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Board of Taxation Secretariat
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30 September 2022

By email: TaxDigitalAssets@taxboard.gov.au

Review of the Tax Treatment of Digital Assets and Transactions in Australia

Dear Secretariat

Ernst & Young (EY) welcomes the opportunity to respond to the Board of Taxation's (BoT) Review of the Tax Treatment of Digital Assets and Transactions in Australia Consultation Guide (Consultation Guide).

The BoT is seeking feedback on the Australian taxation treatment of digital assets and transactions with the review's terms of reference including consideration of whether or not changes to Australian tax law and/or administration are required.

Whilst the Consultation Guide outlines 15 questions, on 5 topics, our submission does not directly respond to each question. Instead, our submission covers a number of broad issues concerning digital assets held as investments, to aid the BoT in developing their report to Government by 31 December 2022.

Our detailed submission including observations and recommendations is attached covering:

- **General observations/recommendations** – in Appendix A
- **Particular managed funds tax considerations** - impacting funds, their managers and financial services industry service providers – in Appendix B.

Should you have any questions in relation to the above, or wish to discuss these matters in further detail, please do not hesitate to contact Tracey Dunn (tracey.dunn@au.ey.com) in our Private Tax practice, Anita Sharma (anita.sharma@au.ey.com) and Kristina Dillon (kristina.dillon@au.ey.com) in our Financial Services Tax practice, or Brian Lane (brian.lane@au.ey.com) in our Tax Policy Centre.

Yours sincerely

Ernst & Young

Appendix A – General Observations/Recommendations on Digital Asset Taxation in Australia

A1. Current tax treatment under the Australian law

Currently there are no specific provisions under the *Income Tax Assessment Act 1997* (ITAA 1997) which deal with the taxation of cryptocurrency and or digital assets in Australia. Rather, in Australia cryptocurrency is typically taxed under the general provisions both as a capital asset and as ordinary income.

In 2014 the Australian Taxation Office (ATO) issued four Tax Determinations each dealing with a separate but common taxation issue associated with bitcoin transactions including foreign currency,[1] capital gains tax (CGT),[2] trading stock,[3] and fringe benefits tax (FBT).[4] This is the only binding guidance currently available to taxpayers on the taxation of digital assets in Australia. The binding guidance is focused on bitcoin and does not adequately address the rapid development of cryptocurrencies and digital assets or the emergence of new blockchain applications including smart contracts and other transactions.

Since 2014 the ATO has also provided some ad hoc web guidance to address emerging tax issues however this guidance is not binding on the Commissioner and causes uncertainty for taxpayers. Further, the web guidance has evolved over time and the lack of access to prior versions of the web guidance could pose risk for taxpayers who rely on original published, and now obsolete, guidance when preparing their returns. The risk demonstrated in the scenario below where the ATO recently changed their view on the appropriate tax treatment of airdrops.

> *Example 1:*
>
> In March 2022 the ATO web guidance stated the market value of tokens received under an initial airdrop was ordinary income and required to be included in a taxpayer's assessable income.
>
> On 7 September 2022 the ATO updated the web guidance to state tokens receive in an initial airdrop are not ordinary income except where the airdrop is of an **established** token.

The original published guidance[5] has now been removed. Taxpayers who relied on the guidance that was available on the ATO website at 30 June 2022, and included the market value of tokens received

[1] TD 2014/25 – Income tax: is bitcoin a 'foreign currency' for the purposes of Division 775 of the Income Tax Assessment Act 1997?

[2] TD 2014/26 – Income tax: is bitcoin a 'CGT asset' for the purposes of subsection 108-5(1) of the Income Tax Assessment Act 1997?

[3] TD 2014/27 – Income tax: is bitcoin trading stock for the purposes of subsection 70-10(1) of the Income Tax Assessment Act 1997?

[4] TD 2014/28 – Fringe benefits tax: is the provision of bitcoin by an employer to an employee in respect of their employment a property fringe benefit for the purposes of subsection 136(1) of the Fringe Benefits Tax Assessment Act 1986?

[5] Published at the following URL (accessed on 27 March 2022) <https://www.ato.gov.au/general/gen/tax-treatment-of-crypto-currencies-in-australia---specifically-%3Ebitcoin/?anchor=Transactingwithcryptocurrency#Stakingrewardsandairdrops>

under an initial airdrop of a new coin, may have overstated their taxable income and as a result, paid more tax than required under the current Australian tax law.

A1.1 'Investors' - Capital vs revenue distinction

The ATO default published view is that typically investors in cryptocurrency and digital assets will hold the assets on capital account, and a subsequent exchange (other than a transfer to a wallet owned by the same investor) will be subject to CGT. On 16 May 2022, the ATO announced 'Four priorities for the ATO this tax time'. The ATO website, in relation to cryptocurrency transactions states:[6]

> *"If you dispose of an asset such as property, shares, or a crypto asset, including non-fungible tokens (NFTs) this financial year, you will need to calculate a capital gain or capital loss and record it in your tax return."*

Assistant Commissioner Tim Loh is quoted on the same webpage as saying:

> *"Crypto is a popular type of asset and we expect to see more capital gains or capital losses reported in tax returns this year. Remember you can't offset your crypto losses against your salary and wages" Mr Loh said.*

The ATO default position that gains or losses arising from disposals of cryptocurrency or other digital assets must be recorded on capital account, and losses can't be offset against salary and wages is not necessarily correct. There is concern this default view may cause some taxpayers, who genuinely hold cryptocurrency or digital assets on revenue to account, to pay the wrong amount of tax under the Australian tax law.

The ATO does recognise cryptocurrency and other digital assets may be held on revenue account however this current view is limited to circumstances where the owner of the digital assets is carrying on a business. Based on this view, a taxpayer will only hold cryptocurrency or other digital assets on revenue account where the indicia of carrying on a business, consistent with established case law, is satisfied.

