Director
Corporate Tax Unit
Corporate and International Tax Division
Treasury
Langton Cres
PARKES, ACT 2600

Dear Director,

Exposure Draft legislation Treasury Laws Amendment (Measures for Consultation) Bill 2022: Taxation treatment of digital currency

Thank you for the opportunity to provide a submission on the Exposure Draft and for the opportunity to participate in the recent roundtables to discuss these matters amongst a select cohort of tax professionals. Representation of the developers, builders and the grassroots Australian crypto community is a role we take seriously.

By way of background, NotCentralised is a web3 venture studio, formed early in 2022 but whose founders have strong backgrounds in technology and finance both domestically and overseas. Our passion for blockchain technology has led us to create a strong community, which we call the Australian DeFi Association (ADA). ADA is a not-for-profit organisation that comprises a melting pot of blockchain developers, corporates, regulators and enthusiasts. Our goal in seeding ADA was to catalyse conversation and shared learnings, about member concerns, successes and ideas, Australia-wide. Given this background, we understand the importance of consumer protection as well as the requirement that regulation does not stifle future innovation.

We feel that the Exposure Draft and explanatory material is a welcome initiative to clarify the application of existing tax laws and identify the areas for tax reform. We believe our positive response is similar to many other responses we have seen shared.

Below we share our observations (which we have stated in the Board of Taxation roundtable we attended), as well as our responses to some of the consultation paper's questions. Our responses reflect our strong ties to the community of developers and investors we are connected with.

Kind regards,

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Observations

Minimal Tax…for now

First and foremost, we see taxation as displaying “cat and mouse” dynamics. We must acknowledge that across all industries that are taxed, there will always be those looking for angles to reduce their tax burden as tax is a friction in the market, albeit a necessary one. In a space that is still evolving, we see it as impossible to tax comprehensively and effectively in its current form. Moreso, we see the potential damage to the long-term growth potential of the Australian technology sector if a ham-fisted attempt is made to do more than tax the most overtly monitorable activities.

A way forward that would be fair, understandable and quite acceptable to many builders and users in the web3 space is to tax only the “on and off ramps” of crypto. What we mean by this is the points where fiat into crypto conversions take place. Once fiat money has been moved into the crypto ecosystem, it would operate on a tax-free basis, as an interim measure. Think of this as analogous to a tax-free investing environment in a superannuation savings scheme. Doing so would ensure the smooth running and clear pathway towards continuous innovation across the blockchain space for DeFi, NFTs, Gaming and more.

Government and constituent gains

In doing this, the Australian government forgoes tax revenue now but creates a far more powerful future taxation base for the wealth of commons. Encouraging more participants to engage with blockchain and crypto technology, while minimally taxing them, will provide a pathway that encourages innovation. Similarly, the government stands to benefit from an economy that starts moving onto blockchain rails. Why? Because there is more chance for **automation and STP (straight-through processing) of inefficient tax processes** as well as the ability to gain **more insights into the state of the economy in real-time.** This is one of the great benefits of blockchain.

Better the DeFi you know

Additionally, it is important that we clarify our stance on decentralised finance (DeFi). Specifically, DeFi does not represent the tired tropes displayed by the media. It is not just about maximising investment returns and yield farming. It is far more than that. DeFi represents new monetary and transaction rails that we can build to improve existing, inefficient and opaque payment systems and services. The welcome government focus on blockchain and DeFi regulation provides the chance to nurture Australian financial innovation and improve society, leaving Australia a dominant web3 innovation hub now and in the future.

Responses to questions

The following are our responses to the questions set out in the Board of Taxation "REVIEW OF THE TAX TREATMENT OF DIGITAL ASSETS AND TRANSACTIONS"

Question 1: Is the current tax treatment of crypto assets clear and understood under the Australian tax law? If not, what are the areas of uncertainty that may require clarification?

We believe that current tax treatment is not completely clear and only partially understood by the community. The current view amongst most community members is that tax on crypto assets occurs for every transaction, however, this is not necessarily logical to them. They understand that if percentage gains on asset prices are made, and these gains are realised via trading, this is equivalent to realising gains on common securities (stocks, bonds, ETFs). However, what does not make sense are the instances where no monetary gains occur, yet existing tax laws require a function to be treated like a realised gain or income on a security.

A very pertinent example is the so-called 'wrapping' of tokens. When Ethereum (ETH) becomes wrapped (wEth), this is done to convert ETH to an ERC-20 token for a specific purpose (such as bidding on an NFT at an auction). In this instance, a CGT event occurs on the conversion of ETH to wETH and on the purchase of the NFT.

