11 October 2022

Mr Anthony Klein and Ms Tanya Titman
The Board of Taxation
Langton Crescent
PARKES ACT 2600

By email: TaxDigitalAssets@taxboard.gov.au

Dear Mr Klein and Ms Titman

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

Chartered Accountants Australia and New Zealand, CPA Australia, Institute of Public Accountants and The Tax Institute (together, the **Joint Bodies**) write to you as the peak professional accounting and tax practitioner bodies in Australia representing the tax profession.

The Joint Bodies welcome the opportunity to make a submission to the Board of Taxation (**Board**) in relation to the Review of the Tax Treatment of Digital Assets and Transactions Consultation Guide (**Consultation Guide** or **Review**).

We also thank the Board for meeting with representatives of the Joint Bodies to discuss the matters canvased in the Consultation Guide and potential solutions.

In the development of this submission, we have closely consulted with members of the Joint Bodies with specific knowledge, experience and expertise in digital assets and transactions and their tax treatment.

Our submission is quite technical in nature and contains a significant amount of detail. As noted throughout, the tax treatment of digital assets and transactions can be complex with nuanced outcomes that depend on a multitude of factors. We consider that the detail in our submission will assist the Board, and members of other Government agencies, to better understand the underlying issues and provide the most useful advice, or design the most appropriate solutions, in response to these matters. We would be pleased to work with the Board to further discuss the points raised in our submission. In these discussions, the Joint Bodies can provide the Board access to the range of tax technical and industry experts that have contributed to our submission.

‘Digital assets’ is a broad phrase that captures blockchain-based tokens, email accounts, domain names, electronic files and statutorily created carbon emission schemes. We appreciate that a more accurate taxonomy of many of the digital assets considered in our submission may be ‘tokens’. However, we have referred to them by the taxonomy utilised by the Board in the Review for ease of reference and to ensure consistency.

The standards for digital assets are constantly evolving, as are the array of activities possible with those assets. In some ways, digital assets are fundamentally different to the existing classes of ‘things’ in the tax law which are classified as property, currency and equity/debt interests.

Australia’s taxation framework consists of legislative provisions and case law, and is supported by the guidance provided by the Australian Taxation Office (**ATO**) in respect of its administration. Given the evolving nature of digital assets and transactions, this framework may not always be able to provide the appropriate tax outcomes. The Joint Bodies are of view that a holistic response is required to ensure the best possible outcomes for taxpayers, advisers, and the administration of the revenue.

These challenges are not unique to Australia. A proactive approach to providing certainty of tax treatment may enable Australia to develop a competitive advantage in both the development of digital assets, and attracting investors to both digital assets and the businesses which are actively engaged in digital asset transactions.

The taxation of digital assets and transactions is not well understood by taxpayers or tax practitioners, with current ATO guidance being general in nature and not providing sufficient clarity on many common scenarios. We acknowledge that potential changes to the tax framework surrounding digital assets and transactions is a complex topic which will likely require time to implement. For this reason, we consider that a staged approach should be taken, starting with the high priority and easier to address aspects, and allowing adequate time to deal with broader and longer-term issues.

In the short term, the Joint Bodies consider that the priority should be changes that address pressing needs of taxpayers engaging in digital transactions and the inequitable outcomes in the taxation of digital assets in particular circumstances. These include:

- appropriate methods for tracking, tracing and valuing gains and losses arising from digital asset transactions
- the treatment of classes of digital assets without a traditional analogue, such as NFTs, liquidity pool tokens and wrapped tokens;
- the tax implications of common activities undertaken by taxpayers including staking, bridging, play-to-earn (**P2E**), game decentralised finance (**GameFi**) and decentralised finance (**DeFi**);
- the application of existing tax law principles to the digital asset space, such as the revenue-capital dichotomy, timing, derivation of income, and whether a disposal event has occurred; and
- establishing a working group comprising the ATO, the Board, Treasury, professional associations, tax professionals and technology experts to collaborate on the design, implementation, and administration of a broader tax framework for digital assets and transactions to ensure the law is effective, efficient, practical, and fair.

The changes made in the short term should be reviewed as part of the process targeting medium to longer term reform. Such changes include the following:

- a holistic approach to regulatory frameworks governing digital assets and transactions more generally. This allows more specific laws and regulations relating to tax to be made based on the legal recognition and characteristics of such items where existing laws cannot cater for reform; and
- driving greater engagement and collaboration between the ATO and taxpayers (and their advisers), to ensure that public guidance and the administration of the tax system more generally, are able to stay relevant and keep pace with technological advancements, as well as address the issues faced by taxpayers.

To ensure they are as effective as possible, the above changes must be undertaken as a coordinated response involving Treasury, relevant government bodies (such as the ATO, ASIC and Austrac), in consultation with external stakeholders. For this reason, we consider that a consultative forum should be established to review and discuss the administrative approaches and needed legislative reform on an ongoing basis. We envisage that this forum would consist of the Board, relevant government bodies (such as the ATO, ASIC and Austrac), Treasury, industry experts and representatives of the professional bodies. Noting that substantive legislative changes may be needed, a forum which holistically considers issues and potential solutions will ensure that a cohesive and collaborative approach is taken. Further, the forum would allow for regular discussions with the ATO to ensure that developments in the digital assets and transactions space are considered, with appropriate guidance being created where needed.

We would be pleased to continue to work with the Board on the development of the principles and law governing the tax treatment of digital assets and transactions in Australia and the Review as it progresses.

Our detailed response is contained in **Appendix A**. A glossary of the terms used in this submission is contained in **Appendix B**.

If you would like to discuss any of the above, please contact The Tax Institute's Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

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APPENDIX A

We have set out below our observations and overarching comments for your consideration. Our responses generally follow the questions contained in the Consultation Guide.

Current tax treatment of crypto assets

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?

The Joint Bodies consider that the current tax treatment of digital assets is generally unclear and not well understood by most taxpayers and tax practitioners. The application of the existing tax framework (which has not been designed with these kinds of digital assets and transactions in mind) results in significant interpretational complexity. The unique attributes of digital assets and transactions make it difficult to apply existing tax law principles. This difficulty arises due to matters such as:

- the lack of human agents;
- the lack of general tax statements in disclosure documentation (if any);
- difficulties in identifying the locations of developers or human teams supporting blockchain networks; and
- the volume and complexity of related activities.

Existing ATO guidance

Our members have noted that the existing ATO guidance on digital assets to date has generally been broad in description and application. It usually does not reflect the nuances and common uses of such assets. As such, taxpayers and advisers have found it difficult to apply such guidance to situations beyond relatively simple transactions. Taxpayers entering into transactions involving more factually complex scenarios have often been unable to apply the existing ATO guidance due to a lack of any general principles. We also note that complexity can arise during seemingly simple transactions as a result of the underlying technology or processes which exacerbates the challenge of applying the existing ATO guidance.

For example, in TD 2014/26 'Income tax: is bitcoin a 'CGT asset' for the purposes of subsection 108-5(1) of the Income Tax Assessment Act 1997?' (**TD 2014/26**), the Commissioner focuses only on mining, selling, and investing in digital assets. However, TD 2014/26 does not address other uses and activities involving digital assets, such as trading, forking, bridging, staking, and offering an initial coin offering (**ICO**). Further, the guidance does not provide any general principles or examples that may assist taxpayers to apply the guidance to digital assets that are not digital currencies. These include assets such as non-fungible tokens (**NFTs**), utility tokens, digital twins, or security tokens.

The Joint Bodies consider that the provision of general principles will greatly assist in the self-assessment of taxation obligations relating to digital assets and transactions, as taxpayers and their advisers can apply them to their specific circumstances. In turn, this can reduce the ATO's burden to ensure compliance through reviews and other engagements.

There are also concerns that the current ATO guidance lacks consistency and clarity, creating uncertainty and confusion for taxpayers and practitioners relying upon them. Feedback from some members of the Joint Bodies have shared anecdotes of how the ATO has issued potentially contradictory private binding rulings on digital assets and transactions that do not appear to be based on a cohesive set of principles. This may result in inconsistent tax outcomes for taxpayers.

For example, Private Binding Ruling (**PBR**) 1051694175099, dated 1 October 2020, states the following in relation to NFTs:

> 'ATO guidance paper 'Tax treatment of crypto-currencies in Australia - specifically bitcoin' confirms that the tax treatment of bitcoin can be applied to other crypto or digital currencies that have the same characteristics as bitcoin. Non-Fungible Tokens have the same characteristics as bitcoin. Therefore, Non-Fungible Tokens are CGT assets.'

As discussed below and in Appendix B, we do not consider that NFTs are akin to Bitcoin or other digital currencies, and may give rise to different tax implications.

In contrast, the ATO updated its web guidance concerning the tax treatment of NFTs on 29 June 2022 as follows:[1]

> The tax treatment of an NFT depends on:
>
> - your circumstances
> - the way you use the NFT
> - your reasons for holding and transacting with the NFT.
> - You may pay income tax on the NFT:
> - as a CGT asset under the capital gains tax (CGT) regime
> - on revenue account as trading stock
> - as part of a business
> - as a profit-making scheme.
>
> As with other types of crypto asset, in rare circumstances you could hold an NFT as a personal use asset.

Based on the above, it is apparent that the ATO has explicitly expanded the breadth of possible tax treatments for NFTs depending on the taxpayer's intentions and usage of the NFTs prior to disposal. Although taxpayers cannot rely on PBRs published on the PBR register as binding advice, there is a likelihood that taxpayers may use this as general information given the current lack of guidance on the tax treatment of NFTs. In this particular instance, there is insufficient detail in the web guidance to assist taxpayers in determining how they should recognise gains and losses on disposals of NFTs for tax purposes. As such, private binding rulings are one of the few available sources of more detailed information with specific references to legislative provisions and application of tax law principles to digital assets and transactions.

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[1] Australian Taxation Office, *Non-fungible tokens* (Web Page, 29 June 2022) https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/transactions---acquiring-and-disposing-of-crypto-assets/non-fungible-tokens/.

The Joint Bodies also have concerns over the ATO's reliance on web guidance when dealing with issues relating to digital assets and transactions. Web guidance allows the ATO to promptly provide general guidance in response to changes, and this can be helpful to taxpayers for a broad overview. The use of web guidance can benefit taxpayers if it provides them with a nimble source of reliable and historic information. However, it is currently not utilised in this way for digital assets and transaction.

The transitory nature of web guidance creates practical difficulties for taxpayers seeking to rely on it. We also note that historical versions of website guidance are not readily available to the public, making it difficult for taxpayers to locate previous web guidance on which they have relied (unless the taxpayer has downloaded a copy at the time and can manually compare versions). It would be beneficial for the ATO to provide a version history for web guidance in a similar manner to Taxation Rulings and other formal guidance products. We acknowledge that this is a problem across all of the ATO's web guidance and that the ATO is aware of this issue.

We also consider that the use of web guidance also implies a positive obligation on taxpayers to check its status at least each income year (noting that it can change throughout an income year). This burden for taxpayers to stay on top of changing advice is made more difficult as the public is usually not notified of any updates to the web guidance. While we welcome web guidance as part of a broader suit of advice products, web guidance is subject to change without notice, placing taxpayers in a difficult position if changes are made after a tax return is lodged.

A recent example of this is the updated guidance on airdrops and staking[2] made on 7 September 2022. Previously, the Commissioner regarded all digital assets received from an airdrop as ordinary income of the recipient. However, the revised web guidance now states that only digital assets that are established and already being traded should be included in the recipient's assessable income as ordinary income. Digital assets that are received as part of an initial allocation airdrop are not included in the recipient's taxable income and have a nil cost base. The guidance signalled a fundamental shift in the ATO interpretation, potentially impacting taxpayers who had already lodged returns based on the ATO's previous view. Such taxpayers would have treated all airdrops as ordinary income and may therefore have been disadvantaged by the timing of the change in web guidance.

