Blockchain Australia

PROMOTING BLOCKCHAIN INNOVATION IN AUSTRALIA

22 September 2023

Open letter to the Board of Taxation, the Australian Taxation Office, the Treasury, the Joint Professional Bodies (Chartered Accountants Australia & New Zealand, CPA Australia, Institute of Public Accountants, The Tax Institute, the Law Council of Australia), and the Australian Law Reform Commission

Dear Representative,

1. We represent the Tax Working Group of Blockchain Australia.

Blockchain Australia

2. Blockchain Australia is the peak industry body representing the blockchain sector in Australia, serving as a unifying force for the country's blockchain community, advocating for the responsible adoption of this transformative technology for the prosperity of Australia and its citizens.

3. The Working Group was established to uphold the principles of a fair, simple, and efficient tax system as tax policy and administrative practices develop in relation to crypto-token activities and participation in global blockchain networks.

4. Our primary focuses include:

   (a) advocating for responsible tax policy,

   (b) consulting with Blockchain Australia members and the public on taxation issues, and

   (c) liaising with domestic and international tax policy and administration bodies.

5. This letter adopts the neutral and factual term ‘crypto-tokens’ rather than cryptocurrency, crypto assets or digital assets, except when a different term is quoted from a judgment or statement.

Executive summary

6. (**Purpose**) In recent months, there have been significant global developments in the regulation of crypto-token activities. The purpose of this letter is to inform you of relevant developments prior to the finalisation of the *Review into the tax treatment of Digital Assets and Transactions in Australia* (the **Review**) by the Board of Taxation (the **Board**). The Board is required to provide their final report to Government on 30 September 2023, and afterward the final report is expected to be released to the public.

7. We ask that you, as a key representative of a tax policy and/or administrative body, consider the impact of these international developments, particularly the *policy direction* of these developments, including:

   (a) the relatively heavy and unaffordable compliance burden imposed on Australian taxpayers participating in crypto-token activities;

   (b) the impact of ongoing regulatory uncertainty on the application of existing tax laws, which increases the cost of tax advice and burden upon Australian taxpayers;

   (c) the appropriate tax treatment of crypto-token activities for Australian taxpayers; and,

(d) how tax policy can incentivise responsible innovation and economic growth from taxpayers participating in crypto-token activities and with global blockchain networks.

8. We have observed that the current approach to developing policy for the taxation of crypto-token activities has predominantly been via non-binding web guidance by the Commissioner of Taxation (**Commissioner**). We submit that this approach is producing unintended policy outcomes and hardships for Australian taxpayers. We further submit that the Government should articulate clear policies for the regulation and taxation of crypto-tokens in Australia, rather than rely on this ad hoc approach. Coupled with ongoing concerns around de-banking crypto-token participants, we are concerned that Australian taxpayers are disincentivised from developing crypto-token related businesses and skills, and participating in crypto-token activities, or are moving offshore to jurisdictions that offer regulatory certainty and clearer tax rules for their legitimate activities.

9. While tax policy is routinely used as an economic lever to achieve non-tax policy goals, the overall goals of simplicity, fairness (including through technological neutrality) and efficiency in the tax system should prevail. Fairness and technological neutrality would mean that some clarity or temporary reform of existing tax laws should be implemented to offset the burdens faced by taxpayers who choose to engage with crypto-token activities, which are not necessarily borne by taxpayers using Australian dollars, foreign currency, or traditional CGT assets.

10. (**Recommendations**) We recommend the following policy actions, presented in order of what would most alleviate the undue tax compliance burden currently faced by Australian taxpayers and by graduating level of complexity to implement:

(a) (**Temporary administrative approach**) Introduce a temporary administrative practice note that states the Commissioner will not devote compliance resources to reviewing tax returns for taxpayers that lodge returns and pay associated tax on time and use genuine and best efforts to arrive at their tax position for crypto-token activities in an income year. The method could include requiring a declaration by a taxpayer that they have used genuine and best efforts to provide complete data about their crypto-token activities to either or both of a crypto-tax software provider or a tax agent that can prepare the crypto-tax position or critically review the crypto-tax software report for its correctness. In addition, that method could require that the taxpayer has searched for relevant ATO guidance and applied it to the best of their ability or sought and lodged in reliance on tax advice.