When crypto tokens are wrapped in such a manner to convert them for purposes that don't involve some sort of profit outcome, it's arguable that this should not be a CGT event. Rather, the token here is receiving a technical change to allow a different functionality, for the same owner. Ownership does not change, nor is there any form of value realisation.

Question 2: Do crypto assets and associated transactions feature particular characteristics that are 'incompatible' with current tax laws? If yes, what are these and why are they incompatible?

Yes. As mentioned in Question 1 above, 'wrapping' of tokens is an action that incurs a CGT event but should be rethought given the nature of this transaction in crypto would mean double taxing before any gain or loss from an investment occurs, if that is what the purpose of the wrapping is for.

Question 3: Do entities which carry on a business in relation to crypto assets or accept crypto assets as a form of payment, have a comprehensive awareness of the current tax treatment of crypto assets and their tax obligations?

There is no brief, definitive answer to this question as it is multi-faceted. The largest and most sophisticated businesses operating in the sector are well aware of their tax obligations and the treatment of transactions. This is due to the presence of experienced tax advisors, internal and external, and the involvement of experienced external counsel in establishing the business operations. Examples would include Binance Australia, FTX, FEX and Digital X.

Indeed, the most prominent crypto tax advisory and calculation platforms have been developed to counter this very lack of clarity that is currently observed in the industry. Examples include Koinly, Crypto Tax Calculator, Syla, and DeFi Tax Calculator, Valles Accountants, Cadena Legal and more.

Smaller operators or startups frequently lack a comprehensive understanding of the current tax treatment of crypto assets and their tax obligations. There are a number of reasons for this, the most pertinent being the difficulty and expense of finding qualified advisors as they are building their businesses on a shoestring budget. Established taxation professionals themselves lack sufficient knowledge of the space, in many instances. We propose a joint public/private sector initiative to provide cost-effective, timely advice to entrepreneurs in the space. It would be a great help in attracting technologists to Australia.

Major legal, tax and regulatory requirements are well understood, such as the need to perform AML/KYC/CTF checks and the need to report realised gains when coins or tokens are sold and repatriated into fiat currency.

Question 4: Are retail investors aware of the current tax treatment of crypto assets? To what extent are they receiving professional tax advice?

Retail investors are not completely blind when it comes to the tax treatment of crypto assets, but we certainly would not deem them experts either.

Retail investors that we see as part of social media discussion groups (such as on our Aus DeFi Discord or other tax-focused Discord channels) frequently engage in discussions pertaining to tax treatment of assets. There are spikes in this discussion during tax season, but these groups are active throughout the year.

Various tax professionals help steer the discussion and answer community questions and in this way, the wider community is able to take advantage of the knowledge shared because of the open forum nature of these chats. However, these advanced tax professionals are, in our experience, in the minority.

If more scrutiny and help are required, retail investors have access to the services of these tax professionals which they can arrange amongst themselves.

Elsewhere, we see increased take-up of crypto tax apps like Crypto Tax Calculator and Koinly. Similar to Sharesight for traditional equity investors, these apps are proving to be a valuable part of the toolkit for retail investors for not just tax but also portfolio management purposes.

Question5: Do wholesale investors understand the current tax treatment of crypto assets? To what extent are they receiving professional tax advice?

Wholesale investors have a better understanding of the tax treatment of crypto assets as they can afford better internal and external resources for these problems, at least from what we observe. Wholesale investors often engage professional accounting firms like Valles Accountants in Melbourne or other mid-tier and top-tier firms like RSM, KPMG and more. The tax advice they are receiving would be top-tier.

Having said this, "wholesale" investors who are essentially individuals, not businesses, would have a varied level of knowledge depending upon how broadly they engage in crypto. The 'hobbyist' style investor with smaller balances, or a very narrow range of crypto assets held, could well lack the knowledge to effectively report for tax purposes. This type of wholesale investor looks an awful lot like a retail investor and may not be able to access qualified advice easily.

Question 6: How can taxpayer awareness of the tax treatment of crypto assets be improved?

Please refer to our proposed initiative above where a public/private partnership model is established to help educate at a grassroots level through tech and venture industry participants such as NotCentralised, Stone & Chalk, Fishburners, Australian Business Growth Fund, Blockchain Australia, HBAR Foundation, Algorand.

Assuming that (i) token mapping exercises are completed, and (ii) definitions of what is taxable are clear and tax rules are created, the key to building up awareness will be via continuous education and industry engagement. While this may involve traditional methods such as explainer PDFs, videos or via the ATO website, this will be insufficient. It is vital that such education is promoted in the forums where investors actually go to interact with crypto assets. This includes centralised exchanges, social media and other platforms. It will require working with them to ensure the message is shared broadly, clearly and consistently.