Importantly, regardless of its content, ATO web guidance provides taxpayers with limited protection if they are subject to a review or audit. Given the general lack of understanding around the taxation of digital assets and transactions in the community, it is all the more crucial that taxpayers and tax practitioners have access to binding ATO guidance on which they can rely to ensure they are afforded certainty and can appropriately manage their tax affairs.

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[2] Australian Taxation Office, *Staking rewards and airdrops* (Web Page, 7 September 2022) https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/transactions---acquiring-and-disposing-of-crypto-assets/staking-rewards-and-airdrops/.

Decentralised autonomous organisations

The Joint Bodies consider that there is insufficient guidance or scope for Australians to adopt or utilise decentralised autonomous organisations (**DAOs**)[3] as a business structure from both a tax and regulatory perspective. From a tax perspective, it is unclear how DAOs and their members should be taxed or how a DAO's tax residency (if it is taxed as an entity) should be determined. Challenges likely exist regarding if and how an Australian permanent establishment may arise and be attributed an amount of income and expenses of the DAO.

We note that it may not always be appropriate to treat a DAO as a company or partnership for tax purposes. Each DAO may have different rules on how members participate in decision-making and receive income from holding DAO tokens that are referable back to the relevant DAO. In our view, the tax treatment should be driven by the way in which the DAO pays income to members, and their respective rights and obligations in relation to the DAO. For example, where the members of a DAO receive income jointly, it may be appropriate to treat it as akin to a partnership. Conversely, it may be more appropriate to treat a DAO that pays a portion of its profits based on its performance and other metrics as akin to a company for tax purposes. A different approach may be needed for DAOs that adopt a hybrid approach. For example, a number of DAOs distribute revenue, not profits, directly and automatically which pushes such schemes into the realm of non-entity joint ventures where each joint venture participant is responsible for determining its tax obligations with respect to the joint venture/s in which it participates. The complexities with the appropriate tax treatment of DAOs demonstrates that the provision of general principles that taxpayers can use to determine the appropriate tax outcome would be useful guidance for the public.

If a DAO is treated as an entity, the tax residency of a DAO is difficult to determine due to the decentralised nature of blockchain technology. We note that DAOs can exist at the blockchain level (e.g. Bitcoin protocol and network of miners and users) or at the application or protocol level (e.g. Maker DAO suite of smart contracts deployed on the Ethereum blockchain).

In the case of protocol DAOs where no person retains 'administration keys', the smart contract code runs on every computer and system participating in the network, which are located across numerous geographical locations. In such cases, it would be a practically impossible process to ascertain the relevant jurisdictions and residencies involved. If a tax analysis looks to the residency of governance token holders that voted in a DAO proposal, the residency, or basis of attribution to one or more permanent establishments around the world, could change multiple times in an income year. The relevant code could be located in many different locations simultaneously. In these instances, it is unclear how the central management and control of a DAO should be determined. We also note that there can be a group of individuals performing functions approved by vote of DAO members which, if performed through an incorporated service entity, are typically designed to be tax neutral (i.e. grant from DAO is allocated to expenses of performing the services).

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[3] Please refer to Appendix B for a brief overview of DAOs.

Further, DAO tokens, which give members the right to participate in the DAO's activities, for some DAOs may be more liquid than traditional stocks and equities. It would be, in our view, unreasonable to determine a DAO's tax residency based on the location of its members, as this could easily change and be in a state of constant flux during any particular income year. This difficulty is compounded by the pseudonymous nature of digital asset wallets. We therefore recommend that the Board seeks to better understand how DAOs operate and create a set of principles for determining their tax residency, potentially in step with international bodies such as the OECD.

From a regulatory standpoint, we note that DAO tokens that are referrable to a DAO may technically be at risk of being illegal, as they may breach the 20-member threshold for unincorporated partnerships and associations under subsection 115(1) of the *Corporations Act 2001* (Cth). However, the Government has demonstrated a willingness to adapt to changes in technology and encourage the uptake of digital assets and transactions on a broader scale. For example, the insertion of the definition for 'digital currency' under section 195-1 of the *A New Tax System (Goods And Services Tax) Act 1999* (**GST Act**) in 2017[4] demonstrates the Government's willingness to encourage businesses to adopt digital currencies as a payment method and use them in the economy as a driver of innovation.[5] This may be perceived as the beginning of a process towards the greater acceptance and usage of other digital assets, transactions and frameworks such as DAOs.

As such, we recommend that the Government formally recognise DAOs as a business structure. Existing DAOs should not be excluded from the continuing their operations. Not legalising DAOs as a business structure may lead to larger DAOs taking their operations away from Australia, which runs counter to the Government's apparent policy intent of attracting the use of digital assets and transactions in Australia.[6]

Initial coin offerings / token distribution events

The Joint Bodies consider that there is insufficient clarity under existing tax laws on how ICOs should be treated for income tax and GST purposes. An ICO is similar in concept to an initial public offering by companies on a stock market. An entity undertakes an ICO by seeking funding from potential investors and offering digital assets in exchange for financing.

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[4] The definition of a 'digital currency' into the GST Act was enacted on 30 October 2017 by Schedule 1 to the *Treasury Laws Amendment (2017 Measures No. 6) Act 2017*. We also note the exposure draft legislation seeking to modify this definition and make digital currencies exempt from income tax consequences, unless they are held on capital account.

[5] See Second Reading Speech to the Treasury Laws Amendment (2017 Measures No. 6) Bill 2017.

[6] Ibid.

It is currently unclear whether the proceeds from an ICO raising in the hands of the issuer should be taxed on revenue or capital account, and when the mutuality principle applies if all proceeds are used to build a protocol for the use of members. If the ICO proceeds should be taxed on capital account, it is not clear which capital gains tax (**CGT**) event should apply in relation to the gains. If the DAO can be characterised as an entity, either as a tax law partnership or tax law company (unincorporated association), then DAO tokens issued via an ICO may be an exempt as the issue of an equity interest or a non-share equity interest. We note that DAO tokens can be assets in and of themselves, but can also represent a right, or bundle of rights, making the selection of 'the most specific CGT for [the] situation' under subsection 102-25(1) of the ITAA 1997 difficult.

It is important to ensure that the distinction between the proceeds falling under revenue or capital account is correctly ascertained. If the prima facie assumption is that these digital assets are held on capital account, deductibility for the relevant expenses may be denied. This includes interest expenses on the borrowings to acquire the relevant assets, if they are on revenue account. On the other hand, it may be difficult to determine that a digital asset, which does not pay returns and is purchased as a long-term investment, has been acquired with a profit-making purpose pursuant to section 8-1 of the ITAA 1997. We note this tension in interpretation may exist for other categories of digital assets as well.

It is also unclear how digital assets offered during an ICO raising should be treated for income tax and GST purposes under the debt-equity rules in Division 974 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**). Many digital assets issued under ICOs may not pay a return to holders, making it difficult to apply the debt and equity tests under sections 974-20 and 974-75 of the ITAA 1997. As there are no returns, it would fail to satisfy the debt or equity tests, and therefore be classified as neither. However, the digital asset can be staked or used in other protocols to receive digital asset returns or rewards not necessarily connected with the revenue or profits, or other digital asset of the ICO project. The lack of returns paid by ICO issuers also makes it difficult to determine whether there is an effectively non-contingent obligation between the issuer and the asset holder under section 974-135 of the ITAA 1997. As such digital assets are listed on centralised and decentralised digital asset exchanges and the obligation, if any, to pay an amount for the ICO digital asset token is shifted to third parties rather than the ICO project.

The Joint Bodies also consider that the GST implications of an ICO are unclear. In particular, it is uncertain whether the GST exemption for financial supplies applies to digital assets issued as part of an ICO under Division 70 of the GST Act.

We therefore recommend that specific and detailed guidance and/or general principles be issued on the tax implications and considerations for issuers when preparing to launch an ICO. As ICOs become more prevalent, it is important that there is appropriate guidance to ensure that all parties to an ICO understand and are equipped to meet their tax obligations. We understand that the industry has moved away from the ICO model seen in 2017/2018 and towards a decentralised token distribution event using either Balancer protocol or Sushiswap protocol. As such, clarity around whether a disposal or cancellation event that occurs on seeding the liquidity pool is also crucial to support token distribution events through these protocols. Further, entities undertaking ICOs play a critical role in determining the jurisdictions in which digital activity is undertaken. Providing these entities with tax certainty will support an objective of attracting such activity in Australia.

Consistency across regulations

We note that digital assets may be subject to additional regulatory requirements in the future which may not be necessarily tax specific. It is important to ensure there is consistency across tax and non-tax regulations to the extent possible. For example, potential changes made to the Australian Financial Services License should have consistent principles and definitions regarding digital assets and transactions. We note that the potential rules surrounding digital asset secondary service providers and the International Financial Reporting Standards (**IFRS**) may provide guidance on the consistency of these terms.

Non-fungible tokens

The Joint Bodies consider that there is insufficient guidance on the tax treatment of NFTs[7] and other digital assets that are not a medium of exchange. Members of the Joint Bodies have raised concerns around the general remarks in the Consultation Guide that the taxation of NFTs 'follows the same general principles as cryptocurrencies.'[8] We note that the ATO has published web guidance on the use of NFTs to similar effect.[9] We do not consider that this is an accurate reflection of the nature and usage of NFTs. It may not be appropriate to approach the taxation of NFTs in the same manner as digital currencies as the two categories of assets are functionally and characteristically distinct from one another. It is also important to recognise that metadata can be stored on-chain, on the InterPlanetary File System (**IPFS**) or on off-chain (e.g. private servers), which can impact characterisation of the tokens as well as the tax implications.[10]

In particular, we consider that it would be beneficial to clarify the factors and situations that lead to an NFT being classified as a collectable or personal use asset, under sections 108-10 and 108-30 of the ITAA 1997. Although the ATO's web guidance alludes to the fact that NFTs may be classified as personal use assets in rare circumstances, it does not provide any principles or guidelines to assist taxpayers and advisers in making such a determination.

There are also issues pertaining to those taxpayers in business and the application of the GST regime where NFTs are involved. The current definition of a digital currency is unlikely to capture such digital assets. As such, the issue of double taxation remains, along with other challenges in compliance.[11]

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[7] Please refer to Appendix B for a brief overview of NFTs.

[8] Board of Taxation, *Review of the Tax Treatment of Digital Assets and Transactions in Australia*, page 10.

[9] Australian Taxation Office, *Non-fungible* tokens, https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/transactions---acquiring-and-disposing-of-crypto-assets/non-fungible-tokens/.

[10] As discussed in Elizabeth Morton and Michael Curran, 'Understanding Non-Fungible Tokens and the Income Tax Consequences' (SSRN Paper, 12 April 2022) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4174666.

[11] Peter Murray and Joni Pirovich, 'The taxation of cryptocurrencies' (NSW Annual Tax Forum, 25 May 2018).

Bridging tokens and events

The Joint Bodies consider that the tax implications of the different kinds of bridging events are unclear, as some bridging events do not involve the trading or exchange of one digital asset for another. In such cases, there is unlikely to be a disposal for tax purposes. It would be beneficial for the ATO to issue guidance (or legislative and regulatory changes to be made if clarity is needed from Parliament) on the tax treatment of each kind of bridging event, based on the economic substance of each event.

