 'The digital economy and Australia's corporate tax system',[21] to explore options for taxing digital business in Australia. The Discussion Paper emphasises that digitalisation has been driving and will continue to drive welfare-enhancing changes in the Australian economy, and has the potential to enhance choice, competition, innovation and productivity.

(h) Submissions made to Treasury have not yet been made public, nor have there been any announcements from Treasury or the Government since the submission period closed on 30 November 2018.

[21] Refer: https://treasury.gov.au/consultation/c2018-t306182/

(i) Treasury's Discussion Paper draws upon work undertaken by the OECD as part of Action 1 of the Base Erosion and Profit Shifting (BEPS) Project - Addressing the Tax Challenges of the Digital Economy - and measures proposed and/or implemented by the European Commission and other countries.

(j) The initial BEPS Action 1 Report, 'Addressing the Tax Challenges of the Digital Economy',[22] released in October 2015, observed new phenomena such as the collection and exploitation of data, network effects and the emergence of new business models, such as multi-sided platforms, as exacerbating the challenges to the existing tax rules.

(k) The OECD's Interim Report on Action 1, released in March 2018, acknowledges that there is currently no international consensus on whether the digitalisation of the economy presents a problem for the existing international tax framework, how to respond to any such problem, or a timeframe for action. Very broadly:

 (i) some countries would like targeted changes to the existing tax framework to recognise user contribution to value creation;
 (ii) a second group of countries believe that the nexus and profit attribution rules may no longer be adequate but that the limitations are not unique to the digital economy; and
 (iii) a third group of countries are generally satisfied with existing international tax rules.

(l) Whilst the OECD's Final Report is expected in 2020, the OECD has released two policy notes (in October 2018[23] and January 2019[24]), a discussion draft and most recently, a public consultation document on possible solutions to the tax challenges arising from the digitalisation of the economy.

(m) In short, the OECD is working towards a consensus-based, global solution by 2020, with an update to be provided to the G20 in 2019. In the meantime, a number of jurisdictions are considering the merit of interim measures that reflect the OECD's design considerations. For example, the European Commission has proposed a Digital Services Tax (DST) upon businesses with total annual worldwide revenues exceeding €750 million and EU taxable revenue exceeding €50 million. If introduced, such businesses will be subject to a DST equal to 3% of gross revenue (net of VAT) derived from the provision digital services where user-created value is central and from the sale of data from users' engagement with digital interfaces.

(n) One of the key questions posed by Treasury includes whether taxing rights under the current international tax framework should change to reflect user-created value.

(o) The current international tax framework allocates taxing rights based on the location of physical assets, capital and labour, the source of income and the residence of taxpayers. However, most digital businesses have the ability to access a market via technological means without necessarily having a physical presence or a significant number of employees in that market. However, for a non-resident business, the international tax framework and Australia's corporate tax framework rely on business activities in Australia being significant enough to constitute a local fixed place of business before an Australian PE will arise.

(p) If taxing rights could be modified to include taxation of user-created value, blockchain and cryptocurrency could offer a relatively efficient means of tax administration and collection of international tax revenue on cryptocurrency

[22] Refer: https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en#page1
[23] Refer: https://www.oecd.org/tax/beps/tax-and-digitalisation-policy-note.pdf
[24] Refer: https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf

transactions, as well as appropriate distribution of tax revenue amongst countries on an agreed upon basis.

ATTACHMENT 2

Hall & Wilcox submission to Treasury dated 5 June 2018

Our submission has been prepared for Treasury's review into ICOs.

This submission cannot be relied on by third parties, for any purpose, without our written consent. Neither Hall & Wilcox, nor any partner or employee of Hall & Wilcox, are liable in any way for any entity other than Treasury relying on this submission.

No copy of or extract from this submission may be supplied to any other person. This submission must not be quoted or referred to in any public document or filed with any government agency or other person without our written consent.

Our submission is based on Australian tax law as it stands at the date of this letter, and the published views of the Commissioner of Taxation, as at the date of the submission.

We express no opinion as to the laws of any other jurisdiction.