



Australian Government
The Treasury

TSY/AU

INITIAL COIN OFFERINGS

Issues Paper

January 2019

© Commonwealth of Australia 2019

This publication is available for your use under a **Creative Commons Attribution 3.0 Australia** licence, with the exception of the Commonwealth Coat of Arms, the Treasury logo, photographs, images, signatures and where otherwise stated. The full licence terms are available from <http://creativecommons.org/licenses/by/3.0/au/legalcode>.



Use of Treasury material under a **Creative Commons Attribution 3.0 Australia** licence requires you to attribute the work (but not in any way that suggests that the Treasury endorses you or your use of the work).

Treasury material used 'as supplied'.

Provided you have not modified or transformed Treasury material in any way including, for example, by changing the Treasury text; calculating percentage changes; graphing or charting data; or deriving new statistics from published Treasury statistics — then Treasury prefers the following attribution:

Source: The Australian Government the Treasury.

Derivative material

If you have modified or transformed Treasury material, or derived new material from those of the Treasury in any way, then Treasury prefers the following attribution:

Based on The Australian Government the Treasury data.

Use of the Coat of Arms

The terms under which the Coat of Arms can be used are set out on the Department of the Prime Minister and Cabinet website (see www.pmc.gov.au/government/commonwealth-coat-arms).

Other uses

Enquiries regarding this licence and any other use of this document are welcome at:

Manager
Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

CONTENTS

- CONSULTATION PROCESS IV**
- INITIAL COIN OFFERINGS1**
 - Introduction1
 - Definitions and token categories1
 - Drivers of the ICO market3
 - Opportunities and risks4
 - Regulation of ICOs9
 - Regulatory frameworks in Australia13
 - Tax treatment of ICOs17
- CONSULTATION QUESTIONS19**
- ATTACHMENT A: TAX TREATMENT OF DIGITAL TOKENS20**
 - Income tax treatment for investors20

CONSULTATION PROCESS

Request for feedback and comments

This Issues Paper forms part of Treasury's review into Initial Coin Offerings (ICOs). The Treasury invites interested parties to make submissions on any or all aspects of the issues raised in this paper by 28 February 2019. Submissions may be lodged electronically or by post. Feedback gathered during this process will inform subsequent advice to the Government.

Closing date for submissions: 28 February 2019

Email: ICO@treasury.gov.au

Mail: Division Head
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Enquiries: Enquiries can be initially directed to ICO@treasury.gov.au

Phone: 02 6263 2111

Responses will ordinarily be published on the Treasury website as submissions to the inquiry. You need to expressly state if you do not want us to publish your name.

INITIAL COIN OFFERINGS

Introduction

The Australian Government has identified innovations in financial technology – or “FinTech” – as potentially transformative for the Australian economy. Australia’s ambition is to be a global leader in technology and financial innovation that will contribute to productivity and economic growth, as well as the efficiency and inclusiveness of the financial system over the long term.

A relatively recent financial innovation that is attracting much attention, both domestically and globally, is the so-called initial coin offering (hereafter, ICO). ICOs, which rely on distributed ledger technology (DLT), emerged as a niche form of private fundraising within the technologically sophisticated developer community. ICOs have since taken on public appeal, with offers being made to mass retail investors. Although ICOs have some parallels with Initial Public Offerings (IPOs), venture capital and crowdfunding, the ways in which they are structured can be quite distinct from existing forms of capital raising.

These distinctions, and rapid growth in the popularity of ICOs, are testing regulatory frameworks around the world. The technology underpinning an ICO means that geographic borders are relatively easily traversed and there is widespread anecdotal evidence to suggest that the organisers of ICOs are choosing to issue from jurisdictions where regulatory settings are seen as most accommodating. A number of jurisdictions are actively competing to attract ICO activity and establish themselves as a hub for innovative technology companies that favour ICO fundraising.

At the same time, regulators in many jurisdictions have expressed significant concerns over the potential risks posed by ICOs to consumers and investors. Reports of fraud and investor loss are numerous and there is also anecdotal evidence that many ICOs have been conducted based on an often incorrect assumption that existing financial regulations do not apply.

This paper is intended to solicit the views of interested parties on: the opportunities and risks posed by ICOs for Australia; whether our regulatory framework is well placed to allow those opportunities to be harnessed whilst appropriately managing the associated risks; and, whether there are other actions that could be taken to best position Australia to capitalise on new opportunities.