The Joint Bodies have identified the following issues relating to bridging tokens and events:

- *Is the transfer of a digital asset from one blockchain to another considered a disposal for tax purposes?*
  - It depends on the bridging approach and intent of the taxpayer. There are centralised and decentralised cross-chain bridges:
    - **Centralised bridge**. This type of bridge requires that the parties entrust an entity to facilitate the bridging of digital assets. This entity can be either:
      - a custodian (where the token is a financial product) or a third party that may hold the digital asset on behalf of another (where the digital asset is not a financial product), who holds the source token and issues the bridged token to the user on the destination blockchain;[12] or
      - a blockchain bridge protocol where users 'lock' the source token in the protocol, and a number of third-party protocol participants jointly authorise the issuance of the bridged token on the destination blockchain.
    - **Decentralised bridge**. These bridges are operated by a series of smart contracts. Where the source token is 'locked' in the bridge's smart contract on the source blockchain, the smart contracts automatically and algorithmically issue a new token on digital asset destination blockchain.
  - A centralised custodian or third party who holds a digital asset on behalf of another may have clear terms and conditions to describe the legal relationship to determine whether a CGT event or taxable event has occurred, but the exercise is not as simple with either a centralised blockchain bridge protocol or a decentralised bridge where a collection of materials and source code may need to be analyzed (the heavy onus of which is on the taxpayer) to determine the technically correct approach.
- The reason or intent for bridging is often (if not always) to access utility on the other blockchain or other layer, not to make a gain by the act of bridging.[13]

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[12] These entities can be incorporated entities. For example, BitGo is the custodian for the issuance of Wrapped Bitcoin.

[13] Layer 2s (**L2**) are a scaling solution that sit on top of, and rely on, Layer 1 (**L1**) (in this case, Ethereum's base layer) and enable users to transact quickly and cheaply.

- The broader intent of moving to a different blockchain could likely be for a profit-making purpose to use the source token as collateral in lending, staking and yield farming, or may be a means to manage one's risk by moving assets to a more secure blockchain or layer.
- The utility may already exist on the layer 1 (**L1**) (or it may not) but typically the gas fees to engage with the utility on layer 1 are higher than layer 2 (**L2**). A tax cost of moving from L1 to L2 could distort taxpayer behavior and stifle utility innovation on L2.
- There is also a disposal event on each disposal of Ethereum (**ETH**) for gas on L1, but the tax implications of these disposal events would pale in comparison to the potential gain (or loss) of bridging a large volume of a digital asset. ETH (or other native blockchain tokens) held on account of payments for gas should be treated as currency and a threshold determined for such transactions to be ignored for tax purposes.

- In addition, one can transfer ETH, as well as other digital assets, from L1 to an L2. The price of a digital asset held on an L2 may deviate from the price displayed on L1 DeFi exchanges and reputable centralised exchanges. This may also be the case with respect to digital assets that are bridged to other blockchains.
  - In some instances, the new digital asset might have additional or less characteristics. For example, native ETH on the Ethereum network requires a user to pay for mining fees, whereas if it is bridged to the Binance Smart Chain (**BSC**) network this is no longer the case.
  - There may also be a difference between digital assets bridged to other blockchains and digital assets bridged to different layers. For example, ETH that is bridged to an L2 may often be regarded as being equivalent to L1 ETH. However, ETH that is bridged to another chain may not be, as it is not issued by the Ethereum network, but by the bridge.
  - As a counterpoint, fiat currency pegged digital assets like US Dollar Coin (**USDC**) are meant to represent the US Dollar on a 1:1 basis, whichever network the stablecoin is circulating on, but not all stablecoins effectively maintain their peg.
- *Would bridging USDC from one network to another be seen as a disposal for tax purposes?*
  - In reality, each digital asset is tracked and recorded by the blockchain ledger unless privacy or shield technology is used. Income tax is not the key issue with respect to stablecoin transactions where the stablecoin reliably maintains its peg. Rather, GST is the key issue if the stablecoin does not meet the GST definition of 'digital currency'.

Liquidity pools

The Joint Bodies consider that there is insufficient guidance on the tax implications of contributing and withdrawing finance from a liquidity pool. We understand that His Majesty's Revenue and Customs (**HMRC**) published guidance[14] suggesting that the provision and removal of liquidity each trigger disposal events for United Kingdom (**UK**) tax purposes (rather than each third-party trade with the liquidity pool when beneficial ownership of the liquidity pool tokens actually does transfer to a third party). The value difference would trigger capital gains or losses.

We note that the ATO has not provided its views on liquidity pools and some members of the Joint Bodies disagree with HMRC's view. A taxpayer can often still demonstrate an ongoing beneficial connection to the assets in the liquidity pool until each time a third-party trades with the pool and there is the receipt of one digital asset as consideration for the disposal of the other digital asset as well as trading fee income.

The above describes the issue regarding the characterisation of particular transactions as part of a whole (i.e. a bundle of rights) rather than as separate events. As a counterpoint to the above, some tax practitioners view a contribution of digital assets to a liquidity pool in return for a liquidity pool token as analogous to disposing of property as consideration for acquiring a unit in a unit trust, where trading fee income earned (in some cases block by block) is treated as analogous to receiving and deriving an annual distribution from the unit trust. We therefore recommend that the Board considers how providing and withdrawing finance to liquidity pool should be treated for tax purposes.

Wrapped tokens

Wrapped tokens are smart contracts that are tied to particular digital currencies at a 1:1 value. They enable holders to access a broader range of decentralised applications and services, and provide more opportunities for staking and investing. For example, wrapped Ethereum is an Ethereum Request for Comment 20 (**ERC-20**) compatible version of Ethereum which is exchanged at a 1:1 ratio with Ethereum.

The tax implications of wrapping Ethereum and other digital currencies in a smart contract remain unclear with mixed views on whether such an activity (such as wrapping Ethereum as a technological solution to compatibility issues) constitutes a disposal event for CGT purposes. A common view is that wrapping should not be treated as a disposal event because the taxpayer's ongoing connection to the wrapped ETH in the wrapping contract can be demonstrated and thus they remain an absolutely entitled beneficiary of a bare trust. We therefore consider that it would be helpful for the Board to form a view and recommend how the laws and regulations should govern the tax treatment of wrapped tokens.

Stablecoins

Stablecoins are digital assets where the price is linked (i.e. 'pegged') to the value of a reference asset which may be fiat currency, or a commodity or financial instrument. Holders of stablecoins can keep their funds in digital assets which are intended to avoid the risk and volatility of other digital assets such as Bitcoin or Ethereum. We consider that there should be guidance on how gains (and losses) on stablecoins should be treated for tax purposes.

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[14] Her Majesty's Revenue and Customs, *CRYPTO60000 - Decentralised Finance* (Web Page, 22 February 2022) https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto60000.

Staking rewards

The Joint Bodies have concerns about the ATO's position on the treatment of staking, namely that it is treated as ordinary income at the time it is derived.[15] The concern is that this view does not properly reflect the underlying mechanisms of a Proof of Stake blockchain, nor the attitude and purpose of investors generally who engage in staking.

Such a view can be detrimental to the financial liquidity of investors as they may not have the immediate cash funds to cover any resulting tax liabilities. Staking rewards in liquidity mining (protocol level) schemes are akin to the creation of new assets, rather than the proportional allocation of annual profits (as share dividends would be). As such, staking activities in the context of liquidity mining schemes do not represent a payment of interest on an investment, nor are they, strictly speaking, a 'distribution', nor the distinction between protocol level staking versus blockchain level staking.

However, staking schemes that are schemes to distribute revenue or profits of a protocol should be treated as assessable income at the time derived. The derivation time is important because a lot of staking schemes require the 'staker' to claim, and the staking rewards are at risk until claimed. Arguably, staking rewards under such schemes are not derived until claimed. This is particularly relevant in light of Ethereum's recent upgrade to use Proof of Stake (i.e. blockchain level staking), where rewards earned by stakers were locked and inaccessible until the upgrade to the network was made.

We suggest that the Board consider the appropriate tax treatment of staking and whether changes to the ATO's published position should be recommended.

Types of digital asset-related activities

The Joint Bodies considers that there is insufficient guidance on the tax implications relating to digital asset-related activities beyond investing and trading activities. As technology has developed over time, digital assets have been applied and used in a variety of ways. We consider that guidance regarding the tax implications of the following should be provided:

- DeFi[16] — it is unclear how DeFi transactions such as derivatives and other financial instruments on the blockchain should be treated for tax purposes. A lending example is provided below.
- P2E and GameFi[17] — it is unclear when players and participants make a gain (or loss) for tax purposes, and whether such gains should be taxed on revenue or capital account.

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[15] Australian Taxation Office, *Staking rewards and airdrops* (Web Page, 7 September 2022) https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/transactions---acquiring-and-disposing-of-crypto-assets/staking-rewards-and-airdrops/.

[16] Please refer to Appendix B for a brief overview of DeFi.

[17] Please refer to Appendix B for a brief overview of P2E and GameFi.

- We note that many users of P2E and GameFi systems tend to be minors who are largely unaware of potential income tax consequences of these activities. We consider that a policy needs to be developed about whether these types of transactions are intended to have tax implications. For example, a safe harbour could be introduced for minors who are not undertaking P2E and GameFi transactions with the intention of making a 'real world' gain.

- Lending — digital assets can be loaned to other individuals using decentralised lending protocols such as Compound and Aave. Users are able to lock up digital assets with the protocol's smart contracts and in return are provided with interest bearing digital assets that are representative of their deposit. These interest-bearing assets are able to be staked to earn digital asset returns (i.e. secondary income streams) and posted as collateral for borrowing, all while continuing to accumulate interest. Users return these digital assets to the protocol to receive their initial deposit plus earned interest. In this instance, questions arise as to whether the locking up of digital assets in a lending protocol and the return of the interest-bearing digital assets to the protocol would be treated as disposal events, and when interest earned on the deposited digital assets would be recognised for tax purposes (i.e. on a accruals or realisation basis).
- Creative industries — the tax considerations and implications of creating NFT artwork or displaying artwork linked to NFTs in an online gallery. Activities can have tax implications on revenue or capital account, in relation to secondary income streams (outlined below) as well as a multitude of taxing regimes (income, GST, royalties, withholding taxes etc.), traversing on-chain and off-chain activities.
- Secondary income streams (referred to in the lending example above) — it is unclear how income streams should be taxed in terms of the principles of timing, derivation and whether they should be treated on revenue or capital account. For example, it should be questioned whether the digital asset returns or rewards from the secondary income should be stream treated as derived only when:
  - the digital assets from the first level activity have been unwound; or
  - the income is accrued in Australian dollar terms, yet there is no ability to convert part of the income into Australian dollars or Australian dollar stablecoins to reserve to meet any associated tax liabilities.

  Secondary income streams may give rise to royalty payments, whether under the ordinary meaning or statutory meaning pursuant to subsection 6(1) of the ITAA 1936. If so, this will have implications for double tax agreements, including deeming an Australian source and giving Australia taxing rights over such payments.
- One-off profit-making schemes — the current ATO guidance appears to indicate that disposals of digital assets that may be part of a one-off profit-making schemes are taxable on capital account.[18] The guidance does not appear to contemplate the applicability of section 25-1 of the ITAA 1997 in these circumstances. Further, the guidance does not account for the fact that digital assets may be held on either capital account or as trading stock as part of a profit-making scheme, depending on the specific facts and circumstances.

[18] Australian Taxation Office, *Cryptocurrency and Tax*, https://www.ato.gov.au/General/Other-languages/In-detail/Information-in-other-languages/Cryptocurrency-and-tax/.