The ATO do not recognise on their website, or in the published Tax Determinations, that cryptocurrency and other digital assets may be held by a taxpayer on revenue account where the taxpayer has a commercial or profit-making intent consistent with the principle in *The Commissioner of Taxation of the Commonwealth of Australia v The Myer Emporium Limited* (1987) 163 CLR 199 ('*Myer Emporium*'). The ATO current view is consistent with the unsuccessful submissions advanced by the Commissioner in *Greig v Commissioner of Taxation* [2020] FCAFC 25 ('*Greig*') that the losses incurred by a taxpayer from the disposal of shares *"…did not have "characteristics of a business operation or commercial transaction, but were instead redolent of private investments on capital account" and therefore did not engage the principle enunciated in Myer Emporium."*[7]

In *Greig* the full Federal Court held losses and expenditure incurred in acquiring shares by a taxpayer, having regard to the surrounding facts and circumstances and the taxpayer intent, was a "business operation or commercial transaction" entered into for the purpose of making a profit. At [245] Steward J stated:

[6] https://www.ato.gov.au/Media-centre/Media-releases/Four-priorities-for-the-ATO-this-tax-time/

[7] Greig v Commissioner of Taxation [2020] FCAFC 25 (Steward J at 189).

> *"The shares were acquired with a view that they be sold at a profit in the short term; whilst no profit in fact was made, if the taxpayer had realised a gain, in my view, that gain would not have been characterised as windfall in nature or as the product of a game of chance or the pursuit of a hobby. Nor would the gain have been characterised as merely a realisation of a capital asset".*

The relevant factors taken into account in determining the shares were in a "business operation or commercial transaction" according to Steward J, being:[8]

- The existence of profit-making intention of the taxpayer at the time each share was acquired
- The subjective intention of the taxpayer for the reason for generating profits (in Greig the intention to profit was part of an overall sophisticated plan for retirement)
- The systematic fashion in which the shares are acquired (there were 64 transactions in Greig).
- The extent of the taxpayer's participation in the transaction
- The level of knowledge and experience applied by the taxpayer in the particular transaction
- Whether the taxpayer relevantly acted as a "business person" would.

Another key factor in *Greig* indicating the taxpayer did not hold the shares on capital account was that the taxpayers' purpose was not to hold the shares as a long-term investment and to receive dividends over time.[9]

A1.2 The 'correct' treatment under Australian tax law

In our view the correct treatment of cryptocurrency and other digital asset transactions under the Australian tax law must be determined on a case-by-case basis and with having regard to:

- The identity of the taxpayer (e.g., entity type, residency status, age and capacity)
- The subjective intention and purpose of the taxpayer at the time of entering into the transaction
- The level of knowledge and experience of the taxpayer
- The type of cryptocurrency or digital asset involved in the transaction
- Any associated rights, embedded or otherwise, attached to the asset including any rights to a revenue stream
- How the cryptocurrency was acquired by the taxpayer (i.e., was the transaction automatic or did it result from some positive act by the taxpayer?)
- The platform on which the transaction was executed (e.g., DCE, wallet to wallet transaction, gaming), the jurisdiction/location of the platform, its role and purpose in the transaction (e.g., issuer, agent, intermediary, custodian) and any relevant contractual terms
- The volume of transactions (e.g., were the assets acquired in a systematic fashion, volume of transactions, period the assets were held)
- Other relevant factors.

Where a taxpayer holds cryptocurrency and or other digital assets for long term capital growth, or for the generation of a yield (e.g., staking, interest) it may be more appropriate to treat gains or losses on the exchange or disposal of the underlying asset on capital account.

On the other hand, where a taxpayer holds cryptocurrency with the intent to profit from the volatility of the market, has a substantial volume of transactions and or uses a cryptocurrency trading

[8] Greig v Commissioner of Taxation [2020] FCAFC 25 (Steward J at 245).
[9] Ibid [246]

algorithm or bot to facilitate it may be more appropriate to treat gains or losses on the exchange, trade or disposal of the cryptocurrency assets on revenue account.

In some cases, it may be reasonable for some taxpayers to hold cryptocurrency assets on both revenue and capital account while holding other digital assets on capital account. Where a taxpayer uses DeFi platforms and invests in products that require the placement of cryptocurrency (capital) at risk in return for a yield (e.g., loans, staking) or invests in different classes of tokens (e.g., security tokens, NFTs) the appropriate approach under Australian tax law to determine which assets have the requisite characteristics to be taxed on revenue account and which assets have the requisite characteristics to be taxed on capital account may be to apply a 'tree' vs 'fruit' principle.

A1.3 Cryptocurrency 'coins'

A principles-based approach may appear appropriate in determining the 'correct' treatment of cryptocurrency transactions under the Australian tax law however this may not be practical where a taxpayer has engaged in a significant number of transactions.

The portability of cryptocurrency across wallets and DCEs and volatility of cryptocurrency markets is vastly different to traditional share markets. Taxpayer behaviour may be influenced by the ease of access and volatility of the markets resulting in behaviour that is inconsistent with that of a 'traditional' investor. A common characteristic of taxpayers who invest or trade in cryptocurrency is to develop or acquire cryptocurrency trading algorithms or bots that track cryptocurrency market movements and prices across DCEs in real time. The algorithms or bots determining the 'right' time to buy or sell cryptocurrency coins and may also be fully automated, transacting in thousands of transactions per day, with little to no physical engagement with the taxpayer who owns the algorithm or bot.

Similarly, the volatility of cryptocurrency markets means taxpayer behaviour when trading on platforms may differ to that of a traditional 'share' investor. Some taxpayers may hold cryptocurrency assets for long term gain however others may invest a significant amount of time monitoring real time market fluctuations and engaging in a substantial number of transactions each year. The latter may be motivated by a short-term profit-making intent rather than long term capital gain. We note that cryptocurrency also differs from traditional share investments in that cryptocurrency 'coins' do not provide rights to a separate income stream, akin to dividends. The value in the cryptocurrency coins being the movement in the trading value of the coin, not from an underlying equity interest or corresponding income/dividend right.

Where taxpayers acquire cryptocurrency with the intention to sell, exchange or trade the asset for profit, the correct approach under Australian tax law may be that the gains and losses from these activities are recognised on revenue account. This treatment would be consistent with the current position in Australian law established in *Greig* and the approach to the taxation of cryptocurrency transactions taken by New Zealand, Singapore and India.