Definitions and token categories

While there is no widely-adopted definition of an ICO, it typically involves the creation of digital tokens by an issuer using distributed ledger technology (DLT). The tokens are acquired by investors and potential consumers through online auction or subscription, typically in exchange for a cryptocurrency such as Bitcoin or for official fiat currency such as United States dollars.

In essence, tokens are a medium of exchange within a DLT-based business venture, allowing token holders the ability to earn value and/or to spend their tokens on services that are internal to the venture. While ICOs are often compared with crowdfunding, these two public online fundraising methods differ in some important respects (refer to **Box 1**).

BOX 1: HOW DO ICOS DIFFER FROM CROWDFUNDING?

Crowdfunding generally falls into two categories: non-investment and investment-based. Non-investment-based crowdfunding allows participants to make a donation to support a cause or pre-purchase a good or a service that will be made using the funds raised. Investment-based crowdfunding involves participants investing money for a financial reward or gain, and is known in Australia as crowd-sourced equity fundraising (CSEF). The CSEF regime commenced in September 2017 for public companies, and was extended to include proprietary companies in October 2018.

While an ICO is essentially a means of crowdfunding a project that relies on DLT, there are some important differences compared with CSEF.

Firstly, participants in an ICO typically exchange cryptocurrencies for a token that may or may not have rights attached. By contrast, in Australia the legislative framework governing crowd-sourced equity funding requires that official fiat currency be used to purchase an equity stake in the form of ordinary shares.

Secondly, ICOs are an entirely decentralised method of fundraising and do not rely, as CSEF does, on intermediaries (or 'platforms') to facilitate the transaction.

Thirdly, the way in which funds are raised in an ICO – via the issuance of digital tokens – can be intimately related to the success of the project. In general, for ICO projects to succeed, it is essential that many individuals create demand for the tokens to establish a customer base, more so than in CSEF projects. Further, CSEF guidelines set out expectations that issuers clearly articulate the intended use of funds and underlying business model, while there are no agreed standards for ICO 'white papers' (unless the tokens being issued fit the definition of a financial product, in which case the white paper must meet existing disclosure standards under the Corporations Act 2001).¹

Most CSEF projects are restricted to investors in a certain region or country that is native to where the project is developed, consistent with financial services or securities laws that generally require offers to comply with the laws of the country in which potential investors are located, rather than that of the project. By contrast, ICOs can potentially be offered to a much wider pool of potential investors and not generally constrained by geographic boundaries.

Lastly, CSEF rules enforce strict caps to the maximum amount of funds raised, while ICOs are not subject to caps. ICO token issuers often release tokens in multiple phases, determining a cap for each stage of release.

Challenges in categorising ICO tokens

Digital tokens issued in an ICO, or crypto-tokens, generally have certain rights attached² which grant to holders:

- the right to another digital currency (a 'currency' token, commonly referred to as a 'stablecoin');
- the right to a promised future cash flow linked to an underlying business or investment (an 'equity', 'asset' or 'investment' token); or
- the right to access a product or service provided by the issuer usually at some future point in time (a 'utility' or 'access', token).³

1 Refer to Box 4 - Regulatory Treatment of ICOs in Australia.

2 Some types of digital tokens confer no particular rights on those that purchase them – for example 'community', or 'donation' tokens – and give subscribers the ability to fund a charitable venture or to establish links with other subscribers (such as via a social network).

3 A comparable list of token categories can be found in Buckley et al (2018).

Neatly defining and categorising digital tokens into one of the above types can be difficult for a number of reasons. Some tokens, for instance, confer on their holders a combination of rights such as access to products and services, profit sharing and the ability to vote. Other tokens may evolve into another type of token as the project develops – such as by starting as a token that represents a financial interest in the project and later used to purchase a good or service available through the network on which it was created. In addition, the rapid pace at which the industry is developing means that new types of tokens are constantly being issued – and these tokens may not fit neatly into the categories identified above.

If a token has the characteristics of a financial product – for example, it confers rights to an equity stake in a business – it is often referred to as ‘security’ token in general discussion. It is important to note that a token may be a financial product even if it is described by another name, such as a utility token. As a result of the varied and dynamic nature of ICO tokens, and the fact that ICOs represent a new form of fundraising, it is difficult to make general and definitive statements on the application of existing regulatory frameworks to all ICOs. For example, while some digital tokens such as ‘equity’ tokens bear the hallmarks of a financial product, others such as utility tokens are more difficult to assess. This is discussed in more detail below (refer to ‘Regulation of ICOs - Global regulatory approaches and challenges’).

