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

By email only: CryptoTax@treasury.gov.au

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. 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.

Some observations on the Exposure Draft Legislation are set out Annexure A, and a proposed simplified basis of taxation is set out at Annexure B which ties to key regulatory and consumer protection goals.

Subject to the findings from the Board of Tax review and based on the emerging state of blockchain technology and types of tokens and token activities, this submission emphasises that taxpayers should continue to have choice about the risk they seek to take in applying existing tax rules and expense they incur in managing that tax risk. However, legislative resources should be prioritised towards implementing a simplified basis of taxation immediately and whilst more holistic tax and regulatory reform is underway.

The proposed simplified basis of taxation includes priority rules, evidence rules and the introduction of either or both of:

- definitions of 'Token' and 'Currency Activity'; and
- a third category of currency, 'Network Currency', in the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**).

The proposals are intended to preserve the integrity of the existing meaning of 'foreign currency' and allow recognition that tokens can be used as a functional form of currency on a blockchain network. Use of the term 'Network Currency' is deliberate to limit the third category to native blockchain tokens for which there is appropriate policy basis to afford currency treatment. However, a broader term 'Protocol Currency' could be considered which would capture blockchain application-level DAO tokens in addition to blockchain-level native tokens to address at a policy level emerging trends we may see of 'sovereign or nation states' forming with territory in the metaverse.

The definition of 'digital currency' in the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (**GST Act**) requires proper review and considered amendment rather than a narrowly focussed amendment that largely serves income tax purposes, and which will likely be subject to further amendment once a proper review is conducted by the Board of Tax. The world has moved on from 'digital currency' and to a large extent also the term 'cryptocurrency', and consensus is building around the terms 'crypto asset', 'crypto token' or 'token'. Continued reference to 'digital currency' in the GST Act and extending that term into the ITAA 1997 could thus be more confusing.

Finally, there is no human rights impact statement included in the Exposure Draft or explanatory materials. Disallowing foreign currency tax treatment of a thing recognised as legal tender by a recognised nation state could be interpreted as a form of limitation on human rights. To the extent

Australian businesses that provide services to El Salvador (or another country that has also declared BTC as legal tender) and seek to transact in BTC rather than the currency issued by the applicable government to steer clear of exposure to inflation or even corruption, then not being permitted to make a functional currency account election puts those businesses at a tax compliance and potentially tax cost disadvantage. The case becomes more compelling if the bilateral trade relates to core health and human services where change to or clarification of a disadvantageous tax treatment has the effect of limiting those persons' (customers') right to health (and life). No policy basis has been given, nor any statements around proportionality of the measures taken with reference to our bilateral trade with countries that declare BTC as a form of legal tender.

I welcome the opportunity to discuss the recommendations and look forward to seeing the progress of sensible friendly policy to support Australian innovation and participation in this innovation.

This submission will be shared and discussed in the 'Taxation of token activities' working group of LawFi DAO with the view that the submission is ratified by the LawFi DAO committee and its members, and more broadly across the tax profession in Australia and interested parties around the world.

My thanks and appreciation is extended in acknowledging the following people that contributed to this submission:

Dion Seymour, UK	Lee Schneider, US	Steven Rees Davies, Bermuda
Simon Akozu, New Zealand	Nupur Jalan, Germany	

Individual taxpayers and human rights experts that wish not to be named or are unable to be named

Treasury needs to keep abreast of changes and developments that impact upon society and the way in which society operates. CBDCs, stablecoins, and other tokens brought about by blockchain technology present a significant change to the way information and value is transferred and stored and how communities will organise. Tax rules should not operate out of step, or hold Australians back from moving, with society.

Yours sincerely,

Signed by:
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Annexure A Observations

A. Holistic, strategic reform requires a policy foundation

[1] The policy issues to be addressed or policy goals to be achieved from this Exposure Draft are not clear and require further clarification given the potential opportunities or consequences, respectively, for Australia. It is difficult to ascertain whether the Exposure Draft is intended to incentivise economic activity involving bitcoin and other 'digital currencies' (as defined by the Exposure Draft) or to disincentivise such economic activity.

[2] The Exposure Draft was published after the commencement of the Board of Taxation (**Board**) review into the taxation of digital asset transactions. Submissions to each are due on 30 September 2022. The Board's work and its final report will be important to put taxation reform into its holistic context, as will Treasury's token mapping exercise.

[3] Holistic thinking is particularly important to keep the tax rules fair, simple and efficient. Within these stated policy goals should exist technology neutrality and principles-based approaches. For example, where tokens are held and used as currency then the taxation of such activity should be on par with the tax treatment of Australian and foreign currency unless alternative tax treatment is pursued to incentivise or disincentivise economic activity to, and within, Australia.

[4] For Australia to compete globally in this space, sensible friendly policy will require holistic thinking across at least tax, AML/CTF, financial services, privacy and consumer protection laws. This Exposure Draft legislation is too narrow and conveys a message to our global counterparts that we are in 'band aid mode' rather than strategically positioning ourselves to capture the growth and benefits of blockchain-based innovation. Swiftly delivered exposure draft legislation is welcome once there is a stated policy foundation and principles by which Australia will incentivise and disincentivise innovation in this area to best support safe and sound mainstream adoption and use of blockchain technology and token activities.

B. Global decentralisation is the policy goal worth protecting

[5] This Exposure Draft is a critical juncture for Australia to choose whether to play a part in upholding the policy goal of geographic decentralisation of blockchain networks and the applications built upon them. Global decentralisation relies on several countries having sensible friendly policy that upholds the security, resilience, censorship-resistance, and trust that decentralisation networks and applications represent over centralised networks and applications.