The ATO approach of treating cryptocurrency transactions on capital account except where the taxpayer is using the cryptocurrency in carrying on a business may be incorrect. This approach can impose a significant administrative and unreasonable cost burden on taxpayers who have a substantial number of cryptocurrency transactions in an income year.

A generalised approach that ignores the taxpayer's intent and other specific facts and circumstances surrounding the cryptocurrency transactions carries a high risk the Australian tax laws will be applied incorrectly. This risk is intensified where taxpayers not only transact in cryptocurrency, but also in other digital assets and transactions.

Recommendations

Where taxpayers acquire cryptocurrency with the intention to sell, exchange or trade the asset for profit the gains and losses from these activities should be recognised on revenue account. However, where taxpayers acquire cryptocurrency with the intention to hold the asset for long term capital growth, or to hold the cryptocurrency asset at risk in return for a yield on a DeFi platform, gains and losses from the exchange, trade or disposal of the underlying asset should be recognised on capital account.

Where taxpayers acquire and hold cryptocurrency on capital account (with the intention for long term capital gains) and the taxpayers engage in a significant volume of transactions each income year, a 'simplified method' of calculating the net capital gain should be provided. For example: a 'net movement' approach comparing opening value of gross holdings at the beginning of the period with the closing value of gross holdings at the end of the period. It might follow that where an election is made to apply the 'simplified method' then taxpayers are not able to apply the general 50% CGT discount to reduce any capital gains made during the period.

A2. Non-fungible tokens (NFTs)

The current ATO guidance on the taxation of NFTs does not adequately account for or recognise the different ways in which NFTs can be acquired, used and exchanged by both investors and business taxpayers, the various rights or obligations that may be attached to an NFT or the jurisdictional issues that can arise when NFTs are traded via offshore marketplaces.

Whilst the ATO guidance recognises the taxation treatment of NFTs depends on whether the NFT is held as a CGT asset, as trading stock, as part of a business or as a profit making scheme, the guidance is extremely limited.

The ATO provides the following web guidance in relation to the taxation of NFTs.

Asset	Tax Treatment
The acquisition of an NFT that provides a right to a limited (one off) viewing of a piece of artwork.	The acquisition of the NFT is a personal use asset.
The minting of 10 NFTs by a business owner that provide holders with a limited right to view a tangible asset. All rights associated with the tangible asset remain with the business owner.	The proceeds from the initial sale of the NFTs is assessable business income. Any subsequent commission income treated as ordinary income and included in assessable income.

The business owner receives a commission (embedded in the NFT) on each subsequent sale of the NFT.	
A business owner acquires one of the above NFTs to use in his tour business as part of an annual art tour of the region.	The NFT is a CGT asset of the business.

Taxpayers seeking advice specific to their circumstances may be required to seek professional advice and/or a private binding ruling (PBR) in order to ensure their interpretation and application of Australian tax law is consistent with that of the ATO. This adds complexity and significant cost for taxpayers who would otherwise have simple tax affairs, and may result in an unfair outcome where taxpayers do not have the financial resources to obtain specialist tax advice.

In our view the taxation treatment of NFTs is highly dependent on a number of factors including (but not limited to):

- NFTs may represent a digital asset and/or an underlying tangible asset
- NFTs may be one of a kind, part of a limited run or part of a larger commercial scale production
- NFTs may have rights attached, the rights may be embedded as self-executing code or attached as part of a separate written contract
- NFTs may provide owners with membership rights to exclusive clubs, these rights may or may not have value
- NFTs may provide a holder with the right to contribute to the decision making within an associated decentralised autonomous organisation (DAO)
- NFTs may be used to authenticate associated assets or prove identity
- NFTs may be used in GameFi or to represent digital assets in the meta verse
- The price of NFTs may be determined by the open market or have a floor price set by an NFT community
- NFTs may be traded directly between privately owned wallets, via certain DCEs or digital NFT market-places (e.g., Opensea)
- The minting of NFTs may incur ‘gas’ fees
- Where embedded rights to commission which self-execute on each subsequent sale, the commission collected may be treated as ordinary income for the original NFT ‘artist’ and may trigger withholding obligations dependent on the jurisdiction of the sale or exchange.

We believe the following ATO binding guidance is urgently required on the Australian tax treatment of NFTs:

- Clearer examples on when an NFT may be a personal use asset for the purposes of Subdivision 108-C ITAA 1997
- Examples on when an NFT may be a collectable for the purposes of Subdivision 108-B ITAA 1997
- Guidance on whether additional rights attached to an NFT (e.g., exclusive membership rights) create a separate CGT asset, or form part of the same CGT asset
- Examples of where ‘gas’ fees incurred on minting NFTs form part of the cost base of an NFT or are deductible expenses
- Guidance on when the sale of an NFT will be a taxable supply for GST purposes, particularly considering the difficulties in determining the location of contracting parties

- Guidance on the application of double taxation agreements (DTAs) in respect of withholding obligations on royalties (e.g., commissions collected on subsequent resale of NFTs)
- Guidance on whether an NFT that is attached to an underlying tangible asset is a separate CGT asset.

Where NFT owners (e.g., people – including minors - who play online games) 'loan' NFTs to friends and associates online so they can gain access to something, or dress their avatar in a certain way, the 'lending' of the NFT should not be treated as a disposal for Australian tax purposes. Clarity on what constitutes a disposal of an NFT, particularly in circumstances where there is a 'temporary' passing of control of the asset to another person, but not a passing of legal and beneficial ownership is required. It is our view that a taxable event should only occur where there has been an actual disposal of the underlying asset for valuable consideration (e.g., fiat currency or another separate and distinguishable digital asset).

Recommendations

Where the NFT is a digital representation of an underlying tangible asset, taxing events could occur both on the change in beneficial ownership of the underlying tangible asset and the transfer of ownership of the NFT. Where the NFT is inherently tied to the underlying tangible asset (e.g., the NFT is both a digital representation of the underlying asset and used as proof of authenticity/ownership) arguably, a taxing event should only occur where there is a change in legal and beneficial ownership of the underlying tangible asset. This approach would be consistent with that applied in India.