(b) (**At least annual review of validity of binding and non-binding guidance**) The existing binding and non-binding guidance from the Commissioner of Taxation should be reviewed at least annually, and include practical examples. In their current form, the everyday taxpayer cannot easily determine how the guidance applies to their circumstances and anecdotally, the guidance is not contributing to improved understanding of tax implications of crypto-token activities. Furthermore, where the Commissioner alters existing guidance, the Commissioner should be sensitive to the significant compliance costs that could be suffered by everyday taxpayers where such change in guidance is specified as applying retrospectively. Any change in general guidance that is specified as applying retrospectively should be accompanied by a clear statement that the Commissioner acknowledges that taxpayers may have taken a different position in past returns based on the previous ATO guidance and the Commissioner will not allocate compliance resources to determine whether a taxpayer's previous positions are consistent with the updated guidance.

(c) (**Alleviate compliance burdens**) Australia should consider alleviating the tax complexity compliance burden for taxpayers engaging in crypto-token activities, with gradual amendments to existing law. For example, this could include introducing a

modified form of limited balance election for individual taxpayers, functional currency elections for corporate taxpayers, and building the capability of the Australian Taxation Office to read, process, and prefill tax returns for a taxpayer's crypto-token activities. This would position Australia as purposefully distinct, but in competition with the US IRS that is considering building its own crypto-tax software.[i]

(d) (**Ecosystem rollover**) Australia should consider introducing a rollover that disregards the gain or loss made on a crypto-token activity when the balance of crypto-token units is exchanged for a balance of other crypto token units. The availability of this rollover could be limited by exclusions or integrity rules. This would align Australia with the direction of tax policy developments in the UK and ensure Australians are not put to a disadvantage competitively compared with international business peers (cf: the reasons the securities lending tax exemption was introduced).[ii]

(e) (**Third category of property**) Australia should consider formalising a third category of property under general law, and then amend the tax law accordingly. This third category, unlike the existing categories, should recognise the flexibility of crypto-tokens to function in multiple ways depending on the context of keeping or use, as well as the level of control a person has to use or transfer their balance. This would align Australia with the direction of legal developments in the UK (and several common law jurisdictions expected to follow the UK). We understand that the Law Commission of England and Wales is currently working to understand the spectrum of control a person may have to use and transfer their balance of crypto-token units. Following such thorough and necessary work, the foundations can be properly laid in statutory reform to settle when the strength of control is sufficient to be worthy of protection as a third category of property or new class of statutorily recognised right, and whether that varies depending on against whom the rights can be enforced.

International developments

Property law

11. (**United Kingdom**) With respect to developments in the United Kingdom:

(a) (**Digital Asset Report**) The Law Commission of England and Wales proposed narrow statutory intervention in June 2023;[iii] however, that work was undertaken from a common law perspective, and tax law was excluded from its scope.

(b) (**Tulip Trading Case**) The Tulip Trading Case highlights the futility of use of the category of a 'thing in action' against a global blockchain network because it is not a distinct legal person that controls the value of crypto-tokens on a blockchain. That is, if a court-orders one or more node operators to upgrade their blockchain software to reinstate a person's ability to use and transfer a balance of crypto-tokens, a majority of node operators are likely to ***not*** upgrade their blockchain software. This results in a contentious hard fork where crypto-tokens on the chain that reflects the software upgrade are likely worthless or worth less than crypto-tokens on the majority consensus chain. Trustworthiness in the reliability and immutability of a blockchain ledger, in large part, comes from both the software design as well as the size and spread of the network of nodes operating the software. Without majority consensus, the trustworthiness properties are absent from the chain that reflects the software upgrade and thus also the valuation likely is absent too. Thus, a legal remedy that forces some but not all node operators around the world to upgrade their software does not likely achieve the economic outcome the person seeks from the software upgrade.

At a high level, remarks from Justice Falk[iv] are that the effectiveness of any remedy to allow for service outside of jurisdiction, that compels the defendants to participate in legal proceedings in the jurisdiction is doubtful because of, and notwithstanding that, the ability for the blockchain to be forked. Because of the ability for the blockchain to be forked, any court-ordered software upgrade to reinstate Tulip Trading's balance of crypto-tokens on a software upgraded chain is likely no longer agreed to be the consensus chain and renders the legal remedy futile to achieve the economic remediation the plaintiff seeks.

12. (**Singapore**) With respect to developments in Singapore:

(a) (**ByBit Case**) The summary judgment of the Singapore High Court in July 2023[v] is to be treated with caution because:

(i) not all relevant facts to the issue of "whether cryptocurrency is a chose in action", or the more accurate issue of "whether USDT that is transferable on the Ethereum blockchain is a chose in action" were advanced; and,

(ii) the High Court did not attempt to explain why USDT or 'cryptocurrency' or 'crypto assets' can be classed as a thing in action with the judgment relying only on the flexibility of the law to expand to cover a diversity of things.