- Airdrops[19] — ATO web guidance initially stated that airdrops are included in a taxpayer's ordinary income at the time they receive it.[20] This position did not contemplate the broad range of circumstances surrounding airdrops. While the updates in September 2022 have gone some way to recognise the need for action, they do not necessary align with the current definition of ordinary income. In order to understand whether airdrops may be more accurately characterised as gifts, or whether an appropriate nexus with some action can be established, it is important to firstly ensure clarity over the definition of airdrops. Importantly, airdrops in many instances represent scams and other undesirable, or unwanted, receipts.
  - For example, if a digital asset were issued to all holders of an existing digital asset by an unrelated party who does not require any services to be performed in exchange for the digital asset, it is not clear how it may be said that ordinary income has been derived by the recipients according to general concepts.
- Forks[21] — the tax consequences of a fork (which the Commissioner refers to as chain splits) occurring are unclear. In particular, it is unclear whether a CGT event occurs when a particular blockchain forks, whether section 112-25 of the ITAA 1997 applies, and (if not) the resulting cost base of associated digital asset after the fork has occurred. Litigation has been on foot against the Commissioner of Taxation since late 2020 to clarify this issue and is hoped to be resolved in early 2023.[22] However, in this case the applicant is seeking declaratory relief rather than Part IVC proceedings and the Commissioner has brought a number of interlocutory proceedings. As such, case law may not provide guidance on the tax implications of forks in the near future.
- Rebase tokens[23] — where more digital assets are issued to an existing digital asset holder, it is unclear whether the additional digital assets should be treated as a dividend, and/or a return of capital and/or an interest-like receipt and/or not taxable. Furthermore, if the underlying digital assets are held as an investment on capital account, it is unclear whether the receipt of additional digital assets are treated as a capital receipt.

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[19] Please refer to Appendix B for a brief overview on airdrops.

[20] Australian Taxation Office, *Staking rewards and airdrops*, https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/transactions---acquiring-and-disposing-of-crypto-assets/staking-rewards-and-airdrops/.

[21] Please refer to Appendix B for a brief overview on forks.

[22] See *ASZ21 v Commissioner of Taxation* [2021] FCA 1304.

[23] Please refer to Appendix B for a brief overview of rebase tokens.

- Splits — splits are commonly confused with forks and are not well understood by taxpayers or tax practitioners. This often results in the tax consequences for splits being conflated with those for forks, which also remain unclear. We note that the tax treatment of splits is currently being considered by the Federal Court.[24] However, in this case the appellant is only seeking declaratory relief and the matter may not proceed any further if the Commissioner issues amended assessments. As such, if this issue is not further considered, case law may not provide guidance on the tax implications of splits in the near future.
- Redenominations — A digital currency can be redenominated (e.g. from 1 to 1000). This might be done algorithmically by a protocol to lower the overall price of the currency. To facilitate the redenomination, the protocol might issue a new digital currency and render the old digital currency no longer supported. In this instance it is unclear whether the change in the digital currency would be treated as a disposal for tax purposes or if the transaction would fall within the CGT treatment for 'split, changed or merged' assets.

We also consider that there should be guidance on how the royalty and withholding tax rules apply in the context of digital assets and transactions. Due to the ubiquity of the code supporting blockchain technology, it is difficult to tie particular assets and transactions to specific jurisdictions. In the longer term, there may need to be a reconsideration of the legislative framework surrounding royalties and withholding tax on transactions involving digital assets.

Tracking and tracing gains on digital assets

The Joint Bodies considers that the current approach of requiring taxpayers to report and track all gains and losses on digital assets and transactions places an extremely high compliance and administrative burden on taxpayers. This compliance burden is exacerbated by the lack of supporting software that can assist taxpayers substantiate their engagement in transactions involving digital assets.

Depending on the kinds of digital assets invested in, taxpayers may need to exchange Australian dollars into another digital asset and undertake several transactions in order to purchase their desired digital asset. A similar process can occur when the taxpayer decides to convert their digital asset holding into Australian dollars. Depending on the number of legs in the transaction, the process of tracking and tracing the relevant gains and losses on each leg of the transaction may be time consuming. This issue is amplified when a taxpayer engages in a high-volume of small-value transactions. Although the resulting tax implications may be negligible, significant time and compliance costs are required to calculate the resulting gains or losses.

A related issue is whether taxpayers should be able to trace through digital asset to the relevant digital or physical asset when transacting with asset-backed tokens. A tracing provision may somewhat simplify the tax treatment of these types of transactions. However, as the value of the token itself is distinct from the related assets, it is unclear how far taxpayers should trace through to calculate their gains and losses on such transactions.

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[24] See *ASZ21 v Commissioner of Taxation* [2021] FCA 1304.

We therefore recommend that specific guidance is developed on how gains and losses from trading and exchanging digital assets should be tracked and recognised for tax purposes. Please refer to our responses to Questions 9 and 11 for more specific recommendations in this regard.

Members of the Joint Bodies have also raised the following issues concerning record-keeping by exchanges and taxpayers:

- NFT project issuers are not collecting data on whether sales are made to or by Australians for the purposes of GST.
- It is unclear whether digital asset platform operators are included in the definition of 'electronic distribution platforms' under current legislation and under the as-yet-unlegislated 'sharing economy reporting regime' rules.[25]
- The tracking of secondary sales is limited with no collection of tax residency data of the original artist, vendor or buyer to be able to determine royalty withholding tax implications and obligations. A similar issue exists for interest withholding tax in relation to interactions with DeFi lending protocols, and dividend withholding tax for revenue distribution schemes offered by DAOs.
- The ATO's expectations of exchanges, digital asset holders and developers in terms of information collection and tax reporting information have not been communicated publicly. For example, exchanges or developers could consider providing tax information to digital asset holders annually like Exchange Traded Funds (**ETFs**). In addition, the data sources for the ATO's pre-filling could be improved to assist taxpayers with meeting their tax obligations.

Valuation of digital assets

We consider that there is insufficient guidance to support taxpayers and their advisers in valuing digital items for tax purposes. The establishment of the cost base for CGT purposes can be especially challenging for airdrops and staking rewards.

There is uncertainty as to how to properly value certain digital assets as the ATO's view of valuation techniques in relation to these items is unclear. As a result, some taxpayers may be assuming, for example, a zero-dollar cost base even when an alternative market value cost base may be available.

Valuation and pricing can also be challenging due to the volatility of the market and there is no industry-specific guidance to assist taxpayers. While crypto-tax software is able to monitor market prices across a range of exchanges and markets, further clarity from the ATO is required to determine the appropriate prices to use and the types of pricing data that are acceptable. Gas fees may also lead to price differentials.

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[25] As contained in Schedule 1 to the Treasury Laws Amendment (2022 Measures No. 2) Bill 2022 https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6760 which is before the House of Representatives for debate at the time of writing.

Price data can be obtained from both centralised and decentralised exchanges as well as digital asset aggregators like coinmarketcap and coingecko. However, further clarity is required on what the ATO considers to be a 'reputable digital assets exchange'.[26] In particular, it is unclear whether 'reputable' means reputable source for digital-asset pricing only, or for valuation of other assets more broadly. From a tax perspective, decentralised exchanges may be more reliable than centralised exchanges because the automation is supposed to reflect the best market price. However, these exchanges may be subject to other forms of risk that impact their reputability.

NFTs are even more complex as they are not currency or typically traded as such, yet hold value. NFT holders can also be given entitlements to fungible tokens. For example, during the 'Bored Ape' fungible token drop, users had a 90-day window to claim their tokens.

In such a case, it is unclear how the option to claim the token should be valued. It could be the exercise price or the value of the fungible token as soon as it is first listed on a decentralized exchange for trading. As such, we consider that it would be helpful for the Board and ATO to develop clear principles for valuing digital assets and provide examples of reputable sources for valuing digital assets to support taxpayers in calculating their gains correctly.

Permitted investments for certain investment vehicles

Certain early-stage venture capital limited partnerships (**ESVCLPs**) are unable to invest in digital assets. This is primarily due to the prescriptive nature of the current regulatory settings.

In relation to ESVCLPs, digital assets are outside the scope of permitted investments. As a result, early-stage ventures involving digital assets are unable to undergo the same vetting process as ventures involving traditional asset classes. This makes it difficult for such kinds of enterprises to test and refine their operations in a suitable setting, with regulatory support and concessions.

We note that this issue has been raised with the Department of Industry, Science and Resources (**DISER**) through Industry, Innovation and Science Australia (**IISA**). However, we have not yet seen guidance or any changes from DISER or IISA on the regulatory restrictions surrounding digital assets. We understand this is due to the limited resources available at these organisations. We recommend that the Board examine the rules governing ESVCLPs and ensure that they allow investments into digital assets.

Practical hurdles for investing in digital assets for other investment vehicles

In relation to Attribution Managed Investment Trusts (**AMITs**), some members of the Joint Bodies have noted that AMITs are disincentivised from investing in digital assets due to the additional compliance burdens compared to other asset classes. These compliance burdens are in relation to the requirement to track and trace gains and losses on each individual transaction. We note that AMITs are currently able to simplify the calculation of gains and losses on traditional assets classes, such as shares and bonds, using the:

- taxation of financial arrangements (**TOFA**) rules in Division 230 of the ITAA 1997;

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[26] See, for example, Australian Taxation Office, *Crypto to crypto exchange or swap* (Web Pag, 19 August 2022) https://www.ato.gov.au/Individuals/Investments-and-assets/Crypto-asset-investments/Transactions---acquiring-and-disposing-of-crypto-assets/Crypto-to-crypto-exchange-or-swap/.

- foreign currency translation rules under Division 775 of the ITAA 1997; and
- capital account election under Subdivision 275-B of the ITAA 1997.

We consider that equivalent concessions should be made to AMITs to allow for simplified calculation of gains and losses relating to digital assets. In particular, AMITs should be able to apply the capital account election to digital assets into which they invest. This may be achieved through an amendment of section 275-105 of the ITAA 1997 to treat such assets as covered assets for the purposes of the capital account election. This would simplify the calculation of gains and losses for AMITs investing in digital assets and provide investors with greater opportunities to diversify their holdings by investing in digital assets and leveraging the expertise of fund managers. We note that some digital assets, such as stablecoins linked to foreign currencies, may not fall within the scope of such a deeming rule, especially if they are primarily used as mediums of exchange.

Other key areas for reform

In addition to the areas above, the Joint Bodies consider that the following issues should be addressed as a priority in any initial reforms, to serve as a foundation for future legislative and regulatory developments for digital assets and transactions.

- There should be clear principles for defining digital assets that are technology neutral. This will ensure the framework for the taxation of digital activities is future proofed and allow such definitions to remain relevant with any future changes and developments.
- Blockchain protocol activities should be better understood to allow tax laws and regulations to better reflect the underlying systems and processes powering digital assets and transactions. An education campaign is required in this regard, for government, tax practitioners and taxpayers alike, adapted to the various audiences.
- There should be clear guidance on the timing of income and expenditure in the context of digital asset transactions.
- There needs to be clear principles to assist in valuing digital assets for calculating the value of income and expenses, and gains and losses on such items.
- There needs to be clear guidance on which jurisdiction has the right to tax transactions involving digital assets given the ubiquity of blockchain networks and difficulty in pinning down the location of participants on blockchain networks.
- The legal and regulatory framework should set out how distinctive characteristics of digital assets and transactions may impact their tax treatment.

The Joint Bodies consider that it would be prudent to revisit these fundamentals as part of a medium- or longer-term review.

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?

The Joint Bodies consider that digital assets and transactions are not necessarily incompatible with Australia's existing tax laws, but the tax entity characterisation of a DAO is arguably incompatible in that there is no clear tax entity characterisation yet. Although the existing law and guidance are somewhat capable of being applied to digital assets and transactions, the factual complexities and continual evolution of the technology in this area make it difficult to apply the existing rules in practice. Even in circumstances where the legal principles themselves may be clear, there is a significant degree of uncertainty around how such principles apply to the facts. There is also uncertainty regarding the presence, or absence, of particular attributes, and the factors that should influence the tax consequences.