Legislative change may be required to address issues arising in respect of withholding obligations where the re-sale of an NFT results in an obligation of an DCE or NFT marketplace to remit a commission collected on resale and the application of any relevant double taxation agreement (DTA) where the host jurisdiction of the DCE or NFT marketplace has primary taxing rights.

Legislative change may be required to provide certainty on when the sale of NFTs by an overseas based supplier is a) a supply connected with Australia and b) made to an Australian consumer for the purposes of paragraph 9-25(5)(d) *A New Tax System (Goods and Services Tax) Act 1999* (GST 1999). Clarification is required around what constitutes satisfying 'particular evidentiary requirements' as discussed in GSTR 2017/1 when the inherent nature of distributed ledger technology means the identity (beyond the users' public key) and residence of a consumer is not able to be obtained.

A3. DeFi

The ATO has not provided any specific guidance on how DeFi transactions should be taxed in Australia although we understand this is currently being considered.

DeFi is a term used to describe platforms akin to traditional financial services that run on distributed ledger technology. DeFi platforms can offer a decentralised service exchange that provides services such as lending, borrowing, saving, derivatives and contracts for exchange.

A principles-based approach to determining the Australian tax consequences of DeFi transactions may be appear appropriate however this may require taxpayers and their advisers to look at each transaction that has taken place on the DeFi platform and identify such things as:

- The nature of the rights
- Whether or not there has been a change in the legal and beneficial ownership of the cryptocurrency or digital asset
- Where a digital asset such as a token has been received in exchange, the circumstances surrounding the provision of that token, any obligations or rights attached along with its market value.

This approach is problematic as it may not be possible to identify the nature of the rights associated with each transaction because of the use of 'labels' by the DeFi platform and a principles-based approach may ultimately result in an outcome inconsistent with the purpose of a particular Australian tax law.

It is critical that the Australian government focus on DeFi, specifically the challenges the recognition and timing of disposals under domestic law has for compliance purposes. DeFi is unregulated and whilst it provides immense opportunities, the lack of regulation combined with the creativity of coders means complex 'financial products' are being made available to Australian taxpayers. There is no guidance on how to determine the appropriate tax consequences under Australian tax law which poses risk for taxpayers and their advisers.

The key issue around how DeFi transactions may be appropriately taxed under Australian tax law may be to apply the 'tree' vs 'fruit' principle discussed previously. Where cryptocurrency or digital assets are held at risk in return for an agreed yield, the yield or return should be returned as ordinary income.

Unless there is a clear disposal of both legal and beneficial ownership of the underlying cryptocurrency or digital asset, the exchange of cryptocurrency under a loan transaction (in return for an escrow or security token) should not be a disposal for tax purposes.

Recommendations

A simplified solution may be to allow taxpayers to elect to use a simplified approach which allows them to determine the Australian tax treatment based on the 'labels' applied to products available on DeFi platforms. (e.g., staking, interest, contract for difference, loan).

Taxing points for DeFi transactions that represent traditional 'loan' products should only be recognised where there has been a clear disposal of the underlying cryptoasset. The exchange of a cryptoasset for a security or escrow token in a lending transaction should not be treated as a disposal for income tax purposes.

A4. Airdrops

The latest ATO view on the taxation of Airdrops under Australian law is that cryptocurrency received from an airdrop of a new coin is not ordinary income, however cryptocurrency received from an airdrop of an established coin is ordinary income.

Section 6-5 ITAA 1997 provides that your assessable income includes the 'ordinary income' you derived directly or indirectly from all sources, whether in or out of Australia during an income year.

Ordinary income is not defined but is generally accepted by the ATO to be 'amounts that everyone would consider to be income.'[10]

The tax treatment of airdrops varies throughout foreign jurisdictions however in the UK, New Zealand and Singapore, crypto assets received via an airdrop are generally not included in assessable income except where the taxpayer holds the underlying crypto asset on revenue account or receives the airdropped token in return for the provision of some act or service.

Jurisdiction	Tax Treatment
UK	• Airdropped tokens are generally not subject to income tax if they are received: ○ Without doing anything in return ○ Not as part of a trade or business
New Zealand	• Airdropped cryptoassets are generally not taxable on receipt except where the taxpayer: ○ Has a cryptoasset business ○ Acquired the cryptoassets as part of a profit making undertaking or scheme ○ Provided services to receive the airdrop ○ Receives airdrops on a regular basis and the receipt is income
Singapore	• Airdropped tokens are tax free

Recommendations

Australia should adopt a similar tax treatment of airdropped cryptocurrency coins to that of New Zealand and the UK. That is, the airdropped assets should not be taxable on receipt except where the taxpayer holds their cryptocurrency assets on revenue account, or the taxpayer acquires the cryptocurrency assets in return for the provision of assets or services.

Alternatively, where a taxpayer holds cryptocurrency on capital account, the airdrop of new or established cryptocurrency coins should be tax free except where the taxpayer receives the airdropped coins in return for doing something (e.g., the provision of services).

Where the taxpayer receives an airdrop of an established coin because of a taxpayers existing holding, the cost base of the existing holding should be apportioned on the same basis a cost base adjustment would occur in relation to a bonus share issue.

[10] https://www.ato.gov.au/business/small-business-entity-concessions/eligibility/definitions/

A5. Initial Coin Offerings

Initial coin offerings (ICO) operate in a way similar to how an initial public offering (IPO) operates for shares.

An ICO is the first time a particular crypto asset is available to the public and are sometimes used as a way to generate funding for a separate project inherently associated with the cryptocurrency issued under the ICO.

The rights associated with the token or cryptocurrency issued under the ICO may typically be found in the crypto asset 'white paper'.

The nature of the crypto asset obtained under the ICO will ultimately be determined with reference to the rights which are attached to the crypto asset. Where the rights attached to the crypto asset are similar to those attached to a share (e.g., voting rights, ownership rights, other decision-making rights) the crypto asset is likely to be a security or a share.

