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By email: TaxDigitalAssets@taxboard.gov.au

Australian Government
Board of Taxation

Dear Sir / Madam

Submission to Tax Treatment of Digital Assets and Transactions Review

We welcome the opportunity to make this submission on the review on the tax treatment of digital assets and transactions as conducted by the Board of Taxation.

We have not sought to provide responses addressing all the questions raised by the Board of Taxation. Rather, our focus has been on highlighting the most common issues and areas of uncertainty encountered during the course of our practice.

Should you have any questions in respect of our submission, please contact Julian Cheng on +61 3 8656 3355.

Yours sincerely

Gilbert + Tobin

1 Background

There is no doubt that the far-reaching digitalisation trend across the globe has presented its challenges to policymakers and law administrators, in particular the rapid evolution of crypto assets and related transactions causing the development of new business models and ways of accessing finance. This has accordingly presented regulators, policymakers and industry participants with the challenge of applying current regulatory regimes that are unclear at best and inapposite at worst to these new models with some participants electing to relocate to other jurisdictions. From a taxation perspective, it is therefore imperative that the Australian taxation regime keeps pace with the sector in order for Australia to remain an internationally competitive jurisdiction for crypto asset investment, innovation, development and entrepreneurship.

There is currently a base legislative framework in place for the tax treatment of crypto assets together with associated Australian Taxation Office (**ATO**) guidance. However, the legislative framework is not, in our view, sufficiently robust to allow it to appropriately deal with the complexities and nuances of the crypto sector (for example, the growing use and complexity of decentralised networks and platforms). Furthermore, there is a need for further ATO guidance on various taxation issues associated with the application of existing tax laws to crypto assets and related businesses and transactions.

We have set out below a selection of taxation issues that we have frequently encountered in practice. It should be noted that the issues raised below are by no means intended to be exhaustive, but rather areas of focus resulting from our experience in the Australian market.

2 Tax treatment of decentralised autonomous organisations (DAOs)

DAOs are an example of an emerging business model that has challenged traditional notions of corporate structure and ownership. In very general terms, a DAO is a decentralised ownership structure that operates on blockchain infrastructure and distributes responsibility for decision-making and governance via “smart contracts”. Typically, this means that members or participants of a DAO that hold governance tokens collectively make decisions (usually by voting) in relation to the DAO’s underlying project.

From a regulatory perspective, it has been difficult to define how a DAO should be treated due to its inherently decentralised nature. Industry commentary has noted that imposing traditional corporate characteristics upon a DAO risks changing this nature (e.g. ‘centralising’ a DAO by nominating a responsible person) however designating DAOs with a legal identity would resolve issues currently facing them such as participant liability and the ability of a DAO to contract with a third party.

This regulatory uncertainty extends to the tax law and it is also currently unclear how DAOs should be characterised and taxed in Australia. Below are some areas of taxation uncertainty faced by DAOs and our recommendations.

2.1 How should a DAO be characterised for tax purposes?

It is presently unclear how a DAO would be characterised for tax purposes (or whether it is even possible to tax a DAO under the current tax framework).

Drawing on existing tax concepts, a DAO could potentially be taxed either as:

- a partnership (comprising of its founders and the holders of governance tokens (**token holders**)); or

- a company.

In order for a DAO to be treated as a partnership under tax laws, the DAO would need to comprise of "an association of persons… carrying on business as partners or in receipt of ordinary income or statutory income jointly…".[1]

There are two limbs to this definition – the first limb is intended to capture general law partnerships which requires a relationship between persons carrying on business in common with a view of profit, and the second limb is a statutory concept of partnership introduced for tax purposes which merely requires the joint receipt of ordinary or statutory income.

As governance tokens of a DAO generally do not carry any entitlements to income, it is unlikely that a DAO will comprise an association of persons in receipt of ordinary income or statutory income jointly, for the purposes of the second limb of the definition of partnership. Thus, a DAO could only be treated as a partnership if the view was formed that it comprises as association of persons carrying on business as partners, i.e. the first limb of the definition of partnership applies.