[6] The Bitcoin Network is the earliest example of a decentralised autonomous organisation (**DAO**). Even if DAOs and their tokens are an innovation blip on our way to a tokenised digital economy of existing financial instruments by recognised legal entities, the fundamental disruption of blockchain technology that this submission assumes will survive is the feature of global decentralisation. In other words, the trust and strength of a blockchain network graduates by reference to either the geographic dispersion of the blockchain network's miners (or validators or other) and / or the number of jurisdictions with friendly law (rather than unfriendly law) applicable to miners (or validators or other).

[7] The ability for any miner or validator (or other) to continue to provide support to a blockchain network, and the ability for miners (or validators or other) to be geographically dispersed around the world, may increasingly be impacted by regulation. As such, policy that preserves the ability of miners (or validators or other) to continue to support a blockchain network is the critical policy goal that is necessary to support ongoing blockchain networks. Sensible friendly policy will be important to the extent that Australia seeks to move in step with other jurisdictions

that have or seek to implement friendly policy to support the security, resilience, and trust in decentralised networks.

[8] A similar case is to be made for the need for policy to support continued confidence of entrepreneurs to build autonomous protocols secured by decentralised blockchain networks as the building blocks of a tokenised economy. However, the legal and tax entity characterisation of a DAO continues to be unclear – that is, to what extent is all or part of a group of persons that hold tokens and use those tokens to interact with the protocol or govern it responsible and liable for regulatory and tax matters of the DAO.

[9] Such 'around the edges' policy making that this Exposure Draft represents continues to support an 'alegal' status of DAOs and DAO tokens where they are neither legal nor illegal. Without a clear and legislated legal and tax policy foundation around DAOs and DAO tokens, the application of existing tax laws is fickle and makes the Australian tax regime potentially more complex and unwieldly to administer from year to year with respect to the tax treatment of token activities and create/increase consequential consumer confusion.

C. Further information is required before the Exposure Draft legislation can be properly considered

[10] The Exposure Draft has been provided to clarify 'that digital currencies (such as bitcoin) continue to be excluded from the income tax treatment of foreign currency'. However, no consultation was undertaken before Exposure Draft legislation and no rationale has been provided for this policy position nor any modelling of the tax impact of various scenarios. Such information should be produced before this legislation can be further considered.

[11] The key area of income tax uncertainty that would have affected all taxpayers was specific to the income year ended 30 June 2022 (**FY22 year**) and how taxpayers could and should reflect in their tax returns a transition from BTC treated as a CGT asset held on capital account or trading stock, to a foreign currency. The tax rules do not cater for such a change in characterisation as they do when an asset ceases to be held on capital account and becomes trading stock or vice versa.[1]

[12] Taxpayers that may have purchased and dealt with BTC in the FY22 year may have relied on the existing tax treatment (as a CGT asset or trading stock, rather than foreign currency) in making their decision so some sort of administrative approach and/or legislated transitional treatment would have been required. The Exposure Draft and explanatory materials do not talk to these considerations and why they were ruled out. Based on my interactions with the ATO and as part of early engagement procedures on behalf of a taxpayer, the ATO was unwilling and perhaps had the view of being unable to issue any comfort letters or rulings (public, private, class or product types). Accordingly, the taxpayer was stuck in an early engagement process for a number of months before it was confirmed the ATO was unwilling to issue any comfort letter or ruling and was unable to provide any feedback on relevant scheme documents because the ATO does not review documents outside of a request for a ruling.

[13] In this regard, modelling should be undertaken and shared to demonstrate:

a) Anticipated gross tax revenue from BTC miners attracted to do business in Australia if the policy foundations provide certainty and protect that they can treat bitcoin as a foreign currency (or the proposed 'Network Currency' or a 'Token' involved in a 'Currency Activity') for income tax purposes and consider making a functional currency election to

[1] s 70-30 ITAA 1997.

keep their accounts denominated in that token.

b) Anticipated gross tax revenue from token miners (or validators or other) attracted to do business in Australia if the policy foundations provide certainty and protect clear conditions as to when they can treat tokens as a foreign currency (or the proposed 'Network Currency' or a 'Token' involved in a 'Currency Activity') for income tax purposes and consider making a functional currency election to keep their accounts denominated in that token.

c) Anticipated gross tax revenue lost from taxpayers making the limited balance election under Subdivision 775-D of the ITAA 1997 which broadly would allow (potentially with no amendment required) up to A$250,000 worth of bitcoin (and potentially other tokens) to be held in, and used from, one or more specified wallets where exchange gains and losses are disregarded.

d) Anticipated gross tax revenue gained from taxpayers attracted to or that remain in Australia because of the ability to make the limited balance election, and where tax is collected on other token activities.

e) Anticipated tax revenue gained or lost from the Commissioner of Taxation clarifying:

   i. that unless tokens are held in a wallet or wallets specified in a limited balance election, bitcoin (and other tokens) acquired for the purpose of speculative investment (i.e. intention to hold for at least 1 year) or for a purpose of trading retain treatment as a CGT asset or trading stock, respectively; and

   ii. thresholds at which a token activity passes into venturing the token into trade with a profit-making purpose such that gains or losses from the token activity are assessed on revenue and not capital account.

With respect to (e)(i), it is noted that the $250,000 limited balance may be appropriate for individuals and small businesses and not medium to large businesses such as BTC miners and token exchanges. Further policy work is required to consider extension of the objectives of the limited balance election in an appropriate way to token activities and wallet practices.

[14] Separately, no consideration has been given to ether (ETH) and other native blockchain tokens which do serve utility as a currency when persons transact on the Ethereum network and other networks. A taxpayer that acquires ETH to have in their self-hosted wallet/s to pay gas fees when sending ETH or interacting with Ethereum-based contracts (such as ERC-20 fungible tokens) should be able to ignore the tax implications of deposits and spending of ETH for gas at least up to a certain limit. This goes to the multi characteristic nature of activities that can be undertaken with a token, and why the desire to characterise a token as currency ***or*** property is not appropriate for multi characteristic tokens.