In contrast, where the funds raised by the ICO are pooled and crypto asset holders are entitled to a proportionate share of a return of profit linked, however the crypto asset holder does not have rights to contribute to the decision making or control of the scheme offered under the ICO, the crypto asset is more likely to have the form of managed funds.

Under current Australian tax law, the ATO take the view that where the issuer of the ICO is an Australian tax resident or has sufficient nexus with Australia the proceeds from the ICO may be required to be returned as assessable income.

The ATO view that proceeds from an ICO should be included in the assessable income of an Australia resident entity for taxation purposes may act as a barrier to entities looking to invest in Australia through the establishment of digital and crypto-asset businesses. This outcome is inconsistent with the government intent as set out in the Senate Committee on Australia as a Technology and Financial Hub report, to attract jobs, investment and innovation to Australia.

Where competitors such as Switzerland and Singapore provide a competitive taxing regime that encourages innovation and investment, Australia risk losing existing digital and crypto-asset businesses, along with the talented employees. In Switzerland for example, the proceeds from ICOs are not generally included in assessable income for tax purposes and are rather, treated more consistently as the creation of an equity interest (which may be subject to a 1% capital duty). The Singaporean tax treatment of ICO proceeds is not clear.

We have identified at least one Australian based digital and crypto asset business where the business owners are considering relocating to Switzerland because it has a taxing regime that is more conducive to achieving the goal of increasing investment and innovation in the digital and crypto asset space.

From a GST perspective, the ATO currently takes the view that where the token provided under an ICO is similar to a security or digital currency, the sale and purchase of the tokens will be a financial supply. However, where the token is excluded from the definition of digital currency because it provides a right or entitlement to goods or services, it may be a taxable supply and subject to GST. Where tokens issued under a 'capital raise' and the tokens have rights that may entitle the holder to a right or entitlement to goods or services, a GST obligation should not arise until such time goods or services are actually provided by the token issuer. An approach that treats the token as a taxable supply based merely on the rights attached to the token (irrespective of exercise) will impose an additional burden on businesses acting as a barrier to investment in Australia.

From an employee incentive perspective, a review of the employee share scheme (ESS) rules is required and where relevant, legislation amended to provide concessional tax treatment for employee incentive schemes that involve the issue of security tokens or other digital assets.

It is important to highlight that the use of different types of tokens with different rights in ICOs (including tokens with rights that convert to equity rights at a later point in time) will continue to evolve as business continue to innovate. Any change to Australian tax law that attempt to address the tax issues that arise from the use of ICOs must be flexible. Laws must be able to rapidly adapt to both a) ensure the appropriate amount of Australian tax revenue is collected but also b) ensure laws do not lead to an outcome that stifles innovation or encourages businesses to go offshore.

Recommendation

Further urgent guidance is required to provide clarity around the Australian taxation treatment of alternative 'equity' or 'capital' raising methods employed by digital and crypto-asset businesses. Where tokens provide equity interests similar to traditional shares or have rights and obligations akin to a traditional loan the proceeds should not be included in the assessable income of the issuing entity. Where guidance is inconsistent with government intent, legislative change may be required to ensure concessional tax treatment for alternative capital raising methods.

A6. Staking

Staking is a system in which a protocol issues rewards to holders of a cryptocurrency, sometimes referred to as users, in exchange for putting their holdings of selected tokens in stake. To become validators in a proof-of-stake network, users are required to lock up (i.e., stake) the network's native asset for a specified period of time. Users lock up their tokens by sending tokens to a 'staking contract address', which locks the tokens in a smart contract platform.

Staking allows users of cryptocurrencies to generate rewards. Validators are tasked with validating transactions with the staked assets, constructing new blocks and maintaining the overall functionality of the blockchain relevant. Users who participate in the process in this way are often rewarded with additional cryptocurrency as an incentive to stake.

Staking can currently be performed in a number of different ways, but the means by which a holder of cryptocurrency can participate in staking is evolving rapidly. A few of the staking methods available to users are mentioned below:

- Direct staking whereby a holder locks the minimum required tokens (e.g., in the case of Ethereum (ETH), 32 ETH) by following the protocol outlined by the creators of the network
- Staking as a service under which a holder locks the minimum required tokens (e.g., in the case of ETH, 32 ETH) and delegates operating authority over the staked holding to a third party operator. The operator generally retains a service fee against any staking rewards
- Pool staking under which a pool provider, often a cryptocurrency exchange, facilitates the pooling of smaller holdings of a number of users to make up the minimum requirement for

staking. Usually, the pool provider will perform the validation functions and will allocate any rewards received to the participants after retaining a service fee

- Centralised Staking where a user ‘deposits’ cryptocurrency in an exchange account in return for a yield. The assets are on-lent by the exchange to the validator to earn the staking rewards.

The ATO’s guidance on staking concludes that staking rewards received by holder are assessable income. We agree with this outcome. However, the guidance does not comment on the treatment of the staked currency for the user. We understand the ATO position is that locking-up cryptocurrency for the purpose of staking does not amount to the disposal and re-acquisition of the staked asset.

We believe that legislative clarity this position is warranted to provide certainty to holders and to staking service providers. As outlined above, there are number of ways for a holder to participate in staking. The mechanisms and technology by which the user’s assets are ultimately staked differs amongst each method and from provider to provider. Consequently, the legal effect of staking may also differ between each method and provider. For example, in the case of direct staking, a change in legal ownership may not occur. However, in the case of pool staking or centralised staking, there may be a transfer of legal and potentially beneficial ownership of the tokens. In many cases, a user is unlikely to have sufficient transparency over the terms and conditions of the staking mechanism to be able to determine whether there has been a transfer of legal or beneficial ownership of their cryptocurrency.

In our view, it would be preferrable to treat all staking in the same way for tax purposes irrespective of the method used, that is, a substance over form approach is preferred. In each case, the user does not receive any proceeds for staking their currency and in each case the staked tokens, plus any staking rewards, are returned to the user (provided the validator has not caused the tokens to be destroyed). Accordingly, we believe it would be appropriate to disregard for tax purposes any change in legal or beneficial ownership of the staked tokens that arises upon locking up the currency, where the staked tokens are subsequently released to the user following the staking process.