KEY QUESTION

1.1. What is the clearest way to define ICOs and different categories of tokens?

Drivers of the ICO market

Distributed ledger technology

ICO activity has been facilitated by developments in DLT. Distributed ledgers are databases that are replicated and synchronised among multiple servers located in different sites, eliminating the need for a central administrator. The underlying code and supporting infrastructure for this sharing and synchronising process is referred to as DLT. This technology has a range of potential applications across the financial sector and more broadly. The popularity of DLT-based projects has increased significantly since the development of blockchain, a type of DLT invented around 10 years ago with the launch of Bitcoin. More than a thousand ICOs have since launched, mostly using blockchain DLT for the underlying platform and digital token.⁴

Digital token creators

Entrepreneurial businesses wishing to create and sell digital tokens in order to raise funds have been attracted to the ICO model for a range of reasons. The freedom to structure an offering according to the individual preferences of the business has particularly high appeal for entrepreneurs wishing to retain full equity, and to businesses wanting to take advantage of growing consumer and investor interest surrounding digital tokens. ICO proponents also consider that digital token sales are assisting businesses to access credit more efficiently relative to venture capital. Digital token issuers have also benefited from the network effects inherent to the ICO fundraising model, and heightened interest surrounding digital tokens in recent years, which has fuelled speculation and market growth.

4 Buckley et al (2018).

Investor exuberance and speculation

There are a range of reasons why ICOs are perceived by some investors as an attractive alternative to more traditional methods of investing. In particular, members of the public who are not sufficiently large-scale to be angel or venture capital investors consider ICOs to be a valuable opportunity to purchase digital tokens in start-ups at an early stage, rather than wait for shares to be offered through IPOs. While speculative investor behaviour has emerged as a key driver of the proliferation of digital tokens, well-publicised losses and outright frauds have recently tempered some of this optimism.

Digital token exchanges

The growth of digital token exchanges (and digital wallet providers) has facilitated digital token trading. This has supported the growth of ICOs by providing liquidity for more popular tokens. Where digital tokens are traded on an exchange, this makes it easier for investors to find tokens that they are interested in buying. In addition to providing a marketplace for trading digital tokens, digital token exchanges may also create an opportunity for investors to crystallise any rise in the value of their tokens or to exit a loss-making position.⁵

KEY QUESTIONS

- 2.1 What is the effect and importance of secondary trading in the ICO market?
- 2.2 What will be the key drivers of the ICO market going forward?

Opportunities and risks

This section looks at the potential benefits that businesses, consumers and the broader economy could gain from emergence of ICOs as a funding source. It also looks at the possible risks that ICOs present.

Opportunities

For industry

The ICO fundraising model offers a number of potential advantages to businesses. An ICO may allow businesses to raise funds by, in effect, issuing equity, accepting funds for management, or bringing forward sales revenue. The money raised can then be spent on early-stage platform and product development. This could enable the business to start up quickly and allow early-mover advantages in rapidly evolving markets.⁶

5 Digital currency exchanges that trade digital tokens that are classed as financial products need to hold a market licence in Australia. Currently, there are no such licenced platforms. Some digital token exchanges therefore appear to only trade a limited pool of digital currencies.

6 However, as the ICO market has evolved, the time involved in setting up and managing an ICO has been lengthening.

For ICOs that are not equity sales, the business is able to retain full equity ownership and control which is a significant motivating factor for some start-ups. In some cases, tokens issued may have no rights attached to them, and so the money received is effectively a donation. By remaining a private company, firms may also avoid incurring the costs typically associated with public reporting requirements.

ICO tokens may be issued to a large number of small investors. Tapping into new investor groups creates an additional funding source for businesses, and may be an attractive option for start-ups that are not yet mature enough to access venture capital or to undertake an IPO.⁷ For some Australian businesses, accessing new sources of capital has also allowed them to stay onshore rather than relocating overseas in search of capital.

Creating a unique token allows the business to retain more control of its blockchain and its ecosystem, including by determining total supply. In addition, raising funds through a digital token offering may make the business's product or service more attractive to consumers who are interested in crypto-related products and services. This can also create value through network effects, by turning customers into advocates and fostering a community that is attached to the business brand from the time of launch.

Finally, the functionality of digital tokens can allow for transactions on the businesses' platform to take place without requiring the services of traditional payment and settlement intermediaries typically required for transactions involving fiat currencies. In contrast with the way in which businesses typically transact across borders, a digital token enables a singular payments system that obviates the need to operate in multiple fiat currencies.