(b) The summary judgment appears to make law, without clarifying what features lead to exercising the flexibility of the law to extend to new categories, by stating:

> *"While the fact that USDT also carries with it the right to redeem an equivalent in United States Dollars from Tether Limited, a company incorporated in the British Virgin Islands ("BVI"), makes it look more like traditionally recognised things in action, I do not consider that this feature is necessary for a crypto asset to be classed as a thing in action. … There is no individual counterparty to the crypto holder's right. But over time the category of things in action has expanded… Holdsworth's historical survey demonstrates the diversity of incorporeal property that has been classed as things in action. This diversity suggests that the category of things in action is broad, flexible, and not closed."*

(c) The practical and policy challenges of the Singapore High Court recognising that a 'thing in action' can exist for 'the holder of a crypto asset' without a clear legal person or legal ground to enforce the 'thing' against, is questionable. Justice Falk has commented as such judicially in the ongoing Tulip Trading Case, Her Honour set aside an earlier order that had granted permission to TT to serve a claim form out of jurisdiction and to set aside service of the claim form.

(d) As such, caution must be used when referring to the Singapore High Court judgment which states that, "… USDT, which may be transferred from one holder to another cryptographically *without the assistance of the legal system* [emphasis added], nonetheless are choses in action". It would be more prudent to distinguish the case to apply only in circumstances where two recognised legal persons are in dispute with each other over whom holds the rightful ability to deal with a balance of crypto-token units, rather than in circumstances where there is a dispute by a recognised legal person against a decentralised blockchain network.

(e) To have the ability to transfer USDT cryptographically from one holder to another on the Ethereum blockchain *without the assistance of the legal system*, the holder must have sufficient ETH to pay for gas and there must be sufficient trust in the size and

decentralisation of the network of validators that the transfer will be processed and finalised within a time period that the trust and size of the network remains largely as it was when the crypto-token transfer was initiated. The right (if any) does not subsist without the network being active and reliable, and a person first making a decision about whether they should make a cryptographic transfer on a decentralised blockchain network at a particular time. If the network is not large enough, or is experiencing uncertainty (from regulatory developments or security threats) then a person may not have the strength of control or confidence to participate in crypto-token activities, or necessarily the same blockchain. In such circumstances, then absent assistance from one or more legal systems, or a hard fork, there can be no real or sufficient ability to transfer crypto-tokens cryptographically.

Securities law

13. (**United States**) With respect to developments in the United States:

(a) There is confusion and disagreement at the US District Court level about whether 'crypto-token transactions' are characterised as securities transactions: compare the order in SEC v Ripple Labs Inc versus the ruling in SEC v Terraform Labs. This creates uncertainty about whether a crypto-token can be statically characterised for tax purposes as a CGT asset, trading stock, currency or an equity or debt interest when it has multiple functions, and the insufficiency of the 'material change' provisions in the debt-equity rules.

(b) In the context of securities laws, the SEC v Ripple Labs Inc summary judgment order in July 2023[vi] emphasises that it is the manner and circumstances of a transaction that determines whether there is a transaction regulated by US securities law or not. This case considered the classification of XRP (ticker: XRP), as a security under US securities laws. XRP is the crypto-token exclusively used on XRP Ledger, created by Ripple Labs Inc, which relies on the Ripple Protocol Consensus Algorithm (in contrast to the Proof of Work algorithm used by the Bitcoin Protocol). The single judge held that XRP, when sold 'programmatically' in the secondary market through crypto-token exchanges to the public is not a securities transaction, but the manner XRP was sold to institutional investors was a securities transaction, under US securities law.

(c) The Ripple summary judgment order represents a turning point for US case law and policy development regarding the application, and appropriateness, of existing securities laws to crypto-token activities generally, as well as when sold as part of fundraising activities. Although in the weeks following the order, the following have occurred:

(i) Terraform Labs and Do Kwan filed a motion to dismiss the action brought by the SEC against them, citing the Ripple order as precedent that support their claim. However, Judge Rakoff of the US District Court for the Southern District of New York denied this motion and criticised the reasoning in the Ripple order stating that:

> *"It may also be mentioned that the Court declines to draw a distinction between these coins based on their manner of sale, such that coins sold directly to institutional investors are considered securities and those sold through secondary market transactions to retail investors are not. In doing so, the Court rejects the approach recently adopted by another judge of this District in a similar case,"*

(ii) Significant US crypto-token policy shifts occurred, with two bills being approved by House committees which include tax policy measures that are aligned to an appropriate policy foundation of defining "decentralized network" and "decentralized governance system".[vii]

(iii) The SEC has requested to file an interlocutory appeal in the Ripple matter,[viii] which is opposed by Ripple Labs.[ix]

14. (**Australia**) From an Australian perspective, the various lawsuits initiated by ASIC in 2022,[x] and this month,[xi] if not settled, will result in case law precedent on the application of existing financial services laws to crypto-token activities provided by Australian companies but will not answer the question of whether the crypto-tokens in and of themselves, or digital wallets, as they operate on decentralised blockchain networks, or blockchain networks themselves are a 'security or other financial product' under Australian financial services laws. Treasury is expected to shortly release a consultation paper proposing a licensing framework for crypto-token custody and exchange activities, but this is unlikely to include tax considerations.