[15] Furthermore, as set out below, with the emerging nature of the metaverse(s) it could be possible that DAOs seek characterisation as a nation state on a declarative basis of recognition by securing metaverse 'territory'. Thus, creating the case for 'foreign currency' tax treatment of a DAO native token (for blockchain level DAOs, i.e. Network DAOs) or a DAO governance token (for application level DAOs, i.e. Protocol DAOs). If this trend eventuates, Australian tax and monetary policy should be clear enough so that taxpayers are not confused by it.

D. Where BTC and other tokens are held and used as currency, the tokens should be afforded access to income tax rules that already exist to ease the compliance burden

[16] Where tokens are held and used as currency then the taxation of such activity should be on par with the tax treatment of Australian and foreign currency unless alternative tax treatment is pursued to incentivise or disincentivise economic activity to, and within, Australia. In the case of BTC, it is now clear by this Exposure Draft legislation that the existing law supports that BTC can be treated as a foreign currency at least from the income year ended 30 June 2022.

[17] Instead of amending the definition of 'foreign currency' in the ITAA 1997 to exclude 'digital currencies' (as proposed to be amended in the GST Act), and introduction of a regulation making power, the Board of Tax and Treasury should consider the merits of either or both of:

a) introduction of 'Token' as a defined term in the ITAA 1997 along with the introduction of the term 'Currency Activity' in the ITAA 1997, which reflects that tokens are multi characteristic in nature and it is inappropriate to continue to attempt to define a token as one thing for tax purposes when the economic substance of the different activities possible with tokens does not align with a static characterisation of a thing; and

b) introduction of a third category of currency, 'Network Currency', in the ITAA 1997, where the definition of 'Network Currency' would preserve the integrity of the existing meaning of 'foreign currency' and allow recognition that a blockchain's native tokens can be used as a functional form of currency on a blockchain network which does not extend to application-level tokens. The definition could be broad enough to include 'Layer 2' native tokens and cross-blockchain bridge native tokens that function similarly to the 'Layer 1' native tokens. This latter recommendation would be a sensible and friendly policy approach to supporting responsible blockchain project innovation and adoption in Australia. It would also support the removal of tax events as a distorting effect for taxpayers that choose or need to use 'Layer 2' for affordability or another blockchain for safety or utility.

[18] The introduction of 'Network Currency' could permit the limited balance election and functional currency elections to be made at least by persons seeking to use the tokens as currency on the blockchain network. The translation rules could also operate more clearly. This approach allows the use of existing rules to ease the compliance burden and put tax treatment of tokens used as currency on par with Australian and foreign currency where tokens are used as currency.

[19] The functional currency provisions could be amended as set out below (by underline) to insert a reference to either Network Currency or Tokens as a defined term at s 960-59 of the ITAA 1997:

> *The object of this Subdivision is, for the purposes of reducing compliance costs and reflecting commercial practice, to allow certain entities (or parts of entities) whose accounts are kept solely or predominantly in a particular * foreign currency <u>or *network currency</u> (the **functional currency**) to calculate their net incomes by reference to the functional currency.*
>
> OR
>
> *The object of this Subdivision is, for the purposes of reducing compliance costs and reflecting commercial practice, to allow certain entities (or parts of entities) whose accounts are kept solely or predominantly in a particular * foreign currency <u>or *token</u> (the **functional currency**) to calculate their net incomes by reference to the functional currency.*

[20] The introduction of defined terms 'Token' and 'Currency Activity' would likely bring the tax rules into a more future fit state for a tokenised economy. For example, either:

a) the limited balance election could be amended to apply to disregard Currency Activities within a digital wallet or centralised exchange account (which may be linked to a debit or credit card that spends tokens) that is the subject of the election; or

b) no limited balance account election is required and any exchange gains or losses on Currency Activities are disregarded;

c) as a result of both of the above the translation rules become redundant with respect to Currency Activities; and

d) to the extent a merchant collects GST on a transaction, applications could be programmed to automatically convert the GST portion of the transaction into an Australian-dollar pegged stablecoin or Australian dollar CBDC and held in an escrow wallet or transferred directly to the ATO. The Convergence.Tech report referred to below summarised from page 62 the legal and tax reform required for the ATO to accept a payment of tax in an Australian-dollar pegged stablecoin.

[21] Proposed definitions:

a) *Network Currency* means a Token that can be used as currency on a Permissionless Blockchain that is not Australian currency or foreign currency.

b) *Currency Activity* means an activity where a Token can be used as currency on a Permissionless Blockchain that is not Australian currency or foreign currency, such as the payment of ether on account of gas on the Ethereum blockchain.

c) *Token* means a record on a Permissionless Blockchain.

d) *Permissionless Blockchain* means a public distributed ledger, allowing any ***person***[2] to transact and produce blocks in accordance with the blockchain protocol, whereby the validity of the block is not determined by the identity of the producer.[3]

E. Further scrutiny required of definition of 'digital currency' in the GST Act before it is amended

[22] If the definition of 'digital currency' in the GST Act is being amended, there are several other issues that should be addressed. A few examples are set out below to demonstrate that further consideration is required.

a) The term 'digital currency' should be replaced with more technology neutral terms such as 'Token' and 'Currency Activity' to enable functional and regulatory equivalence and to align with the proposed amendments to the ITAA 199. For example, s 9-10(4) of the GST Act could be amended as follows (in strikethrough and underline):

*(4) However, **supply** does not include:*

*(a) a supply of * money unless the money is provided as * consideration for a supply that is a supply of money or ~~* digital currency~~ a supply of a Token in respect of a *Currency Activity; or*

[2] Original proposed definition by COALA DAO Model Law refers to 'entity' but this word has been replaced with person to represent an entity, collective or individual.
[3] Definition of Permissionless Blockchain adopted from the COALA DAO Model Law, referenced below at fn 3.