For consumers and investors

An ICO may allow individual investors to gain exposure to a startup or small business in the early stages of growth, and/or provide access to a product or service that they value. Depending on what is promised, the digital token received may allow consumers to earn bonuses and discounts on a product or service, or function like a loyalty rewards program. In addition, compared with traditional venture capital where investors' equity may be tied up for many years, equity in the form of a digital token may provide investors with more immediate liquidity where a secondary market exists for the tokens owned.

While industry and media reports indicate that a large number of digital tokens lose value after the ICO, token-holders may benefit if the token's value appreciates over time. Further, the digital tokens offered via ICOs may, over time, become a more accepted asset class in a diversified investment portfolio.

7 The RBA has noted that young small businesses continue to face challenges in accessing finance to fund expansion plans (RBA Quarterly Bulletin – December 2017). This is consistent with a 2015 Productivity Commission Inquiry Report on Business Set-up, Transfer and Closure. The Productivity Commission found some evidence to suggest that innovative technology startup firms have not been well served by the Australian financial system. It found that innovative new businesses do experience greater difficulty accessing finance than those that are not undertaking innovative activity and that the Australian venture capital market is relatively small scale and focussed on providing funding to companies with proven products and services or for later stage expansion.

In theory, an enterprise using DLT, such as through an ICO, has the potential to reduce counterparty risk for consumers and investors by hard-coding rights into a 'smart contract' on the blockchain (if any rights exist). This may result in a technologically secure way of providing consumer and investor protections. A smart contract is essentially an algorithm that executes an automatic transfer of digital assets, money, or utility between parties when pre-defined events occur, removing the need for an intermediary to ensure the parties' rights under the contract are fairly executed.

For the economy

A number of jurisdictions are actively competing to attract ICO activity and establish themselves as a hub for innovative technologies that favour ICO fundraising. Industry proponents see ICOs as having the potential to help fuel innovation-driven economic growth, although it is too early to tell what might be the long-run benefits.

It has been suggested that ICOs have become a significant source of funding for some start-up projects. Future growth in ICO popularity could potentially create competition with traditional forms of fundraising, generating greater efficiencies across the financial system. So long as the incentives faced by fundraisers and investors are sufficiently aligned, ICOs could help to improve the efficiency of capital allocation and contribute to economic growth.

Further, an ICO-friendly jurisdiction may attract ancillary services and this in turn may generate positive flow-on effects for the wider economy. Examples of such services include digital token exchanges and wallet providers as well as legal and financial consulting services. In particular, it is reasonable to expect that increased ICO activity would result in law and professional services firms investing in these capabilities as well as new specialist firms entering the market.

Risks

For industry

A large number of ICOs have failed, and many have turned out to be scams or have raised money illegally from public investors due to non-compliance with regulatory obligations. The resulting 'wild west' notoriety of the ICO industry has challenged the reputation of some legitimate businesses, and even technologies, related to ICOs. Another key concern raised by businesses considering raising funds via an ICO is the legal and regulatory risk due to uncertainty or unfamiliarity on the application of the regulatory regime.

There is also a high degree of uncertainty as to how much money will be raised by an ICO. Given the increasing effort and cost involved in preparing for an ICO funding round, businesses may also underestimate the upfront costs involved. There may also be challenges in valuing the business and estimating the future financial needs of the business, given the volatility of token prices and that digital tokens may be listed at different prices on various exchanges.

For consumers and investors

Early generation ICOs attracted participation from investors who were technologically sophisticated and were likely to be familiar with the parties seeking to raise funds, and the underlying technology being used. As ICOs have become more popular, many newer investors do not or cannot undertake the due diligence required to have a full understanding of the risks involved with either the technology being used or the investment itself. As a result, risks to consumers are now being highlighted by regulators through published statements.⁸

Financial risks to consumers can be particularly high; while data on ICO activity is incomplete, recent reports indicate that a significant proportion of ICOs fail or are fraudulent, with the number of successful ICOs as low as 7 per cent in 2017 and the majority of financial gains accruing to private parties who invested prior to the public ICO taking place.⁹ Depending on how an ICO is structured, the digital tokens offered under an ICO may fall outside the scope of existing financial regulation, in which case investors are not protected. Further, given the cross-border nature of ICOs, legal protection and avenues for recourse may be limited, including if the tokens are lost or stolen (for example, via hacking or the loss of private access keys).