A7. Chain splits/Forking

The ATO has issued guidance on ‘chain splits’. The guidance concludes that the value of the new cryptocurrency asset issued to the holder of the original asset is not treated as either ordinary income or a capital gain at the time of receipt.

In respect of the cost base consequences for holder, the guidance concludes the holder needs to determine which asset is the new cryptocurrency asset by examining the rights and relationships of the two different assets. The guidance provides that if one cryptocurrency asset has the same rights and relationships as the original cryptocurrency assets, it is a continuation of the original assets, while the other cryptocurrency assets acquired as a result of the chain split will be new assets. The old assets will retain their historical cost base, while the new assets received by the holder will have no cost base.

It is unclear how the existing CGT provisions should apply to forking of cryptocurrency. However, the CGT provisions do provide a modification to the cost base rules in section 112-25(1) of the ITAA 1997 for split assets. Section 112-25(1) provides as follows:

> *This section sets out what happens if:*
> *(a) a *CGT asset (the original asset) is split into 2 or more assets (the new assets); or*

*(b) a *CGT asset (also the original asset) changes in whole or in part into an asset (also the new asset) of a different nature; and you are the beneficial owner of the original asset and each new asset.*

Where section 112-25(1) applies, the cost base of the original asset is spread between the old and new asset on as reasonable basis. When a hard fork occurs, we understand that two blockchains will operate, with one using the original blockchain with the old rules protocol and the other using the updated system. Although the holder receives new cryptocurrency underpinned by the new blockchain, the holder only receives the new cryptocurrency due to its existing holding or investment in the old cryptocurrency. In these circumstances we believe consideration should be given whether section 112-25(1) could be applied to determine the cost base of original and new assets held as a result of a forking event.

We believe that apportionment of the holder's original cost base between the two cryptocurrencies based on their respective market values would be appropriate. However, we understand that adequate market value data is unlikely to be available for each cryptocurrency on the date of the chain split and further that the values of each currency likely to be volatile immediately following a chain split. Consequently, where section 112-25(1) is applied, consideration should as whether an average value over a specified period following the chain split could be used.

A8. Alternative structures - DAOs

DAOs are a new alternative to traditional corporate structures. A DAO is a form of digital organisation that exist on blockchain and offer alternative ways to govern business, share value and encourage investment.

DAOs work by placing an emphasis on governance through computer code. Dependent on the set of rules governing each DAO, token holders will generally have the right to vote on every decision made by the DAO. The more tokens held by a person or entity, the more voting rights they hold and the more influence they have over DAO decisions.

Some new crypto and digital asset businesses not only exist with the traditional corporate structure governed by Australian corporations' law, but also have a DAO that moves the decision making away from traditional directors, CEOs etc toward the DAO.

There is currently no ATO guidance on the Australian tax implications arising from or impacting on DAOs.

The lack of regulation of DAOs and the absence of recognition of DAOs as an entity for Australian tax purposes raises unique questions and issues. For example, whether or not corporate tax residency, from a central management and control perspective, could be influenced by the existence of a DAO remains unanswered. Theoretically, where the decision making of a corporate entity has been delegated to a DAO, and the majority of the token holders (with voting rights) are located in Australia, there is question whether under existing corporate tax residency laws that the central management and control of the entity could be in Australia.

Recommendation

A legislative change may be required to introduce a statutory definition of a DAO for Australian tax purposes. Guidance will also be required on when a DAO is carrying on an enterprise for GST purposes, and any impact the voting power of DAO token holders may have on Australian tax residency.

A9. Source issues

There are no specific provisions in the income tax acts which dealing with the source of cryptocurrency trading gains or, for that matter, trading gains generally. The source of cryptocurrency trading gains will at present be determined in accordance with general legal principles established in case law. The case law makes it clear that determining source is a matter of judgment after assessing the facts and circumstances of the case at hand.

Therefore, a determination of source is an inherently uncertain exercise. A transaction to sell cryptocurrency is affected by way of a contractual agreement. The case law authority in Australia suggests that where trading gains are derived from the making of a contract, and the postal acceptance rules does not apply, the source of the relevant gains is the place at which the contracted is executed (refer to *Premier Automatic Ticket Issuers Ltd v Federal Commissioner of Taxation (1933) 50 CLR 268; Tariff Reinsurances v Commissioner of Taxes (Vic) (1938) 59 CLR 194; Tallerman and Co Pty Ltd v. Nathan's Merchandise (Vic) Pty Ltd (1957) 98 CLR 93; FC of T v Spotless Services Limited & Anor 15 95 ATC 4775; (1995) 32 ATR 309*).

This principle has been applied by the ATO in ATO ID 2004/904 in the context of determining the source of training gains made by a non-resident in carrying on a business of trading shares and options. In the context of the question at hand in ID 2004/904, the Commissioner concluded that the Australian stockbroker performed the contractual act of buying and selling the shares on the ASX and accordingly, the associated trading gains had an Australian source. Similarly, in *TR 2014/7 Income tax: foreign currency hedging transactions - applying the foreign income tax offset limit under section 770-75 of the Income Tax Assessment Act 1997*, the Commissioner concluded that the place where a foreign currency hedging contract is 'formed' is the most important element in determining the source of any resulting foreign currency hedging gain.

Based on the case law and the above ATO guidance, the following principles appear to be most relevant for the purpose of determining the source of cryptocurrency trading gains:

- The source of the gain should be the place where the contract to sell the cryptocurrency is formed; and
- The contract is made at the place where the acceptance to the offeror is communicated.

Applying the existing principles of source to cryptocurrency trading is problematic. The cases, some of which date back to 1930's, look to the 'place' where the trade was executed. This principle is not suited to a digital economy where it is difficult to establish a physical place of execution.