(b) a supply of a Token in respect of a Currency Activity ~~of digital currency~~ unless the Token ~~digital currency~~ is provided as consideration for a supply that is a supply of a Token in respect of a Currency Activity ~~digital currency~~ or money.

The intention of the above proposed amendment is to clarify that entities paying consideration in Tokens, i.e. a Currency Activity for GST purposes, are not liable for GST on the supply of Tokens.

b) Reference in the 'digital currency' definition to 'digital units of value' is a phrase that has been criticised, most recently by the UK Law Commission. The UK Law Commission's work proposes that value is not the key criteria to identify property rights, rather rivalrousness is which is demonstrated through excludability.[4] An extract from the UK Law Commission's work is provided below:

"…our view is that a thing need not have any intrinsic or commercial value for that thing to be capable of attracting property rights. Moreover, value (at least when used in its colloquial sense) is not on its own a principled reason for a thing to attract property rights:

(1) A thing that attracts property rights might not be valuable – it could in fact have negative value…

(2) Value is subjective and may fluctuate… Shares in companies regularly fluctuate in value and may eventually become worthless, yet the fluctuations in value do not affect the property rights in relation to the shares…"[5]

The current definition's requirement that something is 'digital currency' by reference to it being a 'unit of value' has led to difficulty in application of the definition to past GST periods of use of the token where in the past the token met the 'digital currency' definition but subsequently when the token became worthless it no longer meets the GST definition. In such a case, it is unclear whether a taxpayer has an obligation to go back and amend Business Activity Statements. In addition, since blockchain networks support decimals to 9 or more places it is unclear whether 'of value' implies a value that falls within at least 2 decimal places or if any decimal place is considered more than nil.

c) Reference in the 'digital currency' definition to 'designed to be fungible' could capture non-fungible tokens (**NFTs**) in an NFT collection that have the same data traits or whole NFT collections where the entire collection is based on the same data traits. That is, there can be fungibility within an NFT collection or across a whole NFT collection. For this reason, a person should be allowed to use the NFT as consideration and have currency or money equivalent GST treatment but currently does not because of the latter part of the definition that excludes something as a digital currency if it gives 'an entitlement to receive, or to direct the supply of, a particular thing or things, unless the entitlement is incidental to: (i) holding the digital units of value; or (ii) using the digital units of value as consideration'. The current definition confines a token to a static characterisation despite that multiple activities are possible with the token such as for use like currency or to claim a good or service.

d) Reference in the 'digital currency' definition of 'generally available to members of the public without any substantial restrictions on their use as consideration' does not specify whether restrictions refers to any imposed by the issuer or a regulator or both. Given the increasing scrutiny around the regulatory characterisation of tokens, a token could be substantially restricted in its uses including as consideration. If a token comes under

[4] If excludability is difficult to prove (for example because there is no way of proving whether a person has shared their private key with another person), then rivalrousness is best proven by linking a token to a person's identifier. Such discussion goes beyond the scope of this submission but is an important concept to explain for the purpose of the existing definition of 'digital currency' requiring further holistic consideration and amendment.
[5] UK Law Commission, 'Digital Assets: Consultation Paper' (28 July 2022), [33], available at: https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2022/07/Digital-Assets-Consultation-Paper-Law-Commission-1.pdf.

regulatory scrutiny and substantial restrictions eventuate, it is unclear how this impacts the application of the GST definition in current GST periods as well as for past periods. This part of the definition is also difficult to apply in the context of projects that wish to start as 'closed loop' to incubate and experiment with the tokens and token activities possible with a protocol before making the token and protocol generally available to members of the public. In this regard, the definition stifles safe and responsible innovation that could start in Australia.

[23] Continued reference to 'digital currency' in the GST Act and extending that term into the ITAA 1997 could be more confusing. Treasury may be assisted in this task as well as token mapping more broadly by reference to the "Sensible" Token Classification System,[6] which aims to align well-developed regulatory regimes to what is being digital represented to carve out what is truly new with "Natively DLT assets".

F. Exposure Draft amendments paving the way for central bank digital currencies (CBDCs)

[24] If an intended outcome of the amendments is to support the treatment of CBDCs as money, then the definition of 'money' in the GST Act should be amended as follows (in underline and strikethrough):

> *"money" includes:*
>
> *(a) currency (whether issued by a government or central bank of Australia or of any other country)*

[25] 'Currency' and 'Australian currency' is not defined in the income tax law. The Commissioner's public ruling on the matter refers to both the plain meaning of the term as well as that in the *Currency Act 1965* (Cth). This may be an opportunity to include a definition of Australian currency in the income tax law that is the same as the above proposed definition of money in the GST Act.

[26] In addition, privately issued stablecoins exist and will be launched and will assist to educate the Australian government, Treasury and regulators about the design considerations for a CBDC and how business and government dealings could be more efficient when CBDCs are used in conjunction with smart contract programming. As such, stablecoins that are pegged one to one with the Australian dollar and with full collateral reserves held in an Authorised Deposit-taking Institution should also have currency or currency equivalent status for income tax and GST purposes. Accordingly, the definition of 'money' in the GST Act could be further amended as follows with new paragraph (aa):

> "*money" includes:*
>
> *…*
>
> *(aa) Australian dollar pegged stablecoins issued by a private or public person where at least one Australian dollar is held as collateral in an Authorised Deposit-taking Institution for every one stablecoin issued and one Australian dollar is always redeemable per one stablecoin by the stablecoin holder from the stablecoin issuer despite the public trading value of the stablecoin.*

[27] Further and consequential tax law amendments are set out in a recent report I contributed to, led by Convergence.Tech, 'To Excise and Beyond. The National Blockchain Pilot Report – How blockchain can benefit regulators, industry and the economy' (May 2022).[7]

[28] For reference, the New Zealand income tax legislation does not define 'currency' but the relevant question is whether there is any basis under New Zealand law to be taxed on an accrual / mark-to-market basis under the financial arrangements rules that apply to debt like

[6] Lee Schneider, Chambers Global Practices Guides, 'A "Sensible" Token Classification System' (2022).
[7] Available at https://uploads-ssl.webflow.com/60881ab60ee04f67ab0c597e/62a46e42ed9605fb9f11bcd6_Convergence.Tech%20-%20Beyond%20Excise%20-%20The%20National%20Blockchain%20Pilot%20Report.pdf.

arrangements and foreign exchange gains. As I understand, the general answer is no which has been clarified with recent retrospective amendments to exclude cryptocurrencies (subject to certain caveats) from the financial arrangements rules. In addition, New Zealand GST law was recently retrospectively amended to clarify that BTC should not be subject to GST.