There are differing views on how these uncertainties should be addressed, with advantages and disadvantages under each pathway. In the future, there may be merit in establishing a new legislative framework to regulate and tax DAOs and digital assets and transactions more generally. The advantage of such an approach is that the key definitions and principles regulating DAOs, digital assets and transactions would be contained and codified under a single body of legislation. This would reduce the need to make piecemeal changes across various Acts and regulations to keep pace with future changes in technology.

The existing framework is somewhat sufficient in terms of taxing digital assets and transactions and the focus could be future proofing the framework and developing appropriate supporting guidance. Under this approach, the objective should be providing guidance and education to enable taxpayers and tax practitioners to apply common principles to the taxation of digital assets and transactions. A benefit of this approach is that it does not carry the risk of introducing greater complexity in the broader taxation framework by creating a new, standalone regime for DAOs, digital assets and transactions.

We recommend that the Board explores the various alternative approaches, including those described above, in consultation with the ATO, Treasury and external stakeholders.

As outlined above, we consider that a forum should be created to regularly discuss the underlying issues and ensure that ATO guidance and potential legislative developments are canvased and tested. The forum would ideally consist of representatives from the Board, Treasury, relevant government bodies (such as the ATO, ASIC and Austrac), industry experts and professional taxation and industry bodies. The creation of a forum will ensure that developments in digital assets and transactions, and the respective tax implications, are considered and addressed in a timely and coordinated manner. It will also allow for thorough consideration of the appropriate longer-term approach for the taxation and regulatory treatment of digital assets and transactions.

Short-term approach

In the short-term, we recommend that the Board focuses on the issues and recommendations highlighted in our response to Question 1 above. Many of our suggestions seek to utilise the existing framework to manage issues arising from the taxation of digital assets and transactions. Managing the taxation consequences through our current system will prevent any unintended consequences arising from a separate framework. If the application of the existing framework is unmanageable, any shortcomings will provide greater insight and foster a better understanding of the requirements of a more suitable taxation framework.

In addition, we recommend that the Board should complement its existing token mapping exercise as recommended by the Senate Select Committee[27] with a transaction mapping exercise. This will allow for a better understanding of the economic, commercial, and practical substance of the different kinds of digital asset transactions. It will also allow for a comprehensive understanding of the fundamental features that may indicate that a digital asset is held on capital account or used as a medium of exchange. This may provide objective factors that can be used as guiding principles to determine the intentions behind a taxpayer's acquisition, use and disposal of a digital asset. As noted above, a taxpayer's intentions for a given transaction may impact the treatment under certain tax concepts such as whether a disposal has occurred, or if the transaction occurred on revenue or capital account. We consider that the Board should focus on transactions that have not been clearly addressed in current guidance, such as those outlined in our response to Question 1 above.

For example, there are a various DeFi transactions that may take place on a blockchain network. Some of the transactions may or may not involve the exchange of digital assets for others. It would be beneficial for the Board to seek to understand the economics behind the various types of DeFi transactions and determine whether users should be taxed on entry or exit from a DeFi transaction.

Medium to long-term approach

In the medium to long term, we recommend that the Government look to establishing a clear tax framework for digital assets and transactions beyond the short-term solutions listed above. As noted above, whether this framework consists of modifications to our existing laws, or a new set of tax laws and other regulations requires further consideration. Further consultation should be undertaken to determine the appropriate approach, and design and implement a framework which prioritises simplicity and efficiency, and ensures equitable tax outcomes. This period will also allow government to clearly state its intended policy objectives surrounding digital assets and transactions with the benefit of feedback from this Review.

Awareness of the tax treatment of digital assets

At a high level, the Joint Bodies consider that there is a general lack of awareness in the community about the tax treatment of digital assets and transactions. This lack of awareness is fuelled by the underlying complexity surrounding DAOs, digital assets and transactions, and how the concepts integrate with existing concepts used throughout the Australian tax system.

It is also important to recognise that for those with the awareness of the tax treatment, this does not necessarily equate to agreement. There can be a significant lack of consensus in the tax treatment of digital assets and transactions.

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[27] The Senate, *Select Committee on Australia as a Technology and Financial Center*, https://parlinfo.aph.gov.au/parlInfo/download/committees/reportsen/024747/toc_pdf/Finalreport.pdf;fileType=application%2Fpdf, 136.

A lack of awareness as to the challenges in implementing tax treatment is also noted. That is, where there is an understanding that a particular tax treatment ought to apply, there can be fundamental challenges in the logistics of implementing that treatment. This can be either due to the lack of specificity in guidance (e.g., while rewards may be considered to be income being derived, there can be a fundamental issue in timing) or practical challenges (e.g., with respect to high levels of data, valuation methods, customer location data etc.).

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?

Feedback from members of some of the Joint Bodies has indicated that there is a significant disparity in the tax awareness of businesses that deal with digital assets compared with those that only accept them as a form of payment for other products and services. It is our understanding that businesses that are actively engaged in the digital assets space are generally more knowledgeable about the underlying technology and in a somewhat better position to understand how the tax laws may apply.

That said, the lack of clarity around the issues identified in our response to Question 1 prevents businesses of any kind from having a comprehensive awareness about the tax treatment of digital assets and transactions. As such, awareness may be improved by increasing the clarity and consistency of the guidance on the application of the relevant law and regulations. There is also an important role for ongoing education for the community on the tax implications for digital assets and transactions. An education strategy will increase public awareness and facilitate easier compliance with existing tax obligations.

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

The Joint Bodies are of the understanding that retail investors generally have minimal or only high-level awareness of the tax implications surrounding income and gains derived from digital assets and transactions. This lack of sophisticated awareness is due, in part, to a lack of specific principles that should apply to the different kinds of digital assets and transactions for tax purposes, or practical difficulty in their application. As noted above, the relevant tax rules are complex and unclear in relation to key asset classes and transactions in which many retail investors are engaged.

There are also significant practical difficulties with taxpayers seeking to substantiate their tax position. The current stringent record-keeping rules that require taxpayers to track and trace gains and losses on all transactions, are onerous and time consuming for taxpayers to maintain. This is especially the case where individuals are engaged in a high number of low-value trades that result in negligible tax outcomes on a standalone basis, compared to the time-costs involved in calculating their overall taxable gains. The problem is compounded if each transaction involves multiple steps that may have their own tax implications. As a result, there is a risk that the current self-assessment and self-lodgement regime may result in taxpayers lodging erroneous tax returns or not being able to comply with their tax obligations without going to great lengths and potentially incurring significant costs.

In this regard, we note that tax advice relating to digital assets and transactions can be relatively costly due to the time required for practitioners to understand the specific facts and application of the law. A digital asset's lending protocol, its underlying economic principles and governance model is not the same as the next. Feedback from members of the Joint Bodies indicates that taxpayers usually do not understand the time commitment for advisers and may be unwilling to incur the cost of seeking professional tax advice regarding their digital assets and associated transactions. Tax practitioners are reporting challenges with respect to time and value, reliability and availability of information, and capacity for clients to provide adequate information, to meet substantiation requirements.[28]

Further, many retail investors rely on specialised tax calculation websites, such as Koinly and CryptoTaxCalculator, to determine their tax obligations. It is currently unclear whether such websites are providing, or being relied on as if they are providing, tax agent services even where they are not explicitly marketed as such. We consider that technology has a crucial role to play in ensuring accurate tax compliance, however there is a fundamental risk for tax practitioners in complying with codes relating to professional conduct (such as the Tax Agent Services Act Code). The resources mentioned above by way of examples are generally used as aggregation resources that track a taxpayer's transactions, but are not able to identify the taxpayer's intention for entering into the transaction. It would be beneficial for the ATO to work with such providers to help create a transaction list that can assist tax practitioners reduce the time and cost involved in preparing tax advice, reducing the current cost disincentive for taxpayers seeking advice. This may be undertaken in arrangements similar to the current ATO groups that work with taxation and superannuation software providers such as MYOB, Xero and CLASS.

We reiterate that many of those engaged in the digital assets and transactions space, particularly in the context of GameFi, are relatively young and unfamiliar with tax. Such individuals are likely to have limited awareness about the role of the tax system and the associated implications for digital assets and transactions. Many of these individuals are unlikely to seek professional, independent tax advice, or prepare their tax returns correctly, if at all, creating a risk of default assessments and falling into tax debt. The experiences of these individuals during this period may have an impact on their future compliance with their taxation obligations. It is important to ensure an equitable outcome for these individuals, who may be entering into these transactions as a hobby, even if they intend to make money that will be spent on other digital or physical assets. We also note that if these individuals do not have tax file numbers, there may be further difficulties associated with identification and compliance.

[28] Elizabeth Morton, Gillian Vesty, Lan Nguyen and Ken Devos, 'The crypto-economy and tax practitioner competencies: An Australian exploratory study' (Working paper, 2022). Further details of this can be provided on request.

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

The Joint Bodies consider that wholesale investors generally have a better awareness of the tax treatment of digital assets and transactions compared to retail investors. This is likely due to the availability of resources and access to specialised tax knowledge, either internally or through external advisers. However, as mentioned in our responses to Questions 1 and 3 above, even for sophisticated investors, there is uncertainty about how certain classes of digital assets and transactions are treated for tax purposes which limits the availability of reliable advice.

The strict record-keeping and substantiation requirements are likely to impact wholesale investors to a greater extent, assuming they undertake larger scale or more complex transactions. As noted above, we consider it important for the ATO to work with technology providers to minimise the substantiation and record-keeping costs.

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

Style and messaging of guidance

Some members of the Joint Bodies have observed that current ATO guidance can be too sophisticated for certain taxpayers to read and understand. It is important for such advice to be made more accessible. This can be achieved by, among other things, making the text less formal, and providing clear and concise examples and answers to direct questions. In addition, creating summaries, flowcharts and infographics may assist taxpayers to engage with ATO guidance more readily. Translations in languages other than English which are commonly used in Australia would also ensure greater reach. Further, it is important for this advice to provide taxpayers with an appropriate level of protection if relied on in good faith.

Educating younger individuals

As discussed in our response to Question 4 above, a large number of individuals investing in digital assets and engaging in digital transactions are younger individuals who are unlikely to have a sound level of awareness about tax generally. If it is Government's intended policy to tax these individuals on gains arising from these transactions, there needs to be guidance and resources appropriately tailored in a structure and format that young people can readily access and understand. The focus should be on helping them understand the relevant tax principles, rather than using technical terms or documents in the style of other ATO guidance products. For example, a younger audience may resonate more with audio-visual material, compared with reading text in the form of web guidance.

The way in which this material is disseminated is also crucial to its efficacy. Proactively using a combination of mediums such as social medial platforms and providing information through schools in a holistic strategy will be more effective than simply publishing information on the ATO website which may suffice for more sophisticated users who regularly frequent the ATO website for other guidance.

Ensuring minors are provided with easy to access and understand guidance regarding their potential taxation obligations will also encourage voluntary self-compliance in the future. To achieve this, minors should not be subject to taxation outcomes that are perceived as unfair or inequitable, such as incurring a tax liability for simply playing a game online. Further, any taxation liabilities need to be easy to understand and apply.

Usage of crypto tax software

We consider that the ATO should review the services provided by specialised tax calculation websites, and provide an assurance that its compliance resources will not be allocated towards reviews of calculations undertaken in good faith in reliance upon such services. This approach would require the ATO to work with these software providers to ensure that the tax outcomes of the underlying calculations are accurate and reliable. It will also require the creation of sound principles and guidance that can assist software providers to tailor the tax outcomes based on the taxpayer's individual circumstances. For more information on these principles, please refer to our response to Question 1 above.

The increased use of crypto tax software will reduce the barriers for retail investors to meet their compliance obligations, especially if the software is able to track the majority of the transactions undertaken by the user. Further, some of the current challenges for tax practitioners would be reduced as they could rely on an accurate and largely complete list of transactions regarding their clients' digital asset tax affairs.