Extreme volatility in the value of new digital tokens also exposes consumers to significant risk. While much of this volatility reflects inherent uncertainty over the true value of the tokens, it may also be driven by instances of market manipulation. In a large proportion of cases, tokens will have been offered to private investors in a 'presale', sometimes with significant discounts of up to 80 per cent. Those initial investors may seek to create an undue level of hype surrounding the offering in order to sell their tokens at an artificially inflated initial trading price, before the value of the tokens decline markedly (so-called "pump and dump" schemes).

In addition to the traditional financial risks of investing in early-stage start ups, retail investors in ICOs may find that the rights attached to digital tokens do not accord with their expectations or do not exist. 'White papers' are the typical disclosure document where ICO issuers detail mission statements, employee biographies and the technical specifics of a project – however these documents often lack detailed, consistent information and some contain fraudulent claims or plagiarised language. Misrepresentations made by token issuers over the specific rights attached to the tokens, or the prospect of significant potential or guaranteed returns, is an area that has potential to be of significant harm to consumers.

There are also operational risks if the platform, product or service fails or does not perform as expected, leaving the consumer with worthless digital tokens. Further, risks surrounding digital infrastructure security have materialised internationally, particularly in relation to digital wallet providers and cryptocurrency exchanges.¹⁰

8 The Australian Securities and Investments Commission issued a consumer warning in April 2017: www.moneysmart.gov.au/investing/investment-warnings/initial-coin-offerings-icos. Refer also to footnote 12.

9 Cryptoasset Market Coverage Initiation: Network Creation, Satis Group, 11 July 2018.

10 For example, there have been reported experiences in Japan over 2018 where digital token exchanges have been stolen from their token wallets linked to the exchange. See Gearoid Reidy, Hackers Steal \$60 Million From Japanese Crypto Exchange Zaif, Bloomberg (20 September 2018) <https://www.bloomberg.com/news/articles/2018-09-19/tech-bureau-says-6-7b-yen-in-cryptocurrency-lost-in-zaif-hack>.

For the economy

While the advent of a new mechanism which could direct capital efficiently to innovative companies has the potential to deliver real economic gains, the realisation of those gains partly depends on the incentives faced by investors and those seeking to raise the capital. The exuberance surrounding ICOs has been evidenced by a rapid increase in the number of ICOs brought to market in a relatively short period of time, and in the volume of funds raised, with individual ICOs raising funds well in excess of expectations and often on the basis of scant, or at times fraudulent, information about the underlying company, its prospects and the rights of investors.¹¹

The historical record demonstrates that such signs of overexcitement can be associated with instances of speculative excess, fraud and capital misallocation. This can ultimately lead to lower returns on investment with deleterious impacts on overall economic growth. A large number of failed ICOs and instances of significant consumer and investor loss could also tarnish views on DLT more generally and reduce people's willingness to learn about and invest in its genuine economic potential. Further, a large-scale ICO failure may undermine investor trust and confidence in our regulatory system and harm Australia's reputation for having a well-regulated financial sector.

Emerging fund-sourcing mechanisms such as crowdfunding could also be undermined in the event of large-scale ICO failure, potentially resulting in negative investor sentiment towards non-traditional forms of fundraising. Such an outcome would be expected to limit new and existing businesses' ability to capitalise on a full range of fundraising capabilities, hindering business growth.

Although the ICO market is small relative to the broader economy, new digital tokens are being created at a rapid pace and, if current trends were to continue and tokens became widely adopted in mainstream society, this could ultimately create difficulties for macroeconomic management. Digital tokens, at least to date, have been subject to wide swings in value. Should individual and institutional investor exposure to digital tokens continue to grow, the financial stability implications of this volatility could become non-trivial. Further, much wider adoption of digital tokens as a means of payment could eventually present some challenges for monetary policy.

KEY QUESTIONS

- 3.1 How can ICOs contribute to innovation that is socially and economically valuable?
- 3.2 What do ICOs offer that existing funding mechanisms do not?
- 3.3 Are there other opportunities for consumers, industry or the economy that ICOs offer?
- 3.4 How important are ICOs to Australia's capability to being a global leader in FinTech?
- 3.5 Are there other risks associated with ICOs to raise with policymakers and regulators?

¹¹ While the data on ICO activity is incomplete, there are some studies that attempt to quantify the funds raised by legitimate ICO campaigns. For example, Buckley et al (2018) indicates that more funds were raised in ICOs the last six months of 2017 than in all previous 3.5 years. Buckley et al (2018) also indicates that many ICOs have been scams and Ponzi schemes, and others have had governance issues.