G. Need for a simplified basis of taxation of token activities

[29] The experience mentioned above at paragraph [12] demonstrates that the ATO requires further specialist resourcing and/or a clear legislated policy foundation from which to apply and administer the tax law. If a taxpayer approaches the ATO through early engagement and requests rulings, where neither produces tax certainty (or a sense of it), then absent a more judicious and expeditious process a simplified basis of taxation and administration is justified. In addition or as an alternative, the review of whether existing and any new tax laws are and continue to be fit for purpose could be undertaken more regularly.

[30] A proposed basis for simplified taxation is set out at Annexure B. It is intended that this proposal is discussed and considered properly through the Board of Tax review and across the tax profession.

H. The legal and tax characterisation of the DAO that is referable to the token is required to set policy foundations and before sustainable principles of tax treatment can be properly determined

[31] Legislating 'around the edges' and not addressing the legal and tax entity characterisation of a DAO could continue to make existing laws more difficult to apply. Guidance from each of the ATO and the Australian Securities Investment Commission (**ASIC**) is not readily available or regularly updated regarding the application of existing legal and tax rules to determine the entity characterisation of a DAO for Australian legal and tax purposes. As such, foreign laws, guidance, and enforcement actions are referred to below to illustrate how existing foreign laws are being applied or new laws implemented in relation to DAOs, DAO tokens and DAO token activities. The COALA Model Law for DAOs alludes to this lacuna as indicating DAOs may be 'alegal' – that is, they are neither legal nor illegal[8] -- thus making the case for global consensus on minimum standards being required for legal recognition of a DAO.

[32] I understand this experience played out in some European states in the 2017-2020 period. At least in Switzerland the decision was made to postpone discussions on characterisation of a DAO and its native token to legislate more swiftly to clarify that a blockchain transaction represents the legal and not just the factual transfer of title.[9] The Swiss legislation supports the transition of traditional financial market infrastructure to blockchain-based infrastructure, so that traditional legal entities can tokenise their existing securities and financial products or issue 'registered uncertificated securities' (DLT securities) without a central securities depository to facilitate transfers. Concurrently, the Swiss non-profit foundation structure has supported the launch of several blockchain networks including where the token generation events were used to raise capital.

[33] This ability for Swiss law to move quickly has come off the back of the Swiss Financial Market Supervisory Authority, FINMA, having already published ICO guidelines setting out how it intended to apply financial market legislation in handling enquires from ICO organisers. In that

[8] Coalition of Automated Legal Applications, 'Model Law for Decentralized Autonomous Organisations (DAOs)' (2021), [5], available at https://coala.global/wp-content/uploads/2021/06/DAO-Model-Law.pdf.
[9] See, for example, PwC, 'Swiss DLT law: New regulations bring new opportunities' (d), available at: https://www.pwc.ch/en/insights/regulation/swiss-dlt-new-regulations.html. Note that the Swiss position is opposite to the provisional approach proposed by the UK Law Commission that the blockchain ledger record represents factual but not legal transfer but in the context of tokens that are outside the UK regulatory perimeter.

guidance, FINMA set out three main types of tokens – payment, utility and asset tokens[10] -- noting that hybrids were possible. With key categories defined, the income tax and VAT treatment of an ICO (or token generation event) was and is more straightforward, with some structures set up as foundations qualifying for non-profit tax status. There is recognition that the issue of utility tokens could qualify as a taxable service subject to Swiss VAT where the ICO proceeds are considered a pre-payment of services to be provided in future.[11]

[34] However, the FINMA guidance and commentary doesn't extend to the ongoing determination of the issuer or legal counterparty when tokens are newly emitted, or existing or new tokens are earned by interaction with a blockchain protocol, or a service is provided by a protocol which may require use of the native protocol token (and other tokens). Perhaps in the context of Swiss foundations with non-profit status the materiality of tax on ICO proceeds is insignificant but the issue of legal and tax entity characterisation of a DAO remains. If a Swiss non-profit foundation is used to initially distribute tokens and collect proceeds to fund protocol and community development and services, but does not control or direct the community or model of governance of the protocol, then existing private international law concepts of entity recognition break down. This is because, using Swiss law as an example, the non-profit foundation is an entity recognised by Swiss law but does not encompass the protocol. Whilst a protocol does not have a distinct legal personality it is also unclear but unlikely that it is included in the assets or legal responsibilities of the Foundation entity (or another legal wrapper). As the protocol is not given legal recognition anywhere in the world the legal and tax entity status of the protocol is alegal. Even in states like Wyoming that have introduced DAO law per which a DAO needs to be registered to be recognised as a DAO,[12] the inclusion or separateness of the autonomous protocol as part of (or separate to) the registered DAO entity is still unclear.