A transaction executed through a cryptocurrency 'exchange' is affected on a digital platform. The transaction is then recorded on the applicable cryptocurrency blockchain. Arguably, the acceptance of a cryptocurrency trade effected through an exchange is communicated to the offeror on the digital platform. As the platform only exists in digital form, it does not have a readily identifiable physical location. The location of the exchange could potentially be the country in which the owner of the exchange is incorporated, or alternatively, the country in which the hardware housing the platform software is located. There are several cryptocurrency exchanges that are either owned by Australian incorporated companies or were founded in Australia.

In our view, it not appropriate to fix the source of cryptocurrency gains on the location of the exchange. This is because the execution of cryptocurrency is fundamentally different to that of listed shares. Australian listed shares, for example, are executed on either the ASX or Chi-X. Although trade orders can be placed on a digital platform from any location, the execution of those trades must occur on the ASX by a participant of that exchange. An investor does not have a choice to execute direct ASX listed securities on offshore exchanges.

By contrast, the execution of a particular cryptocurrency does not need to occur on any particular exchange or jurisdiction. There are multiple exchanges available to investors to facilitate the trading of cryptocurrencies. However, in our view, there is a reasonable risk that under current law, trades executed through an exchange that is owned by an Australian resident or was founded in Australia could have an Australian source. To this end, we are aware of foreign domiciled funds avoiding execution of cryptocurrencies on Australian owned exchanges to mitigate the risk of gains having an Australian source. We further note that the ownership or founding details of an exchange, or the place where the hardware housing the platform software, will not always be publicly available.

Cryptocurrency trades do not need to be executed on an exchange and may for be executed directly between buyer and seller (e.g., on a peer-to-peer basis). For such trades, we would not consider it possible for most taxpayers to determine the place where the acceptance of the trade is communicated.

Recommendation

Given the difficulties with establishing source of trading gains under general principles, we believe it would be appropriate to legislate specific source rules for cryptocurrency trading gains. In light of the challenges that a taxpayer disposing of a cryptocurrency is likely to face in determining facts that are normally relevant to the source question, in particular, how and where the execution of the contract was affected, a pragmatic approach which confines any required factual analysis to the circumstances of the seller is preferred.

A10. Record keeping and other issues

A10.1 The role of DCEs and crypto 'tax calculators'

Accurately identifying transactions adds to taxpayer compliance complexity, particularly where taxpayers transact across multiple DCEs (including offshore jurisdictions) and acquire cryptocurrency and digital assets via DeFi platforms. The lack of globally recognised and accepted regulation of DCEs and other digital asset platforms means not all platforms provide detailed transaction reports or integrate with a third party crypto 'tax calculator' platform.

Guidance is required on the circumstances under which transactional reports generated by DCEs and third party 'tax calculators' will satisfy the 'substantiation' requirements for the purposes of Division 900 ITAA 1997.

A review may be required in relation to the representations made by DCEs and third party 'tax calculator' platforms in relation to the accuracy of tax calculations performed by the platforms and or appropriateness to a taxpayers' specific circumstances.

Guidance and education are required in respect to tax agent obligations under the Tax Agent Services Act 2009 (TASA) where tax agents seek to rely on 'tax' reports generated by DCEs or third party 'tax calculator' platforms, in particular the following specific requirements under the Code of Conduct:

- Rule 7: Competence
- Rule 8: Maintaining knowledge and skills relevant to the tax agent services the practitioner provides
- Rule 9: Taking reasonable care in ascertaining a client's state of affairs
- Rule 10: Taking reasonable care in applying tax laws

A10.2 Crypto 'tax' calculators and blockchain 'accounting platforms'

Where Australian tax laws refer to 'accounting records', legislative references to 'accounting records' may need to be updated to include records of blockchain transactions sourced and provided by an approved DCE or third party 'tax calculator' platform.

Education is required on the risks associated with relying on tax reports generated by 'crypto tax calculators', particularly given these platforms are not subject to the same requirements under the TASA as tax agents, and there is no guarantee the reports provided are a) consistent with Australian tax law or b) take into account specific taxpayer circumstances which may have an impact on the appropriate tax treatment of cryptocurrency and digital asset transactions under Australian tax law.

A10.3 Self-Managed Superannuation Funds – record keeping

Self-Managed Superannuation Funds (SMSFs) are subject to a requirement under section 35AE Superannuation Industry (Supervision) Act 1993 for SMSF accounting records to correctly record and explain the transactions and financial position of the SMSF. The records must be kept in Australia in writing in the English language; or in a form in which they are readily accessible and readily convertible into writing in the English language. This requirement may be problematic where records of blockchain records are generally only convertible into writing by use of a program that can identify the transaction and convert the code to English, and because of the nature of blockchain, the records may be maintained in multiple jurisdictions around the world.

A10.4 Transfer pricing documentation

From an international tax and transfer pricing perspective, guidance is required on the use of self-executing smart contracts internally by Australian resident entities and between subsidiaries, specifically documentation requirements.

A10.5 Valuation methodologies

Urgent, clear and practical guidance is required on appropriate valuation methodologies to calculate gains or losses on actual disposals of cryptocurrency or digital assets. There have been a number of questions asked on the ATO Community in respect to whether a FIFO, LIFO or average weighted cost method is appropriate when determining the amount of a gain or loss on disposal, however, there is no binding guidance on this issue. It should be noted that using a FIFO or LIFO method of valuation may not be practical, or even possible, where a taxpayer has thousands (or tens/hundreds of thousands) of cryptocurrency and digital asset transactions in an income year.

Appendix B - Managed funds issues

Australia has been an early adopter of digital assets. Fund managers are increasingly striving to provide access to investors to these new investible assets, and in particular to cryptocurrencies. However, the application of the existing income tax law to digital assets is unclear.

In our experience, this has given rise to the following issues in the managed fund context:

- Some fund managers have chosen not to trade actively in cryptocurrencies and instead have chosen to invest indirectly in such assets through a foreign fund managed by a third party fund manager located offshore
- A component of the funds management sector has proceeded on the assumption that cryptocurrencies are treated in the same way as other financial assets, for example shares, for income tax purposes.

The key issues we have experienced in this context are outlined further below.