Another way that awareness can be spread is via the various community groups across Australia. We suggest engaging with groups like ours as well as Blockchain Australia, Blockchain Sydney, All Things Blockchain, NFT Melbourne, NFT Melb, NFT Sydney, NFT SYD, Aussie Crypto Roadshow, NFT Fest AUS and many more. Either attendance from the ATO, or by endorsing tax professionals to convey this message at these events will be a key way to spread awareness across the community.

Question 7: How should the tax transparency of crypto assets be improved, including what information tax administrations need to know about transactions for purposes of compliance and enforcement?

The main challenge is the lack of knowledge of how the crypto, NFT and gaming ecosystems work in web3, leading to some perverse outcomes for users. For example, should I be playing a web3 based game that has in-game assets such as weapons or magic potions, those assets are often in the form of NFTs, so that the user can trade the assets in the game with other players. If I have a crossbow that fires golden bolts, which are NFTs, I could be creating an awful lot of CGT disposal events every second, when battling other players.

This seems like an unnecessary burden on the taxation system, and gamers, to look at each of these bolt-firing incidents as separate disposal events. Yet with current tax rule interpretations, this will be the case.

Question 8: What lessons can Australia draw from the taxation of crypto assets in other comparable jurisdictions, including novel ways of taxing these transactions?

There are some interesting examples of tax treatment globally worth noting. Germany has been deemed a “crypto tax haven” as it does not recognise crypto as a monetary currency, commodities, or stock. Instead, crypto is considered private money. This distinction is important since private sales bring tax benefits in Germany. Private sales where profits do not exceed €600 are tax exempted, for example. Italy, not known for its strong balance sheet nor hatred of taxation, only levies a tax on cryptocurrency profits above 51,000 euros.

Such exemptions are worth consideration for small-scale crypto users in Australia, allowing people to get familiar with the technology without fearing tax uncertainty.

Portugal is another country that has benefitted from an influx of technology founders and builders, due to its tax regime for crypto. Capital gains on crypto are effectively exempt from tax, unlike stocks, bonds etc.

Most countries deem cryptocurrencies to be assets, like property, and thus subject to CGT upon “disposal”. It is this nebulous notion of “disposal” though which warrants detailed consideration to avoid massive stifling of crypto innovation.

Question 9: What changes, if any, should be made to Australia’s taxation laws in relation to crypto assets, whilst maintaining the integrity of the tax system? If changes are required, please specify the reasons.

Currently, the only crypto activity that does not create a CGT event is ‘air-drops’ - a mechanism by which users are given a token or asset without paying, or even requesting in some instances! The vast majority of other crypto activity does create CGT events, and we believe that this will restrict innovation and usage of crypto in the future. Rather, we suggest that the only taxation occurs, at least for an interim period, on the fiat/crypto on-ramp and off-ramps.

Whilst on the one hand, this would marginally reduce the amount of tax revenue generated for the Commonwealth, it would greatly encourage participation and development of crypto related services and payment rails. Therefore, in the future, the ATO would have a vastly larger digital asset base from which to generate tax revenue, and it could take advantage of the superior monitoring and collection technology that comes with composability. Having straight-through-processing of taxes as well as a better ability to monitor risks in an economy that is blockchain based would greatly outweigh any foregone revenues, due to making tax less restrictive in the near future.

Question 10: How could tax laws be designed to ensure that they keep pace with the rapidly evolving nature of crypto assets?

As mentioned in Question 9, we suggest restricting taxation points to the fiat on-ramp and off-ramps, while leaving the internal crypto ecosystem tax-free, for the time being. This would help to ensure that whatever taxation policies are adopted in future, the base of digital assets to which they are applied has had a chance to evolve and grow. The token mapping process being done by Treasury is helping, but while the industry evolves, this exercise will be one of herding cats for several years.

We are at a similar stage to the early days of the internet. There we evolved from read-only sites to sending emails but waiting for slowly loading pictures, before reaching streaming movies and other forms of online entertainment. As the technology evolved, so did the ability of citizens, companies and governments to take advantage of more efficient processes. So too we see that in Australia, from paper forms of tax to the e-tax system we have today.

Another example is the pricing of mobile phone plans. When we moved from 2G to 3G services, providers like Telstra were still charging on a per kb (kilobit) basis. With new technology moving us to faster services, the per kb charge rate saw users charged hundreds of dollars. This is because mobile websites began loading with images, meaning the old model of charging for such small amounts of data made no sense.

As technology rapidly changes, it is best to design laws that are light touch and focus instead on outcomes-based principles, like ensuring a smoother path towards greater crypto adoption.