[35] Miles Jennings describes the issue helpfully in comparing web3 to web1:

> *"Much of our internet experience currently depends on web1 communication protocols like HTTP (data exchange for websites), SMTP (email) and FTP (file transfers), which are open source, decentralised, autonomous and standardised… Web3 protocols (blockchains and smart contracts) are analogous to advanced communications protocols – they enable users to send messages and trigger autonomous computer programs, which update the state of a blockchain's shared ledger. And because those ledgers can account for value, web3 protocols can form a settlement layer for the next version of the internet…Apps …provide users with access to protocols…so why should we regulate apps, not protocols? Because: (1) It's not technologically possible for protocols to comply w/ regs; (2) it's impractical for protocols to incorporate global regs; and (3) it's unnecessary given that apps can comply w/ regs… Switching to web3, we can think of tokens as being like email…"*

[36] Expanding on the points made by Miles, the treatment of BTC disposed of to pay the network fee as a taxable event gives rise to double tax – albeit not upon the same taxpayer, but upon the same transaction. The taxpayer paying the fee in BTC pays tax on any gain on disposal of the BTC to pay the fee and the miner that receives the BTC fee (depending on jurisdiction) treats the fiat currency value of BTC fees as assessable and subject to tax. As such, currency treatment of the fee component appears to be a more appropriate policy basis.

[37] Some lawyers that specialise in this area colloquially refer to DAOs or their protocols or 'non-counterparties' and DAO tokens as 'non-counterparty property'. If this is the appropriate policy and legal position for Australia to adopt, then in the case of currency and foreign currency there should be recognition of a new category of 'entity' or 'state' for protocols or 'non-counterparty'

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[10] Finma, 'FINMA publishes ICO guidelines' (16 February 2018), available at: https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/; and Finma, 'Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)' (16 February 2018), available at: https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/1bewilligung/fintech/wegleitung-ico.pdf?sc_lang=en&hash=83EE49D77DA54DD079F314D9EDCBDC3D.

[11] See, for example, EY Global, 'Swiss Canton of Geneva publishes Initial Coin Offerings Guide' (15 November 2018), available at: https://www.ey.com/en_gl/tax-alerts/swiss-canton-of-geneva-publishes-initial-coin-offerings-guide#:~:text=Generally%2C%20ICO%20proceeds%20are%20qualified,tokens%2C%20or%20hybrid%20tokens).

[12] See, for example, a simplified summary by Max Dilendorf, 'Forming & Operating a Wyoming DAO LLC' (2022) available at: https://dilendorf.com/wp-content/uploads/2021/06/Forming-and-operating-a-Wyoming-DAO-LLC.pdf

technology. For the reasons set out in more detail below, a new category of entity, a 'Network', is preferred because of the highly political nature of recognition of a state. However, if the law can move to focus on characterisation of token activities rather than characterisation of a token by reference to an entity that issues it then more appropriate concepts can be introduced that align with the multitude of activities possible with tokens.

[38] The token known as bitcoin (**BTC**) is referable to a type of blockchain level DAO that comprises the Bitcoin protocol, a network of miners and BTC users. The token known as ether (**ETH**) is referable to a type of blockchain level DAO that comprises the Ethereum Foundation, the Ethereum protocol, a network of validators and ETH and Ethereum-compatible token users. The Ethereum network has recently transitioned from Proof of Work consensus to Proof of Stake consensus (referred to as the Merge), prompting claims from SEC Chair Gary Gensler that ETH can be characterised as a security for US securities law purposes because validators are a type of third party that investors in ETH rely on in their expectation of returns from investing in ETH.[13] However, it is unclear whether each validator or the Ethereum Foundation or Vitalik Buterin or some other persons or group of persons should be subject to the compliance obligations that attach to the issue of a security in the US or tax compliance obligations that would attach to the issue of an 'equity interest' and distributions made in relation to the equity interest (such as dividend withholding tax).

[39] The recent sanctions by the US Treasury's Office of Foreign Assets Control (**OFAC**) on 38 smart contract addresses associated with Tornado Cash has raised questions about sanctions compliance by miners (or validators or other) and whether a blockchain network can and should be 'resilient' to domestic law (more colloquially, 'censorship resistant').[14] Whichever law is used for the next type of 'influence' upon the borderless technology will be highly controversial, as the preceding examples have shown such legislative and regulatory attempts to be.

[40] The OFAC sanctions upon smart contract addresses evidence that there is a willingness within OFAC to apply the law to a 'non-person' or a 'personless protocol', which is novel and may lack validity upon review by a court (if an eligible applicant can bring the matter). To date, there have been no similar efforts by any tax regulator with regard to a DAO or smart contract addresses that are no longer actively governed by a DAO.

[41] Based on the above points, global decentralisation of a blockchain network is a policy goal worth protecting but the right balance must be struck between the protections our existing laws seek to uphold (including tax compliance) and the resilience of a blockchain network. The attempt to define a legal relationship between a person and a node, or a person and many nodes, or a person and each member of a DAO for legal and / or tax purposes could be a type of 'influence' that a majority consensus of nodes reject and then 'hard fork' to refute what may be deemed an improper 'influence' from the law of one or more countries. As set out in the Ooki DAO example below, members of a DAO may refrain from engaging in voting and governance with their tokens for fear of joint and several liability for the actions of a DAO by regulators defining DAOs as unincorporated associations of positions rather than an alegal and yet unrecognised entity type.

[42] The US Commodity Futures Trading Commission (**CFTC**) has recently filed a federal civil enforcement action against Ooki DAO, defining it as an unincorporated association of persons comprised of Ooki token holders that voted on Ooki DAO governance proposals.[15] For

[13] See, for example, Benjamin Pimental of Protocol Fintech, 'Could Gensler put ether to sleep?' (20 September 2022) available at: https://www.protocol.com/newsletters/protocol-fintech/gensler-ether-security?rebelltitem=5#rebelltitem5.
[14] See, for example, CoinYuppie, 'OFAC sanctions and Ethereum PoS: some technical nuances' (22 August 2022), available at: https://coinyuppie.com/ofac-sanctions-and-ethereum-pos-some-technical-nuances/; and A Thorn, C Kim, C Yu and R Rybarczyk, 'OFAC Sanctions Tornado Cash: Issues & Implications' (10 August 2022), available at: https://www.galaxy.com/research/insights/ofac-sanctions-tornado-cash-issues-and-implications/.
[15] See, CFTC, 'Release Number 8590-22' (22 September 2022) available at: https://www.cftc.gov/PressRoom/PressReleases/8590-22.