Characteristics and features of crypto assets

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

The Joint Bodies consider that the ATO will need detailed information in order to properly administer the tax laws in relation to digital assets and transactions. The ATO's existing data-matching program provides the ATO with a wealth of data regarding dealings conducted through regulated Australian exchanges. However, some members of the Joint Bodies have shared anecdotes that the pre-filled reports generated using the ATO's data do not always tie the correct digital wallets to the correct individuals, with the result that such data should not necessarily be treated as an absolute source of truth. We understand that this issue may be driven in part by the fact that the ATO's data-matching attempts to link digital wallets to individuals by their name, rather than the digital wallet identification numbers. As noted above, greater cooperation between the ATO and software providers may reduce such inaccuracies.

We also acknowledge the challenge that arises for the ATO when Australians transact on offshore exchanges. The Organisation for Economic Co-operation and Development's (**OECD**) ongoing work on the Crypto-Asset Reporting Framework[29] (**OECD Framework**) appears likely to assist greatly in overcoming these challenges. However, this assumes that the Financial Action Task Force (**FATF**) Travel Rule will be implemented. A number of countries have not done so yet on principle and for practical and security reasons.

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[29] See OECD, Crypto Asset Reporting Framework and Amendments to the Common Reporting Standard *Consultation Paper*, https://www.oecd.org/tax/exchange-of-tax-information/public-consultation-document-crypto-asset-reporting-framework-and-amendments-to-the-common-reporting-standard.pdf.

Importantly, the OECD Framework may not require significant legislative change to ensure effectiveness, but the underlying data required may be quite some time away as countries grapple with the privacy and security implications of the FATF Travel Rule. It will also facilitate consistent tax outcomes across foreign jurisdictions. We support further consultation on the appropriateness of the OECD Framework with respect to Australian taxation obligations.

International tax treatment of crypto assets and experience

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

UK HMRC's Cryptoassets Manual

The Cryptoassets Manual[30] published by HMRC provides detailed and relevant guidance on the taxation of digital assets and transactions. In particular, the Cryptoassets Manual addresses a wide range of transactions and is regularly updated and maintained. We note that HMRC develops new guidance in consultation with industry experts and professional bodies to ensure that the Cryptoassets Manual addresses the immediate needs of taxpayers.

We consider that Australia could adopt aspects of HMRC's Cryptoassets Manual. Allowing industry and community feedback to drive the direction of new and timely guidance should be integral to this process. Further, all guidance should be regularly reviewed and updated on an ongoing basis to ensure that taxpayers may rely on, and have confidence in, such materials to assist them to understand and meet their tax obligations.

UK recognition of 'digital objects'

The UK Law Commission recently proposed a new category known as 'data objects' to formally recognise certain kinds of digital assets for legal purposes.[31] The purpose of the UK Law Commission's public consultation is to seek to understand how digital assets differ from traditional asset classes and determine how they should be recognised and protected by the UK law.

Although the UK Law Commission's proposed reforms are not tax-related, we consider its approach is worth considering. The focus of the consultation is understanding the distinct features and characteristics of digital assets, and then allowing such attributes to inform the appropriate legal characterisation. It would be beneficial for the Australian approach to the taxation of digital assets and transactions to be driven by the practical, economic and commercial substance of such items. This can be achieved through the creation of the forum proposed above.

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[30] Her Majesty's Revenue and Customs, *Cryptoassets Manual*, (Web Page) https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual.

[31] UK Law Commission, *Digital Assets*, https://www.lawcom.gov.uk/project/digital-assets/.

Changes to Australia’s taxation laws for crypto assets

The Joint Bodies consider that any changes to the tax legislation should be aimed at reducing uncertainty and the compliance burden on taxpayers, while balancing these factors with revenue raising objectives. We reiterate our recommendation that the Board ensures that any changes to the law that fundamentally alter the taxation of digital assets and transactions should be a longer-term priority that is subject to further thorough consultation.

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.

The Joint Bodies recommends that the Board considers and adopts our suggestions in Questions 1 and 2 above. In the process of effecting any changes, it is also important to keep the following factors in mind.

Prospective vs retrospective application

The Joint Bodies recommend that the Government should determine the extent to which any new framework to tax digital assets and transactions will be prospective or retrospective. Such a decision is crucial, as many taxpayers have lodged tax returns which deal with gains and losses relating to digital asset transactions, and will be required to continue managing their tax affairs on the basis of any guidance, rulings and existing law prior to any legislative changes.

If the law is to be applied retrospectively and becomes unfavourable to certain taxpayers, we recommend that safe harbours, transitional provisions and administrative protection should be given to taxpayers who have relied on existing guidance, including private binding rulings, in good faith. This would ensure that taxpayers who have taken reasonable steps to ensure they have complied with their tax obligations are not penalised for adopting positions that were historically accepted or endorsed by the ATO.

For example, the Joint Bodies understand that there have been cases where taxpayers have prepared their tax returns based on reasonably arguable position papers (**RAPPs**) contending that digital currencies are eligible for treatment under the foreign currency rules in Division 775 of the ITAA 1997. These RAPPs were drafted prior to the Government’s announcement on 22 June 2022,[32] and are now contrary to that announcement.

As a general principle, we consider that the law should be applied prospectively where possible, to ensure simplicity and certainty for taxpayers and tax practitioners. If the law is to be applied prospectively, clarity should be provided on whether existing arrangements will be grandfathered or transitioned over to the new rules over a specified period of time. We encourage a sufficient transitional period to provide taxpayers adequate time to understand the impact of any changes and ensure they are compliant with the new rules.

[32] The Hon Dr Jim Chalmers MP and the Hon Stephen Jones MP, *Crypto not taxed as foreign currency* (Web Page, 22 June 2022) https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/media-releases/crypto-not-taxed-foreign-currency.

Taxation of only 'clearly definable gains'

The Joint Bodies consider that the Senate Select Committee's recommendation to only tax digital assets and transactions when clearly definable gains are made would significantly reduce the record-keeping onus on taxpayers and increase certainty. Clearly definable gains arise when digital assets are exchanged for fiat currency, or when digital assets are exchangeable for fiat currency.[33] In some instances, definable gains may also arise when digital currencies are exchanged for good and services or property. Such a change would particularly benefit taxpayers who invest and trade in digital assets that are not readily convertible into fiat currency. These investors are more likely to have limited cash to fund their tax liabilities from such transactions, and therefore face greater difficulties in paying associated tax debts. Broadly aligning the tax liability with the availability of cash will generally also ensure that the appropriate tax is collected as gains or losses on transactions involving only digital assets will be reflected in the final conversion to fiat currency.

If this approach were to be adopted, it should be subject to appropriate integrity measures to ensure that it does not encourage manipulation or tax avoidance. For example, users may choose to avoid transactions that give rise to clearly definable gains unless they are planning on exiting the system. Such users may instead prefer to retain digital assets that are not exchangeable for fiat currency in the hopes of extending their gains and avoiding tax in the process. While this is likely to be a timing issue, the risk to revenue may be greater if these taxpayers are able to exchange their digital assets for goods and services that do not result in a tax liability.

Blanket treatment of all gains and losses on digital assets and transactions

Some members of the Joint Bodies have also suggested that the taxation of digital assets and transactions could be simplified by recognising all gains and losses either on revenue or capital account. This reduces the need to characterise each kind of digital asset and transactions and analyse whether it is revenue or capital in nature. We consider that this approach should only be adopted as part of a longer-term objective, or be subject to review, after careful consideration of the potential fiscal consequences and compliance costs. We note that this approach may not necessarily result in an equitable outcome for all taxpayers.

Consideration may also need to be given to whether taxpayers, apart from managed investment trusts (**MITs**), should be permitted to make the MIT capital election[34] (or an equivalent concession) in respect of their digital asset holdings. This would give taxpayers the choice to elect that all gains on their digital assets and transactions should be treated on capital account. The nature of the election means that taxpayers who want to continue applying the current tax framework would be free to continue doing so. We also recommend that consideration should be given to whether taxpayers should be eligible to apply any CGT discounts when making such a capital account election in respect of digital assets and transactions. Confirming the government's policy objectives in this regard will provide taxpayers with greater certainty.

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[33] The Senate (n 27), 141.

[34] The existing MIT capital account election is governed by Subdivision 275-B of the ITAA 1997.

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

The Joint Bodies consider that there are a number of approaches to ensure that tax laws can keep pace with the continuing evolution of digital assets and transactions. Irrespective of the final approach adopted, we recommend that any future changes are technology-neutral, with the laws being principles-based and focused on substance rather than form. This will ensure that any new laws and regulations do not become obsolete or irrelevant due to further developments in digital assets, blockchain technology and related products.

Funding a dedicated ATO team

We consider that funding should be provided to establish a dedicated team within the ATO to keep pace with the underlying technology, provide appropriate guidance and actively report outcomes back to policy makers. Some members of the Joint Bodies have shared experiences of the challenges of dealing with ATO officers who are inexperienced with such matters and cannot provide sufficient guidance or assurance. This has led to delays and inefficiencies in the system and has created significant frustration for taxpayers.

Some members of the Joint Bodies have provided feedback regarding contradictory messaging from different ATO officers regarding the ATO's willingness to deal with particular issues pertaining to digital assets and transactions. In particular, we understand that test case funding applications for digital asset-related matters have been denied on the basis that such matters do not affect a large part of the community. We acknowledge that the decision to provide test case funding is subject to a number of criteria, however, we do not consider this to be an accurate assessment of the prevalence of digital assets and transactions. In contrast, some members of the Joint Bodies have also shared experiences of the ATO delaying issuing guidance and rulings by more than six months in some cases, stating that their views would have wide-ranging impacts on the community.

The establishment of a specialist team in the ATO to deal with all tax implications relating to digital assets and transactions would ensure that sufficiently trained, experienced and knowledgeable staff at the ATO are engaging with taxpayers and practitioners on these issues. This would help to ensure consistent and accurate advice for taxpayers, and the development of reliable and accurate guidance.

Digital assets and transactions tax advisory group

We consider that an advisory committee should be created consisting of tax professionals and subject matter experts to assist the ATO in producing timely and useful guidance for taxpayers. The current ATO guidance tends to be piecemeal and is usually unable to keep pace with changes in technology. We note that this advisory group would be separate to (but may somewhat overlap with) the working group mentioned above, which would also focus on the longer-term strategy concerning the tax framework for digital assets and transactions. The tax advisory group would focus only on assisting the ATO to provide timely and accurate guidance on tax issues for digital assets and transactions.

Establishing such a group would ensure that guidance released by the ATO is subject to external checks and balances before being released for broader use and reliance by the community. This approach would build confidence in the community, as the public would be assured by the involvement of tax and technology specialists in the development of the guidance. Further, if this approach were to be adopted, it is likely that new guidance could be published more frequently and in a timely manner.

Use of regulations

It may also be possible to utilise regulations to effect certain changes, rather than enacting legislation through Parliament. Such an approach would allow changes to be made more rapidly, as it avoids the need for such changes to undergo the potentially lengthy Parliamentary process.

A potential situation where the use of regulations would be beneficial is where new kinds of bridging arrangements or blockchain-based organisational structures emerge. Using regulations to provide roll-over relief or deemed tax treatment would allow the Government to respond to a specific scenario that is becoming prevalent and is sufficiently analogous with another kind of structure or arrangement that is well-defined for tax and legal purposes. This may provide taxpayers with timely guidance about their arrangements and avoid the risk of the ATO revising and later withdrawing or amending guidance.

Although regulations generally allow for greater flexibility and timely response to evolving environments, there is a need to appropriately balance flexibility with providing certainty to taxpayers regarding their tax affairs. We do not consider it appropriate for potential future regulations to be made on a frequent basis that may introduce substantial changes to the underlying legislation and a taxpayer's resultant tax obligations. If regulations are used, it is important that the language used is future-proofed to the extent possible to mitigate the need for frequent tweaks. Where possible, wording should be principles-based rather than prescriptive. Further, there need to be mechanisms that ensure that the regulations are reviewed at regular intervals, ensuring that the regulations are subject to greater Parliamentary oversight in a constantly evolving environment.