Question 11: How can the existing tax treatment of crypto assets be improved to ensure better compliance and administration?

The existing treatment/management of taxation for digital assets can be improved by (i) incorporating more blockchain related services in the tax workflow and (ii) encouraging the move of businesses and users towards more blockchain related rails for commercial use cases (as mentioned above).

NotCentralised is building a protocol to bring about better compliance (and protection for consumers) in the crypto space, by wrapping legal compliance around tokens. We call this protocol Layer C and more details can be found here - https://www.layer-c.com/

In a nutshell, Layer C takes existing laws governing securities (which we feel is what most tokens are) and creates compliant 'wrappers' with which to envelope any underlying token. This is similar to how we create wEth or wrapped ETH. The compliant ('C') wrapper contains various programmatic rules, such as who can and cannot transact in a token and what types of transactions it can be used for. We look to embed compliance from the token level up, as opposed to pushing it down on unregulated assets from the top. By doing this, we envisage that traditional regulatory compliance in the TradFi (traditional finance) space is also extended to crypto transactions.

The inspiration for Layer C is from a lack of clarity on compliance and regulation, which is holding back many developers, businesses and users from moving into crypto. This lack of protection has also enabled various types of illicit activity to occur, especially for less knowledgeable consumers.

In a tax context, Layer C can be extended to enable straight-through-processing of tax on certain transaction types such as when crypto is used to pay taxes. A charitable organisation could have a Layer-C wrapper around any tokens it receives from donations, have tax automatically calculated and sent to the ATO, as well as ensuring that only 'whitelisted' wallets are able to participate in these actions. This can be extended across other industries too where blockchain-related transactions are set to increase.

In addition to these automated actions, government and regulators will be able to change how different events are taxed in real time, and to monitor changes in the economy from on-chain data.

For consumers and businesses, the advantages of these innovations include more streamlined processes for tax reporting, increased visibility with respect to counterparty risk, and supply chains.

Question 12: What data sources are available to assist taxpayers in completing their tax obligations and/or the ATO in implementing its compliance activities?

The standard sets of data that individuals use come from transaction reports downloaded from centralised exchanges, or records of transactions from on-chain data through self-custodied wallets.

On-chain analytics and data companies are a vital part of the ecosystem which could help administer tax laws through insightful data provision. The market leader in our opinion is Chainalysis, which has a global presence. NotCentralised is proud to have hosted Chainalysis leading data scientist from the US at a recent Sydney event. Other players include Dune Analytics, Delphi Digital and Nansen.

In terms of assistance or guidance sources available, we are aware that consumers go through what they see available on the ATO website or from what is provided by accounting firms and service providers. Other sources of guidance and information come from the community and social media. However, there is no quality control over these sources and thus authorities should be wary of outsourcing education to unqualified “influencers”.

Question 13: . Are there intermediaries (such as exchanges) that are involved in particular crypto asset transactions that could play a role in the administration of the tax laws? If so, what would their involvement look like?

As mentioned in Question 11, the Layer C protocol, being developed by NotCentralised, could assist in the facilitation and administration of tax laws.

Additionally, the various tax service providers like Koinly and Crypto Tax Calculator could potentially help. The large exchanges such as Binance and FTX should be considered key nodes in the crypto ecosystem. Encouraging standardised reports, anonymised, from those players will help the taxation department with overall system visibility.

On-chain analytics and data companies are a vital part of the ecosystem which could help administer tax laws through insightful data provision. The market leader in our opinion is Chainalysis, which has a global presence. NotCentralised is proud to have hosted Chainalysis leading data scientist from the US at a recent Sydney event. Other players include Dune Analytics, Delphi Digital and Nansen.

Question 14: How can taxpayers be further supported to understand their tax obligations in relation to crypto assets?

Clear, concise checklists and guidance notes, distributed through all the mediums that those involved in crypto will be familiar with. Advocacy through accounting bodies to impress upon accountants and tax professionals the importance of understanding crypto basics.

We mentioned the various web3-related meetups and associations in our answer to Question 6 and there are also a variety of crypto related media commentators. Some appear on their own social media channels (on YouTube, TikTok, Instagram), and some via mainstream media such as Ausbiz, Australian Financial Review, CoinDesk, Coin Telegraph, The Chainsaw, The Defiant and other crypto related publications.

Question 15: What additional support can be provided to the tax adviser community to assist them in advising their clients in relation to the tax treatment of crypto assets?

Clear, concise checklists and guidance notes, distributed through all the mediums and platforms that those involved in crypto will be familiar with. Advocacy through accounting bodies (e.g. CPA) to impress upon accountants and tax professionals the importance of understanding crypto basics.