Other comments

15. Since the characterisation under general and securities law continues to be subject to legal uncertainty, the tax analysis is also uncertain as to whether crypto-tokens (or any related description of a crypto-token) is a CGT asset, trading stock, currency, or an equity or debt interest, and when that changes. For example, each BTC or ETH 'transaction' is made up of at least two parts: the substantive transfer and the payment of 'network'/'gas' fees. In respect of the latter, the BTC or ETH is held as currency and to function as currency (as the only accepted form of blockchain network payment).

16. As such, when a crypto-token is held and spent on network fees on its native blockchain the crypto-token component spent on network fees meets the functional meaning of 'money' and should be afforded income tax treatment as a foreign currency or as a third category 'network currency'. Such acknowledgement at the policy level would allow taxpayers to avail themselves of a more sensible tax treatment similar to elections introduced historically to alleviate the compliance burden around foreign currency dealings. If taxpayers believe they can achieve a better tax position by not disregarding gains and losses on gas fees, then the existing tax law should still be available to them.

17. Crypto-token activities initiated by a taxpayer directly from their digital wallet (as opposed to through a centralised crypto-token exchange) are generally more complex than the everyday person understands or can afford to retain tax advice about. Shortcut methods and bespoke tax concessions must be considered: see, for example, the UK HMRC report recommending a 'DeFi tax exemption' following their Call for Evidence about the tax treatment of DeFi.[xii]

18. Crypto-tax software (and increasingly, crypto-accounting software) is still in development, prone to both technical error and human user error, and yet everyday taxpayers are forced to pay for and rely on software to produce a tax position. This contrasts with data matching protocols in place for tax authorities to receive information about share trades and dividends paid on equity interests which means the tax administration settings are inherently incentivising the market to invest in equity for the ease of tax compliance rather than innovative crypto-tokens and crypto-token activities.

19. Crypto-tokens received in a similar way to natural resources being mined for the first time or natural increases in livestock should not be subject to tax, nor constitute a supply for consideration for GST purposes, until the crypto-token is subsequently sold. Whilst there is a liquid market to sell some crypto-tokens such as BTC or ETH that can be received from mining or staking or from other forms of participation with a blockchain network or blockchain

application, this is not true for most crypto-tokens. Responsible tax policy would see a distinction drawn where there is no liquid or large enough market to sustain immediate disposals of tokens as soon as they are received in order to fund a tax component. Compare latest guidance from the US IRS that stakers receiving crypto-tokens from staking must report the rewards as income when they get 'undisputed possession' of it,[xiii] as well as academic research recently published.[xiv]

20. Decentralised autonomous organisations (**DAOs**) are being recognised as legal persons by US courts, as unincorporated associations: see the default judgment in CFTC v Ooki DAO and the federal court ruling upholding US Treasury sanctions on Tornado Cash. In addition, jurisdictions have introduced or are introducing legislative frameworks for DAOs or DLT Foundations, such as Utah, Wyoming, New Hampshire, the Republic of Marshall Islands, the Catawba Digital Economic Zone and the Abu Dhabi Global Market.

21. These developments highlight that blockchain is a novel technology, as are decentralised blockchain networks, that do not neatly fit within existing legal concepts and structures that critically inform the appropriate application of tax laws and principles. More specifically, they also demonstrate that either clarification or reform to the current tax rules is necessary to the extent that crypto-tokens and activities do not comfortably sit within our existing legal concepts of property or securities or consumer products.

22. We encourage each Representative to closely consider the above developments in formulating any further policies in Australia.

23. The Working Group welcomes any opportunity to assist you in preparing current or future tax policy regarding crypto-token activities and global blockchain networks. Our Working Group members routinely advise on ongoing crypto-token activities and have developed extensive expertise in this space. We thank the members of the Working Group that assisted us in preparing and reviewing this letter.[xv]

Yours sincerely

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[i] Internal Revenue Service, 'RFI DAIPO Digital Asset Marketplace Analysis' (12 June 2023), available at: https://sam.gov/opp/c9ffa23337b244a6bd3c954755b1f433/view.