B1. Managed investment trusts

Australia introduced the Managed Investment Trust (MIT) and Attribution Managed Investment Trust (AMIT) regimes to advance the Government's objective of promoting Australia's position as a financial services hub in the Asia-Pacific region, to provide consistency in respect of the tax treatment of investments and to provide certainty to investors. The MIT and AMIT regimes, amongst other things, include reduced withholding tax rates on distributions made to foreign investors and deemed capital gains tax (CGT) treatment on gains made by the trustee of the fund on the disposal of certain covered assets. Under the existing law, digital assets do not appear to be assets that a fund that intents to qualify as a MIT or AMIT is permitted to hold. We have confined our comments in this regard to cryptocurrencies as it is these digital assets where we have seen interest from fund managers.

B1.1 Trading business

One of the conditions for a managed fund established as an Australian unit trust to qualify as a MIT is that the trust must not be a "trading trust" within the meaning of Division 6C of the Income Tax Assessment Act 1936 (ITAA 1936).

A trust will be a "trading trust" within the meaning of Division 6C of ITAA 1936 where it:

- carries on a "trading business"; or
- controls, or is able to control, directly or indirectly, the affairs or operations of another person in respect of the carrying on by that other person of a trading business.

"Trading business" is defined in section 102M of ITAA 1936 to mean a business that does not consist wholly of "eligible investment business".

"Eligible investment business" (EIB) is defined section 102M of ITAA 1936 exhaustively as:

(a) investing in land for the purpose, or primarily for the purpose, of deriving rent; or
(b) investing or trading in any or all of the following:
 (i) secured or unsecured loans (including deposits with a bank or other financial institution);

(ii) bonds, debentures, stock or other securities;
(iii) shares in a company, including shares in a foreign hybrid company (as defined in the Income Tax Assessment Act 1997);
(iv) units in a unit trust;
(v) futures contracts;
(vi) forward contracts;
(vii) interest rate swap contracts;
(viii) currency swap contracts;
(ix) forward exchange rate contracts;
(x) forward interest rate contracts:
(xi) life assurance policies
(xii) a right or option in respect of such a loan, security, share, unit, contract or policy;
(xiii) any similar financial instruments; or

(c) investing or trading in financial instruments (not covered by paragraph (b)) that arise under financial arrangements, other than arrangements excepted by section 102MA.

In our view, cryptocurrencies do not fall within the scope of paragraph (a) or subparagraphs (b)(i) to (b)(xii).

In respect of subparagraph (b)(xiii) and (c), these each make reference to a "financial instrument". We consider it unlikely that a cryptocurrency could be properly regarded as a financial instrument as it is not a contract that gives rise to a right of the holder to receive cash or any other financial benefit from the issuer with a corresponding obligation on another entity to deliver cash or a financial benefit to the holder. Furthermore, it does not constitute an equity interest of any type in any entity.

We note that the IFRS Interpretations Committee has previously concluded that cryptocurrency is not a financial asset because a cryptocurrency is not cash, an equity instrument of another entity or a contractual right for the holder. Rather, the committee found that it is an intangible asset (being an identifiable non-monetary asset without physical substance) for financial accounting purposes.

Accordingly, in our view, a cryptocurrency should not currently qualify as EIB. As a result, a fund established as a unit trust that holds cryptocurrency directly would not qualify as a MIT. A further consequence of cryptocurrencies not qualifying as EIB is that a unit trust that is also a public unit trust within the meaning of Division 6C would be treated akin to a company and subject to tax at the corporate tax rate, rather than as fiscally transparent.

As a result of the current law, we have seen some funds managers opt to invest indirectly into cryptocurrency by holding portfolio interests in foreign funds managed by third party fund managers located offshore, rather than trade in cryptocurrencies directly.

For foreign funds or foreign residents engaging an independent Australian fund manager to manage their cryptocurrency investments and trades, another consequence of cryptocurrency not qualifying as EIB is that the investment manager concessions available under the Investment Manager Regime in Division 842-I of the ITAA 1997 would not apply to trading gains made by the foreign resident.

Building a better working world

Recommendation

If the policy intention is to support the growth of active investment management services in respect of cryptocurrencies in Australia, we recommend that a specific paragraph addressing cryptocurrencies is included in the definition of EIB to enable cryptocurrency to qualify as EIB.

B1.2 MIT capital election

Recommendation

If the definition of EIB in section 102M of ITAA 1936 is amended to include direct investment in cryptocurrency, we recommend that a corresponding amendment is made to the definition of "covered asset" in section 275-105 of ITAA 1997 to allow gains realised on trading cryptocurrencies to qualify for deemed capital account treatment.

B2. Investment Manager Regime

The Investment Manager (IMR) regime in Division 842 of ITAA 1997 was established to position Australia as a leading regional financial centre. Its objective is to place individual foreign investors that invest into Australia through a foreign fund in the same tax position in relation to disposal gains and disposal losses that they would have typically been in had they made their share of the fund's investments directly, rather than through the fund.

The IMR regime achieves this objective by disregarding gains made by foreign entities into Australian assets, with the exception of real property, irrespective of whether those gains were made on revenue or capital account. Secondly, the regime deems qualifying gains not to have an Australian source where the use of an Australian fund manager would otherwise give rise to an Australian permanent establishment.

The IMR concessions only apply in relation to "IMR financial arrangements". An IMR financial arrangement is defined in section 842-225 of ITAA 1997 as a financial arrangement that does not relate to an asset that is taxable Australian real property or an indirect Australian real property interest. Financial arrangement is defined in section 230-45 and section 230-50 of ITAA 1997. In our view, cryptocurrency does not meet the definition of a financial arrangement. Accordingly, the concessions contained in the IMR regime do not currently apply to cryptocurrencies.

We are aware of foreign funds that invest directly in cryptocurrency that have sought to limit their use of Australian fund managers to mitigate the risk of causing a permanent establishment for the fund in Australia.

Recommendation

If the policy intention is to promote the provision of funds management of this asset class in Australia, we recommend that consideration is given to extending the definition of IMR financial arrangement to include cryptocurrencies.