The formal amendment of legislation to include powers to make regulations should be subject to sufficient consultation with the profession and industry to ensure they will meet their set objectives. Those objectives need to be sufficiently robust and forward thinking, as well as aligning with the principles outlined above (e.g. technology neutrality etc.).

Continued use of legislation

Although digital assets and transactions are constantly evolving, the underlying technology is developing slowly enough to ensure that there is sufficient time to implement changes through legislation, provided that it is drafted in a principles-based style and future-proofed in terms of the language and concepts used. For example, the most recent major development in the digital assets space was arguably the use of liquidity pools to fund blockchain activities, which began to be used approximately two years ago. Although there have been new developments since then, these have not been as significant in nature.

As such, the Government may, in the longer-term, consider creating an entirely new set of legislation to govern digital assets and transactions from legal, regulatory and tax perspectives. Although the Government may be able to create short-term reforms by amending existing provisions and assisting the ATO with creating guidance for taxpayers, it may be more viable and sustainable in the long run to create a new, holistic framework that governs digital assets and transactions.

Such an approach would ensure that any rules and principles governing of digital assets and transactions are segregated from the existing law and would, in the tax context, minimise the impact of changes to the existing tax laws from creating unintended interactions with other provisions. This would also allow for such legislation to account for the unique characteristics and features that are not contemplated by the current laws that deal with traditional classes of tangible and intangible assets.

If adopted, we recommend that the approach taken by the UK Law Commission, as outlined in our response to Question 8 above.

Administration of Australia's taxation laws for crypto assets

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

Our recommendations below should be considered in conjunction with our comments above.

ATO approach to client engagement

We consider that the ATO's current client engagement processes are unable to appropriately manage the issues concerning individuals that are investing in or trading digital assets. This is likely a result of under-resourcing and funding constraints for the ATO in the key business areas that would otherwise manage these issues. Further, the current approach may not be the most efficient manner for assisting individuals who are knowledgeable about digital assets and the supporting technology but lack the requisite procedural knowledge or access to expertise regarding effective engagement with the ATO.

We consider that the ATO should review and revise its current client engagement process in the context of digital assets and transactions. In particular, the ATO should proceed with matters on the basis that taxpayers are managing their tax affairs in good faith, recognising that discrepancies may arise due to the difficulties associated with record-keeping and uncertainty regarding the tax implications in certain cases. Where there are reasonable grounds to do so, the ATO should seek to understand and ascertain whether taxpayers are being inadvertently or deliberately non-compliant with their tax obligations. It is also important for affected individuals to have an effective and transparent pipeline in their engagement with the ATO, from advice to audit and review. This will increase the consistency of the taxpayer experience and the resulting tax outcomes.

Election for automatic ATO default assessments

Some members of the Joint Bodies have suggested that allowing for taxpayers to opt into default assessments in respect of gains and income from digital assets and transactions may alleviate the administrative and compliance burden in the system. Such an approach is particularly beneficial for taxpayers and advisers who lack the requisite tax and technology experience, or have relatively simple transactions. This approach may require the ATO to work with digital asset platforms and software providers to ensure the appropriate pre-fill information is available and likely to correctly reflect the taxpayer's circumstances.

The elective nature of such an approach would allow other taxpayers to continue tracking and calculating gains themselves. This flexibility is important as it is not always possible to classify the kinds of transactions taxpayers are entering into based solely on the amounts entering and exiting their digital wallets. For example, a taxpayer may receive digital assets from mining, staking, airdrops, donations or creating them themselves. Each of these activities may have different tax implications, and the ATO's current data-matching capability may not be able to identify and reflect the differing tax implications of such transactions.

If such an approach is to be considered further, we recommend that the Board should take into account the OECD Framework before proceeding. This would ensure that there is a harmonised universal standard for reporting, to the extent possible, allowing the ATO to use more reliable information for the purposes of pre-filling reports and default assessments.

Personal use wallet exemption

We also recommend that a personal use wallet exemption should be considered. This would allow any gains or losses on digital assets purchased below a designated threshold (e.g. $10,000 per year) and held in a personal use wallet for the purpose of paying personal expenses to be disregarded for tax purposes. Such an approach would reduce the tax burden borne by taxpayers engaged in low-value transactions to pay for personal expenses using digital assets primarily as a medium of exchange.

We acknowledge that subsection 118-10(3) of the ITAA 1997 already disregards capital gains and losses on personal use assets from giving rise to a tax liability. However, as outlined in our response to Question 1 above, the circumstances in which a digital asset constitutes a personal use asset are unclear. There is also the possibility that a personal use wallet may not fall within the scope of a personal use asset for CGT purposes. Creating a personal use wallet exemption gives taxpayers greater clarity about the tax implications of transacting with digital assets when purchasing goods or services for personal use and enjoyment.

We note that the personal use wallet exemption would need to be subject to integrity rules to ensure that taxpayers do not take advantage of the wallet for tax planning or avoidance purposes. For example, there may be a requirement that the digital assets held in the personal use wallet should be turned over periodically. This would ensure that taxpayers do not hold their digital assets in their wallet indefinitely and profit from the gains by spending them once their market value has significantly risen.

Restructure rollover relief for DAOs

As part of a longer-term approach to the tax treatment of DAOs, consideration should be given to providing restructure rollover relief for existing entities seeking to transition to a DAO, or similar blockchain based, structure. This would encourage existing businesses to consider and adopt DAO-based structures where it aligns with their broader commercial objectives.

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

Digital currency exchanges

We understand that exchanges are able to provide taxpayers with information on their past transactions in varying formats. The data is often provided in the form of an Application Programming Interface (**API**) which can be fed into other applications, or a comma-separated values (**.csv**) file that may be opened with database software such as Microsoft Excel.

However, some members of the Joint Bodies have shared experiences that such information is not always accepted by the ATO as appropriate evidence and substantiation of a taxpayer's tax affairs. This has often led to the Commissioner issuing default assessments, in some cases on the full gains without any deductions or losses to appropriately offset such gains.

We note that the data provided by exchanges may not be straight-forward to use in calculating a taxpayer's gains and losses from digital assets and transactions. This is especially the case where a taxpayer enters into numerous transactions across multiple exchanges and intermediaries. It can be difficult to reconcile and align the data for tax calculation purposes.

To minimise these risks, the ATO should consider requesting platforms and networks to share relevant data with them to improve the quality and accuracy of their data and pre-filling reports. This may reduce the risk of the ATO's data-matching linking the wrong digital wallets to individuals. However, privacy and confidentiality concerns with exchanges and other intermediaries sharing data with the ATO would need to be appropriately managed.

Crypto tax software

The complexity of calculating tax liabilities in relation to digital assets and transactions has led to the emergence of a number of competing specialised tax calculation websites. We consider the ATO should support the use of such software, as it promotes voluntary compliance and engagement with the tax system. These providers can also play a role in educating taxpayers about the potential tax issues associated with their digital asset-related activities.

We note that there are limitations on the usefulness of the information which crypto tax software is able to access. At a high level, such software generally acts as a bookkeeping application and basic calculator for gains and losses. Although the software can aggregate and compute gains and losses relating to each kind of digital asset, they are generally unable to identify or classify the kind of transaction in which the digital assets were involved. That is, the software is usually only able to identify that gains were made, but cannot identify whether such gains are revenue or capital in nature, or could be exempt from tax. Individual taxpayers are responsible for classifying the various transactions they have undertaken in order for the software to accurately calculate the taxable gains on their digital assets and transactions.

We recommend that the ATO seeks to understand how the various crypto tax software products operate and work with them to identify the kinds of data available to taxpayers. Additionally, the ATO should work with these software providers to ensure they are able to provide a level of record-keeping that taxpayers and tax practitioners can rely on when managing their tax affairs. This can be achieved through the creation of a consultation group with the relevant software providers, similar to existing arrangements with taxation and superannuation software services providers such as MYOB, Xero and CLASS.

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?

The Joint Bodies consider that exchanges can play a significant role in supporting both the administration of, and compliance with, tax laws through data reporting. However, we note that any consideration of more active interventions must be mindful to not place Australian exchanges at a competitive disadvantage. Even relatively straightforward steps, such as the implementation of a withholding regime similar to that operating for Australian bank accounts, may risk encouraging taxpayers to transact using offshore exchanges instead.

Further, the appropriate use and regulation of crypto exchanges may assist with tax transparency, especially if such exchanges are required to adopt anti-money laundering (**AML**) rules. The data required to comply with such rules would provide the ATO with greater certainty around the nature of transactions occurring across various key blockchain networks.

However, we note that there may be practical challenges to ensuring that all exchanges share information with the ATO. Reporting obligations may be contrary to the decentralised nature of some blockchain technologies which have a fundamental principle of eliminating all intermediaries, including government agencies. There is also a potential risk of individuals who start their own exchanges, by copying and running the publicly available code powering the platform, not being aware of, or potentially avoiding, reporting or information sharing requirements. An appropriate policy response and administrative strategy needs to be created to appropriately manage these issues.

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

In addition to our recommendations contained in our responses to Questions 3 to 6 above, we recommend the following suggestions to better support taxpayers in understanding their tax obligations in relation to digital assets and transactions.

Guidance on top 50 types of transactions

Some members of the Joint Bodies have suggested that the ATO could provide guidance on the tax implications of the 50 most common digital asset transactions. This could serve as a starting point for taxpayers with questions about frequent and common transactions in the blockchain space. It would also reduce the current levels of uncertainty among taxpayers and reduce non-compliance in the system. Any such list should be updated regularly to ensure it reflects the current market and could, as a starting point include guidance on the following classes of transactions:

- creating an NFT;
- earning commissions from NFTs;
- transferring digital assets between wallets;
- using digital currency to purchase digital assets;
- airdrops;
- staking; and
- public trading trust issues for crypto-funds.

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?

Educating and empowering tax agents and advisers

The Joint Bodies consider that supporting tax agents and advisers in relation to digital assets and transactions is a multi-disciplinary issue. Having an in-depth knowledge about technology, systems and software is generally outside the knowledge, training and experience of most tax agents and advisers. Many advisers are likely not well equipped to advise their clients on their tax affairs concerning digital assets and transactions with confidence that they have arrived at the correct tax outcome.

As a starting point, we recommend that tax advisers should be educated and trained on the typology of smart contracts to provide them with foundational knowledge to understand digital assets and transactions, and begin applying the tax laws to them. Additionally, tax agents may need access to education on the tax treatment of digital assets and transactions in order to fulfill their obligations under the *Tax Agent Services Act 2009* and in accordance with the Taxpayers' Charter.[35] Specific aspects for further education include the following:

- taxpayer and tax agents' rights and responsibilities;
- approaches to data compilation, reconciliation and understanding data sources;
- understanding client wallets and activity identification;
- verifying the accuracy of prefill reports; and
- substantiation and record keeping requirements.

Current inability to rely upon pre-filling reports

The Joint Bodies also have concerns that tax agents are unable to rely on pre-fill reports when preparing tax returns for individuals investing in digital assets. Currently, the pre-fill only flags a taxpayer's participation on digital currency exchanges. Tax agents are required to trust that their clients have fully disclosed all of their digital asset-related dealings as part of the tax return preparation process, or incur the cost of going through this process with them. There is a significant concern among tax agents that they may be held responsible for incorrect tax returns (and potentially sanctioned) notwithstanding that they have dealt with their clients in good faith and taken reasonable steps to obtain the necessary information. Concerns have also been raised regarding the difficulties associated with otherwise accessing the relevant information.