We query whether the members of a DAO could ever reasonably be said to be carrying on business as partners – given they would typically lack any intention to do so. Relevantly, in its report on a 2016 offering of tokens by a virtual organisation known as 'The DAO', the Securities and Exchange Commission (**SEC**) concluded that the intended decentralised nature of the organisation meant that the SEC did not consider it to be a partnership. The SEC stated:[2]

> *[T]he pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. Investments in The DAO were made pseudonymously (such that the real-world identities of investors are not apparent), and there was great dispersion among those individuals and/or entities who were invested in The DAO and thousands of individuals and/or entities that traded DAO Tokens in the secondary market – an arrangement that bears little resemblance to that of a genuine general partnership.*

As to whether a DAO may be a company for tax purposes, we note that a company is broadly defined to include "any other unincorporated association or body of persons".[3] MT 2006/1 provides that an unincorporated association or body of persons may be seen as "consisting of a group of persons who associate to achieve a common aim or purpose and who are bound by mutual obligations and rights".[4]

Applying the existing tax framework, our view is that a DAO is currently more appropriately characterised as a company than a partnership for Australian tax purposes.

There are also further issues that require clarification by policymakers (and / or the ATO), some of which are noted below.

2.2 Can the "mutuality principle" apply to DAOs?

Broadly, under the existing tax framework, the essence of the mutuality principle is that you cannot derive any gain, and therefore income, from dealings with yourself. The mutuality principle provides

[1] Refer to the definition of "partnership" under subsection 995-1(1) of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).

[2] Securities and Exchange Commission (2017), *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (https://www.sec.gov/litigation/investreport/34-81207.pdf), page 14.

[3] Definition of "company" under subsection 995-1(1) of the ITAA 1997.

[4] Miscellaneous Tax Ruling MT 2006/1 para 47.

that where a number of people associate for a common purpose and contribute to a common fund in which they are all interested, any surplus of those contributions remaining after the fund has been applied to the common purpose is not income or profit.

Assuming a DAO can be taxed under the existing legal framework, it is unclear as to whether a DAO could apply the "mutuality principle" on receiving "mutual receipts". For instance, a DAO receiving proceeds from issuing tokens could be viewed as analogous to a club receiving membership fees, where the objective of the DAO is to promote a purpose for the benefit of the members collectively, and not individually. Each token holder may be able to participate in a common purpose of the DAO by way of the governance and voting rights attached to their tokens.

Irrespective of the legal form that is ultimately attributable to DAOs, administrative guidance will be required on whether the mutuality principle can be extended to DAOs, particularly in the context of token issues. This is subject to our comments further below on how such issuances should be treated for tax purposes.

2.3 What is the "tax residency" of a DAO?

If the mutuality principle does not apply to DAOs and a DAO is considered a company under the current tax framework (as discussed previously), it becomes necessary to consider the tax residence of a DAO.

Broadly, under the existing tax framework, where a company is not incorporated in Australia it will only be treated as a tax resident of Australia if it carries on business in Australia and has either its central management and control (**CM&C**) in Australia, or its voting power controlled by shareholders who are residents of Australia.[5]

As a DAO is (by its nature) decentralised, it is unclear as to whether a DAO could ever properly be regarded as having its CM&C located in Australia. Further, because a DAO's voting power is generally controlled by the token holders (not shareholders like in a typical company structure), it also does not appear to be technically possible for a DAO to have its voting power controlled by Australian resident shareholders. Some DAOs may also establish governance committees whose membership changes on a periodic basis. The residence of token holders who are appointed to those committees may not be known which, in such cases, also suggests that the CM&C of the DAO cannot be attributed to a particular jurisdiction.

We note that the Senate Economic on Australia as a Technology and Financial Centre recommended in its final report that a new DAO company structure be established.[6] If this recommendation is adopted, principles governing the tax residence of a DAO will need to be considered in light of the decentralised nature of these entities.

3 Tax treatment of the proceeds from token raisings

At its core, raising funds by way of the issue of tokens is a form of raising capital. However, given the unique and widely varying rights attaching to tokens, the issue of tokens by a company, DAO or other business entity would not typically be treated as an issue or allotment of equity interests, nor would it

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[5] Para (b) of the definition of "resident" under subsection 6(1) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**).

[6] The Senate (2021), *Select Committee on Australia as a Technology and Financial Centre* (https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Financial_Technology_and_Regulatory_Technology/AusTechFinCentre/Final_report).

be viewed as a form of borrowing money or obtaining credit (as those concepts are ordinarily understood).