[ii] See history here, Australian Securities Lending Association, 'History of Securities Lending', available at: https://www.asla.com.au/about-securities-lending/#history_of_securities_lending.

[iii] Law Commission of England and Wales, 'Digital assets: Final report' (27 June 2023), available at: https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2023/06/Final-digital-assets-report-FOR-WEBSITE-2.pdf.

[iv] Tulip Trading Limited v Bitcoin Association For BSV & Ors (2022) EWHC 667 (Ch) (25 March 2022), available at: http://www.bailii.org/ew/cases/EWHC/Ch/2022/667.html.

[v] *ByBit Fintech Limited v Ho Kai Xin, Persons Unknown, Foris Dax Asia Pte Ltd, FTX Trading Ltd, Consensys Software Inc, Quoine Pte Ltd* (2023) SGHC 199 at [36], available at: https://www.elitigation.sg/gd/s/2023_SGHC_199.

[vi] *SEC v Ripple Labs Inc, Bradley Garlinghouse and Christian A. Larsen* (2023) US District Court South District of New York (20 Civ. 10832 (AT)) at [15] – [16], available at: https://www.nysd.uscourts.gov/sites/default/files/2023-07/SEC%20vs%20Ripple%207-13-23.pdf.

[vii] House Financial Services and Agriculture Committees endorse Financial Innovation and Technology for the 21st Century Act (H.R.4763), which establishes federal regulatory framework that defines "decentralized network" and "decentralized governance system", and clarifies when persons acting through a decentralized governance system are treated as separate persons, which has implications for tax purposes.

[viii] SEC letter to the Honourable Analisa Torres, United States District Judge, Southern District of New York re SEC v Ripple Labs, Inc et al., No. 20-cv-10832 (AT) (SN) (S.D.N.Y) (9 August 2023), available at: https://www.docdroid.net/jbnzuoG/latest-file-pdf.

[ix] Ripple Labs letter to the Honourable Analisa Torres, United States District Judge, Southern District of New York re SEC v Ripple Labs, Inc et al., No. 20-cv-10832 (AT) (SN) (S.D.N.Y) (16 August 2023), available at: https://storage.courtlistener.com/recap/gov.uscourts.nysd.551082/gov.uscourts.nysd.551082.889.0.pdf.

[x] ASIC v BPS Financial Pty Ltd (ASIC alleges unlicensed conduct of carrying on a non-cash payment facility involving crypto asset token called Qoin, the Qoin Facility, without holding an AFSL, as well as false, misleading or deceptive representations), available at: https://www.comcourts.gov.au/file/Federal/P/QUD380/2022/actions#:javascript:void(0); ASIC v Web3 Ventures Pty Ltd (ASIC alleges unlicensed conduct of carrying on an unregistered managed investment scheme, investment facility or derivative involving a range of fixed-yield earning products based on crypto-assets under names USD Earner, Gold Earner and Crypto Earner, without holding an AFSL), available at: https://www.comcourts.gov.au/file/FEDERAL/P/NSD1007/2022/order_list#:javascript:void(0); and ASIC v Finder Wallet Pty Ltd (ASIC alleges Finder offered a debenture (Finder Earn product) without a disclosure document (TMD) and failed to hold an AFSL), available at: https://www.comcourts.gov.au/file/Federal/P/NSD1102/2022/actions.

[xi] ASIC, 'ASIC sues crypto exchange alleging design and distribution failures' (21 September 2023), available at: https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-256mr-asic-sues-crypto-exchange-alleging-design-and-distribution-failures/.

[xii] UK HMRC, 'The taxation of decentralised finance (DeFi) involving the lending and staking of cryptoassets' (27 April 2023), available at: https://www.gov.uk/government/consultations/the-taxation-of-decentralised-finance-involving-the-lending-and-staking-of-cryptoassets/the-taxation-of-decentralised-finance-defi-involving-the-lending-and-staking-of-cryptoassets--2.

[xiii] US IRS, 'Rev. Rul. 2023-14', available at: https://www.irs.gov/pub/irs-drop/rr-23-14.pdf.

[xiv] See also Christina Allen and Mark Staples, 'Taxing staking arrangements–Looking down the rabbit hole of new crypto tax issues' (2023) 111(9) Tax Notes International; Elizabeth Morton, 'Income tax complexities for proof of stake rewards' SSRN (Online, August 25, 2023) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4556238.

[xv] With thanks to Damian Lloyd, Elizabeth Morton, Luke Higgins and Timothy Graham.