We recommend that adequate protections be afforded to tax agents who have taken reasonable steps to obtain all records and data pertaining to their clients' dealings in digital assets and transactions. These tax agents should not be penalised where the client has omitted transactions relevant to their tax liability for digital asset transactions, whether deliberately or inadvertently.

Further, we recommend that the ATO and/or the Tax Practitioners Board should provide guidance about the checks and balances tax agents should undertake when proving advice on the tax implications of digital assets and transactions. Such guidance would allow tax agents to identify areas they should focus on to ensure they have prepared their clients' income tax returns as accurately as possible. We also refer to our comments above regarding the ATO working with crypto tax software providers to provide tax agents with a complete list of digital asset-related activities can use when providing advice to their clients.

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[35] Australian Taxation Office, *Taxpayers' Charter* (Web Page, 22 October 2018) https://www.ato.gov.au/about-ato/commitments-and-reporting/taxpayers--charter/.

APPENDIX B

We have set out below for the Board's reference a glossary of terminology, some of which is used throughout our submission. Those which have not been used in our submission have been included for context and for the Board's information. We highlight the importance of defining the relevant digital assets and transactions, and associated products, and the need for such definitions to be used consistently across government.

Glossary of terminology

Airdrop

Broadly a promotional or marketing activity, typically undertaken by blockchain based start-ups to assist with funding a digital asset project. An airdrop is generally an unsolicited distribution of tokens or coins, to existing cryptocurrency traders or users for free to encourage adoption of that asset.

Asset-backed tokens

An asset-backed token represents the holder's ownership of an asset residing outside of the blockchain. The token derives its value from the off-chain asset. For example, Tether Gold is a token that is backed by gold, and derives its price from the global gold price.

Binance Smart Chain / BNB Smart Chain

The Binance Smart Chain is now referred to as the BNB Smart Chain. The BSC is a blockchain network designed for smart contract-based applications and is Ethereum Virtual Machine compatible, thus Ethereum-based applications are enabled on the network.[36] BSC works in conjunction with the BNB Beacon Chain (for governance in the form of staking and voting), together forming the 'BNB Chain'. BNB stands for 'Build 'N Build', a reference to building the community and then letting the community build.[37]

Blockchain

The UK Law Commission defines a blockchain as follows:[38]

> A method of recording data in a structured way. Data (which may be recorded on a distributed ledger or structured record) is usually grouped into timestamped 'blocks' which are mathematically linked or 'chained' to the preceding block, back to the original or 'genesis' block.

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[36] 'A beginner's guide to the BNB Chain: The evolution of the Binance Smart Chain' *Cointelegraph* (Online) https://cointelegraph.com/altcoins-for-beginners/a-beginners-guide-to-the-bnb-chain-the-evolution-of-the-binance-smart-chain.

[37] Ibid.

[38] UK Law Commission, *Digital Assets Consultation Paper* (28 July 2022) https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2022/07/Digital-Assets-Consultation-Paper-Law-Commission-1.pdf, viii.

Bridging

The connection of two blockchains through a blockchain bridge or cross-chain bridge that allows interoperability between networks that are potentially vastly different (for example Bitcoin and Ethereum) and between a parent blockchain and its child chain (side chain). Bridges allow users to transfer information and assets from one chain to another. This may include the transfer of tokens, data, and smart contract instructions.

Decentralised Autonomous Organisation

A DAO is an organisation comprising members that is regulated by rules programmed into code that runs on a blockchain network. As such, there is no need for any central bodies or responsible persons to regulate the processes, protocols and procedures required to run the DAO and govern the actions and decisions of its members. It is completely automated by the code stored on the relevant blockchain network.

Decentralised Finance

DeFi allows investors to perform financial transactions through peer-to-peer distributed networks without the need for financial intermediaries (such as banks and brokers). Individuals hold their funds in a personal digital wallet that is bound to them, rather than in an account run by a bank or similar financial institution. DeFi facilitates activities such as borrowing and lending, issuing and purchasing financial instruments, speculating on price movements through derivatives, and trading cryptocurrencies.

Digital twins

A digital twin is a token that is a digital model intended to accurately reflect a real-world asset. Unlike asset-backed tokens, a digital twin is designed to be a digital representation and stand-in for the real-world asset.

Ethereum

Ethereum is a decentralised blockchain platform with its own native titular tokens. The Ethereum network is unique compared to the Blockchain network in that it allows smart contracts to power programs and transactions that were not originally possible on the Bitcoin and similar networks.

Ethereum Request for Comment 20

ERC-20 is the standard governing the creation of smart contracts on the Ethereum blockchain. The standards ensure that all current and new tokens are exchangeable with other tokens on the network using smart contracts.

Fork/Forking

HMRC provides the following guidance on forks:[39]

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[39] HMRC, *Crypto Assets Manual CRYPTO22300 – Cryptoassets for individuals: Capital Gains Tax: blockchain forks* (Web Page, 22 February 2022) https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto22300.

Some cryptoassets are not controlled by a central body or person but operate by consensus amongst that cryptoasset's community. When a significant minority of the community want to do something different, they may create a 'fork' in the distributed ledger.

There are two types of forks, a soft fork and a hard fork. A soft fork updates the protocol and is intended to be adopted by all. No new tokens, or distributed ledger, are expected to be created. A hard fork is different and can result in new tokens coming into existence. Before the fork occurs there is a single distributed ledger. Usually, at the point of the hard fork a second branch (and therefore a new cryptoasset) is created.

The distributed ledger for the original and the new cryptoassets have a shared history up to the fork. If an individual held tokens of the cryptoasset on the original distributed ledger they will, usually, hold an equal numbers of tokens on both distributed ledgers after the fork.

Gas fees

On the Ethereum blockchain, gas fees is the term given to transaction fees and refer to the cost to perform a transaction on the network. All smart contracts and other transactions are executed by participating miners on the network using the computing power of their hardware. The gas fees charged is based on the supply and demand at the time of the transaction and amount of computing power required to perform the transaction.

InterPlanetary File System

The InterPlanetary File System (**IFPS**) is a protocol which allows files to be stored and accessed in a decentralised manner across different users across the network, rather than being stored on a central server or network. This allows larger files to be stored and accessed more efficiently and avoids situations where files may become corrupted or inaccessible due to server issues.

Layer

Systems and protocols that run on the blockchain can be seen to operate either on the blockchain itself (**Layer 1**) or using the systems and protocols on Layer 1 as the foundation for their operation.

The UK Law Commission defines Layer 1 as: [40]

> [a] general term used to describe base-level blockchain or crypto-token architecture, systems, networks or protocols.

The UK Law Commission proceeds to define Layer 2 as follows:[41]

> A general term used to describe a secondary protocol built on top of an underlying ('Layer 1') blockchain or crypto-token architecture, system, network or protocol. Layer 2 protocols generally use the underlying Layer 1 protocol for certain functions, including settlement of transactions and transaction security.

[40] UK Law Commission (n 38), xi.

[41] Ibid.

Liquidity pools

It is common to provide liquidity to an exchange by adding two (or more) assets to a liquidity pool and receiving a token in return (**LP token)** that gives the holder a right to a share of the trading fees earned from third parties trading with the liquidity pool. When the holder returns the LP tokens, they will receive the two (or more) assets that had been added (as well as any earned trading fees), however, the quantity and ratios of both assets can be different. Sometimes the value of the assets being returned is negative due to the rebalancing of the pool (known as an impermanent loss).

Non-fungible Tokens

NFTs are a class of digital assets that represent code on a blockchain network which are associated with digital or physical objects. The NFT contains unique identifiers, metadata, and links to digital objects such as images, audio and videos.

It should be noted that the NFT itself is distinct from the digital or physical assets which it is associated with. The NFT only describes the attributes and serves as a hyperlink to the associated digital assets in question. As such, purchasing or owning an NFT does not necessarily convey intellectual property rights such as copyright, or other legal rights over the associated assets. Holding an NFT also does not necessarily prevent others from sharing or duplicating the associated assets. Further, new NFTs may be created that reference the same digital objects as other existing NFTs.

Play-to-earn and game decentralised finance

P2E or GameFi systems allow participants to earn digital currency or NFTs through playing digital games. They are often linked to a blockchain platform. Such digital currency or NFTs may be traded or sold to other players for other digital currencies or NFTs. P2E and GameFi systems incentivise players to play such games and engage with the platforms by allowing them to effectively earn money while participating in recreational gaming.

Proof of Stake

HMRC defines Proof of Stake as follows:[42]

> Under Proof of Stake, the ability to create a new entry is determined by a user's wealth in the cryptoasset (or 'stake') rather than them having the computer power to solve a puzzle before anyone else does. Here, those verifying transactions are rewarded with fees for facilitating the transaction instead of any new tokens.

Rebase tokens

Rebase tokens are similar to a redenomination and can also function algorithmically. For example, a user can create a token that has a relatively stable price, by facilitating a rebase to all token holders at set intervals, where tokens are either issued or burned depending on how high or low the price is from the target. Importantly, the project team can programmatically control who receives the issued tokens based on certain criteria. For example, a user might receive more tokens if they hold the assets for longer.

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[42] HMRC, *Crypto Assets Manual CRYPTO10300 – Introduction to cryptoassets: consensus – proof of work and proof of stake* (Web Page, 22 February 2022) https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto10300.

Redenomination

Redenomination occurs when the value of the digital asset is changed, e.g. from 1 to 1000. This might be done algorithmically by a protocol to lower the overall price of the currency.

Smart contracts

The UK Law Commission defines a smart contract as follows:[43]

> Computer code that, upon the occurrence of a specified condition or conditions, is capable of running automatically according to pre-specified functions.

Stablecoins

The UK Law Commission defines a stablecoin as follows:[44]

> Crypto-tokens with a value that is intended to be pegged, or tied, to that of another currency, commodity or financial instrument. The peg might be based on assets held by the issuer, or on a mathematical algorithm and is generally intended to remain on a stable (often 1:1) basis over time.

Staking

The UK Law Commission defines taking as follows:[45]

> The term staking derives from its use within the 'proof-of-stake' type of consensus mechanism used by certain blockchains or crypto-token systems to achieve distributed consensus. Under proof-of-stake consensus mechanisms, validators transfer or "stake" capital or value into a smart contract within the system. This staked value then acts as collateral that can be destroyed if the validator behaves in certain, pre-agreed ways which are considered to be negative for the overall consensus mechanism or system security (such as acting dishonestly or lazily). The validator is then responsible for checking that new blocks propagated over the network are valid and occasionally creating and propagating new blocks themselves. The validator is rewarded (often with new crypto-tokens) for undertaking this process (and contributing to the overall security of the consensus model) and penalised by the destruction of some or all of its staked collateral if it behaves in certain negative ways.
>
> The term staking has recently been used by market participants in a broader, less specific way, simply to refer to transferring or locking certain capital or value to smart contracts in return for a reward, even where no positive contribution is made by the staker and/or where the staked capital or value is not at risk.

Wrapping/wrapped tokens

Wrapped tokens are smart contracts on a blockchain that hold the value of a token on a different blockchain network that has been locked to serve as collateral. This enables holders to use such tokens for DeFi activities on a different blockchain.

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[43] Ibid, xiii.

[44] Ibid.

[45] Ibid, xiii–xiv.

For example, wrapped Bitcoin is a token that exists on the Ethereum blockchain that represents Bitcoin that has been locked and held as collateral on the Bitcoin blockchain. It allows the Bitcoin to be used in DeFi activities on the Ethereum blockchain, despite this not usually being possible due to the differing attributes and protocols between the two networks.

Yield farming

Yield farming refers to the practice of using digital tokens to earn financial rewards. For example, this can occur when a participant becomes a liquidity provider in a liquidity pool and as a result earns a share of trading fees.