Given this, there is significant uncertainty as to whether the proceeds from issuing tokens should be included in the assessable income of issuers for Australian income tax purposes. This could be in the form of ordinary income (i.e. income from the disposal of tokens) or a capital gain arising under CGT event D1 being the creation of contractual, legal or equitable rights in another entity.[7]

If it is accepted that the issue of tokens is a form of raising capital, our view is the Australian tax law needs to be revised to clarify that these forms of capital raising (at least for some types of tokens, such as those being issued to raise finance for a particular project) should not be subject to tax in Australia. We would view this clarification as being critical to ensuring that Australia can remain competitive in the digital asset market.

4 Remunerating employees and contractors via the issue of tokens

Australian tax law does not presently accommodate tokens being used as a means of incentivising employees or contractors.

Like shares or options over shares in a company, tokens can similarly be granted subject to various vesting conditions (e.g. satisfaction of performance milestones) and/or disposal restrictions. These vesting conditions are, in some circumstances, enforced by way of escrow "smart contracts", which essentially hold tokens on behalf of contributors subject to a programmed logic (that makes disposals of the tokens impossible until vesting conditions have been met).

Although token schemes may share many of the same features as a grant of shares or options under a typical Division 83A employee share scheme, they are not afforded comparable tax treatment due to Division 83A being limited to grants of shares in a company or rights to acquire a beneficial interest in such shares. This means such grants would likely fall for consideration under the fringe benefits tax regime – which creates a significant disincentive for organisations wishing to incentivise employees in this way.

Consideration should therefore be given to the appropriate means of taxing token schemes in Australia. We would suggest that a new regime (similar to Division 83A of the ITAA 1997) be considered that is specifically targeted at the taxation of employee token schemes (or Division 83A could be amended to extend to employee token schemes). Key features may include flexibility for recipients to pay tax on the value of their tokens "up-front" or defer payment of tax until the first point in time when all vesting conditions are met, and they are able to realise the value of their tokens. The ability to access a deferred taxing point is particularly important given the potential volatility of the cryptocurrency market. Furthermore, insufficient liquidity in some tokens also supports the introduction of an ability for taxpayers to access deferred taxation (since requiring taxpayers to sell tokens to fund a tax liability could adversely affect a token's market price in certain circumstances).

5 Taxation of Australian funds which invest in digital assets

There are a range of uncertainties in relation to investments in crypto assets by common fund vehicles in the Australian market. In our view, two key issues requiring consideration are as follows:

- In order for a unit trust to qualify as a managed investment trust (**MIT**) or attribution managed investment trust (**AMIT**) its activities must, broadly, be comprised wholly of "eligible investment

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[7] Noting the typical exclusions for issuing equity or borrowing money contained in subsection 104-35(5) of the ITAA 1997 would not generally be applicable in the context of a token raising.

business". Eligible investment business is exhaustively defined in section 102M of the ITAA 1936, and it does not appear that an investment in tokens or digital assets would be captured by this definition. This means that unit trusts making such investments would not be eligible to qualify as MITs and, furthermore, there is a risk that they would be taxed as companies if they are also "public unit trusts".

- If the law is amended (or guidance is released) to ensure that investments in crypto assets are eligible investment business, then it should be considered whether the definition of a "covered asset" (contained in section 275-105 of the ITAA 1997) should also be amended to clearly include such assets in the list of asset classes that are afforded deemed capital treatment.

6 Source and digital assets

The nature of tokens as digital assets, and the ability to transact in those tokens (e.g. to buy goods and services) online, stake tokens with validators in multiple jurisdictions or to trade tokens on almost 600 cryptocurrency exchanges worldwide raises questions as to the source of income. Foreign residents for tax purposes are only taxed on income from Australian sources and there is a need for further guidance on how to determine the source of income derived from various transactions involving digital assets. For example, if an offshore fund invests in cryptocurrencies which they stake through an Australian validator, a question arises as to what extent, if any, the income derived by the offshore fund is Australian sourced. The source of income is a question of fact which looks at factors, for example, such as where contracts are negotiated or executed and the location of any exchanges on which trades are made. Where a double tax agreement (**DTA**) applies, income will only be sourced to the extent that it is attributable to a permanent establishment (**PE**) (as defined in the treaty). However, if a DTA does not apply, an analysis based on the factors mentioned above would be required to determine source.

In light of the above, given the ability to globally deploy cryptocurrencies in order to derive income in different jurisdictions, we recommend that the ATO develop and issue guidance on the application of source principles to digital asset transactions.

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