Australian income tax purposes, and by reference to principles of private international law,[16] the CFTC action gives credence to characterising a DAO as a tax law company on the basis that an unincorporated association of persons is included in the definitions of 'company' and 'entity'. However, the CFTC action does not provide any guidance that tax practitioners could helpfully glean from as to the jurisdiction or jurisdictions of formation of a DAO, or where central management and control of a DAO may reside (if there is any central management and control).

[43] Under s 115 of the Corporations Act 2001 (Cth), it is an offence of strict liability for persons to be involved in the *formation* of a partnership or association with the object of profit or gain for its members which has more than 20 members. It is unclear how this provision would be relied upon by ASIC if persons based in Australia were involved in the formation of the Bitcoin network (or other blockchain networks or applications). However, if this provision were to be interpreted broadly by ASIC then all persons involved in BTC mining and potentially those involved in acquiring, holding, selling or spending BTC are exposed to a strict liability offence. If the Bitcoin protocol and network of miners and users is not a partnership or association within the purview of s 115, then there may be a yet undefined category of entity for legal purposes where tokens should be appropriately characterised for legal and tax purposes by reference to that yet undefined category of entity.

[44] Based on the above, it is unclear whether, from the perspective of the holder, BTC is properly characterised as property (a CGT asset or revenue asset) or a foreign currency. It is also unclear who the issuer of BTC is and whether, from the perspective of the issuer(s), BTC is properly characterised as a currency (if it is a 'nation state'), or an equity interest (if it is an 'entity'), a debt interest or neither an equity or debt interest for income tax purposes. If the full facts of a DAO scheme are analysed, DAO tokens such as BTC and other 'digital currencies' could be equity interests from the perspective of the issuer and thus property and a CGT asset for the holder. However, the currency characterisation becomes complex.

[45] In summary, BTC could be treated as issued either by one or a combination of:

a) the miner that 'wins' a block, or
b) the collection of miners involved in computations to secure that block, or
c) the pseudonymous founder Satoshi Nakamoto, or
d) a 'personless' or 'non-counterparty' protocol, or
e) all users of BTC as being involved in the unincorporated association of persons that use the Bitcoin protocol.

Each category produces its own complexity for income tax and GST purposes in determining the tax residency of the counterparty when miners interact directly with the blockchain and users pay fees to the 'network'.

[46] The characterisation of BTC as currency or not under existing law is highly political. However on principle, the exclusion of BTC as foreign currency where it is genuinely used with respect to trade in El Salvador (and other countries that have declared BTC as legal tender) puts Australian taxpayers in a disadvantageous tax position for interacting with those countries in their form of legal tender. The explanatory material makes no human rights statement or reference of the impact upon taxpayers that do business with El Salvador and other countries that have declared BTC as a form of legal tender.

[16] See, for example, Bank of Augusto v Earle, 38 US 519 (1839) extracted at footnote 3 of the COALA DAO Model Law, '…though a legal entity (such as a corporation) is an artificial creature of national law and only exists because of that law, "it does not by any means follow that its existence there will not be recognised in other places; and its residence in one state creates no insuperable objection to its power of contracting in another."

[47] The El Salvador declaration of BTC as legal tender confuses the determination of BTC as a 'foreign currency' under Australian legal and tax rules because BTC is not issued by the government or central bank of El Salvador. Thus, BTC is 'foreign currency' in the sense that it is accepted legal tender in El Salvador (as well as Panama and Central African countries) but not 'foreign' in the sense that the jurisdiction of issue of each BTC is unclear. A number of other countries with weak currency are high users of the USD-pegged stablecoin Tether (USDT), such as Argentina and Brazil. If not for the availability of USD-pegged stablecoins these countries may have already considered, and may still yet consider, adopting BTC as a form of legal tender.

[48] It is unclear whether the Bitcoin Network (the unincorporated association of persons however that is defined) could be characterised as its own state.[17] It is beyond the scope of this submission to provide comprehensive thinking on this point but this is the critical point deserving of robust thought by Treasury, the current Labour Government and the Board of Taxation.

[49] The Montevideo Convention on the Rights and Duties of States was signed on 26 December 1933, although Australia was not a signatory, and confirms the declarative theory of statehood (rather than the constitutive theory of statehood which defines a state as a person only if it is recognised as sovereign by other states). The declarative theory does not require recognition of the state by other states and requires that the state as a person of international law should have the following:

a) a permanent population;
b) a defined territory;
c) a government; and
d) a capacity to enter into relations with other states.

If a blockchain network can be a state under the declarative theory of statehood, perhaps by purchase of territory in the metaverse(s), then in theory the Bitcoin Network can enter into relations with other blockchain networks through bridging and wrapping. The remaining criteria could arguably also be satisfied.

[17] See for example, Dr Balaji Srinivasan, 'The Network State: How to Start a New Country' (2022) where he defines a network state as '…a highly aligned online community with a capacity for collective action that crowdfunds territory around the world and eventually gains diplomatic recognition from pre-existing states.'; and Vitalik Buterin, 'What do I think about network states?' (13 July 2022) available at: https://vitalik.ca/general/2022/07/13/networkstates.html.

Annexure B Proposed simplified basis of taxation

Subject to the final report provided by the Board and completion of the token mapping exercise by Treasury, this submission provisionally recommends:

1. A new Division within the *Income Tax Assessment Act 1997* (Cth) – Token activities. Further consideration is required regarding a simplified approach to GST.

2. Objectives of the new Division should be based on the following principles:

    a. ***Priority Rule***: This Division takes priority over other provisions of the tax law. This achieves simplicity by making clear that analysis of other provisions such as the CGT provisions, Foreign Currency rules, and Debt-Equity rules do not need to be considered if the criteria in the new Division are met.

    b. ***Transition***: Further discussion is required to determine if a taxpayer can apply the simplified basis of taxation for previous years where returns have been lodged or if the regime would be prospective only.

    c. ***Ordering and Evidence Rule***: Where a token can be used for two or more activities (e.g. as currency, for speculative investment, for voting, for trade), then the intention of the person at the time of acquisition of the token or at the commencement of an income year as set out in writing is the tax treatment applicable. The intention set out in writing can be different per token – that is, a split portfolio can be maintained. If there is no evidence in writing or evidence to the contrary, then a token is treated for income tax purposes as property and a CGT asset. All taxpayers are intended to benefit from this Rule particularly individuals, AMITs and MITs.

    d. ***Activities basis of taxation***:

        i. *Currency Activities* are disregarded for income tax purposes.

        ii. *Financing Activities* undertaken by a DAO will not give rise to assessable or statutory income where the financing is used to develop and support Public Goods in Open Source Format.

        iii. *Business Activities* that occur above the Threshold Rules will give rise to assessable income and allowable deductions.

        iv. *Gaming and Lifestyle Activities* are disregarded for income tax purposes, unless $10,000 or more is invested in the Gaming or Lifestyle Activities.

        v. *Collectible Activities* are disregarded for income tax purposes where a Token is acquired for $500 or less and is held for at least 2 years.

        vi. *Personal Use Activities* are disregarded for income tax purposes where either Tokens are acquired for A$10,000 or less and are used on a blockchain network, or a limited balance election is in place with respect to one or more self-hosted wallets, centralised token exchange accounts and/or contracts where the total Australian dollar value of Tokens at the beginning and end of the income year does not exceed A$250,000.

        vii. *Bridging and Wrapping Activities* are disregarded for income tax purposes where the activity is necessary to make a token software compatible with one or more blockchains.

viii. *Borrowing, Staking and Liquidity Providing Entry Activities* are disregarded for income tax purposes where Tokens are provided to a contract as collateral for loan proceeds or to earn staking returns or as liquidity for a trading pool and where the collateral is not at risk from use by third parties or other contracts. Note: Further consideration is required regarding an appropriate tax principle around Borrowing, Lending and Staking where the collateral is at risk. Further discussion is also required regarding the treatment on Exit with respect to a change in the collateral and Token returns earned.

ix. *Token Reward and Airdrop Activities* will give rise to assessable income once the Token rewards or Airdropped Tokens are sold to a third party or used as collateral in a protocol. The amount of assessable income is determined as the Australian dollar value received on sale or use of the Token rewards or Airdropped Tokens.

x. *Team Incentive Activities* will give rise to assessable income once the Tokens received as an incentive for contributing to a DAO are sold to a third party or used as collateral in a protocol. The amount of assessable income is determined as the Australian dollar value received on sale or use of the Tokens. This puts team token incentive schemes on par with the start-up concessions available for employee share schemes.

xi. *Early Stage Investment Activities* in Tokens are disregarded for income tax purposes where certain criteria are met. This is to put investors in DAOs and their Tokens on par with the tax concessions afforded to ESVCLPs and investors in ESICs.

Open Source Format means the Open Source Initiative's definition of open source, available at: https://opensource.org/docs/osd.

Public Goods means software, governance processes and operational processes developed for the benefit of public use and enjoyment that improve access to choice, transparency, trust and other purposes advanced in good faith in the public interest.
NOTE 1: A broad interpretation is to be used when determining public interest.
NOTE 2: This definition attempts to steer away from use of the term non-profit purpose and replace with 'good faith and in the public interest' to enable permissible member benefits (elements of for-profit) during the course of developing, delivering and maintaining a public good protocol or platform (with protocol and community governance).

e. ***Completeness of Token Storage Location Rule***: A taxpayer is responsible for keeping an appropriate record of all self-hosted wallets, centralised token exchange accounts and contracts in which the taxpayer treats as the place of storage of tokens owned or earned by that taxpayer.

f. ***DAO Recognition Rule***: If a DAO meets the Recognition Requirements (to be defined through further discussion with Treasury and the Board of Tax), it is treated as a pass-through entity where DAO Members are responsible for determining their Australian income tax obligations with respect to any distributions of revenue, profit or other tokens to the taxpayer by the DAO Treasury wallet or DAO-controlled wallet.

g. ***Threshold Rules***: Subject to robust discussion with the Board of Tax, the tax profession and Treasury but as a start some indicators are proposed below.

A person is not in the business of token activities because they:

i. have two or more digital wallets, centralised token exchange accounts;
ii. interact with two or more blockchains;
iii. interact with two or more DeFi protocols;
iv. deploy their tokens to earn token returns, such as in blockchain level or application level staking.

A person is in the business of token activities if they:

v. have undertaken more than 20 trades or contract interactions per week in an income year (where interaction with a protocol that triggers multiple transactions recorded on the ledger is assumed as one transaction/trade for repetition/frequency of activites); or
vi. have incurred more than A$50,000 of tangible equipment to participate in Proof of Work mining or other blockchain consensus mechanism that requires tangible equipment; or
vii. sell and/or accept tokens as payment for goods or services, however the merchant can document an intention that tokens received as payment are then held as CGT assets on capital account rather than as trading stock if that reflects their intention.

Disclaimer

Nothing in this submission or associated documents or correspondence constitutes legal, tax, financial or accounting advice. The content is general and not specific to your or your clients' circumstances and is a point in time reflection in an environment of transitionary and rapidly evolving technology and regulatory change. You are responsible for seeking independent, professional and timely advice specific to you or your clients' circumstances.

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