Regulation of ICOs

Internationally, some countries are actively seeking to attract and develop a vibrant ICO market, while others have banned crypto-token activity entirely. Within Australia, ICOs are subject to Australian Consumer Law where the tokens issued are not classed as financial products.¹² If the tokens issued are classed as financial products, the ICO is subject to the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

Global regulatory approaches and challenges

In general, financial market regulators are taking various steps to clarify how existing laws apply to cryptocurrency trading or issuance, while in the case of some smaller markets, new bespoke frameworks have been created, often through targeted legislation. Aside from specific regulatory approaches, the relative attractiveness of a jurisdiction as an ICO host may be influenced by tax settings, the vibrancy of its local FinTech and startup ecosystem, and various other characteristics or conventions of that country or state.

Some jurisdictions (such as China¹³ and South Korea)¹⁴ have banned or actively sought to suppress cryptocurrency trading or issuance (including ICOs). According to public statements, regulators in such jurisdictions are largely driven by concerns of fraudulent activity and scams. In the most extreme cases, the use, creation and sale of cryptocurrencies may be prohibited by law and punishable by imprisonment.

Actions that may be taken to enforce a ban include banning banks from dealing with businesses involved in exchanging or processing digital assets, blocking access to websites, the forced closure of exchanges, and placing restrictions on search engines and social media platforms. However, there are significant practical challenges in enforcing a complete ban, given the decentralised and global nature of digital tokens.

Other regulatory responses have been to issue statements to warn consumers and investors of the risks associated with ICOs and to put ICO organisers on notice that their activity is being monitored.¹⁵ The United States' Securities and Exchange Commission (SEC) and Europe's European Securities and Markets Authority (ESMA)¹⁶ have taken steps to clarify how existing regulations apply to ICOs. In addition, some jurisdictions have announced they are analysing ICO developments and may move to regulate the sector more actively in the future.¹⁷

12 Australian Consumer Law refers to the *Competition and Consumer Act 2010 (Commonwealth)*, Schedule 2. Refer to Box 4 – Regulatory Treatment of ICOs in Australia.

13 Lulu Yilun Chen & Justina Lee, Bitcoin Tumbles as PBOC Declares Initial Coin Offerings Illegal, Bloomberg (4 September 2017), www.bloomberg.com/news/articles/2017-09-04/china-central-bank-says-initial-coin-offerings-are-illegal.

14 While South Korea has banned ICOs, media reports indicate that policy makers may be reviewing their stance. See Kim Yoo-chul, Korea shifting to embrace cryptocurrency, The Korea Times (5 July 2018), www.koreatimes.co.kr/www/biz/2018/07/602_251786.html, Park Si-soo, South Korea Mulls Tax on Cryptocurrencies and ICOs, says Financial Minister Nominee, The Korea Times (3 December 2018), https://www.koreatimes.co.kr/www/biz/2018/12/367_259753.html.

15 Regulators in over thirty five countries have issued statements on ICOs. See statements at www.iosco.org/publications/?subsection=ico-statements (extracted 13 July 2018).

16 Hayley McDowell, ESMA: Crypto Platforms Should Trade Under MiFID II Rules, (9 January 2019), <https://www.thetradenews.com/esma-crypto-platforms-trade-mifid-ii-rules/>.

17 For example, the United Kingdom Cryptoassets Taskforce released its final report in October 2018 setting out actions that will be taken forward.

Identifying when an ICO falls within financial services or securities laws

One of the key challenges for market participants and regulators in accommodating ICOs within existing frameworks has been determining when an ICO token is a “financial product” and thus falls within relevant financial services and securities laws. Uncertainty of whether and how to comply with financial services regulations appears to have constrained some jurisdictions’ digital token issuance.

If an ICO token is subject to financial services or securities laws, issuers are expected to comply with specific obligations as they might apply to those undertaking an IPO, the sale of an options contract, or the sale of units in a managed fund. This could require token issuers to prepare detailed disclosure documents, complete independent audits, hold certain licences, submit specific reports to regulators and comply with a range of financial market provisions.

There are some challenges in applying financial services and securities laws to ICOs

Where a digital token grants the holder an equity interest, a right to an expected future cash flow, or where its value is linked to the performance of a real or financial asset, it may be self-evident that it is a financial product. However, in many cases this determination is less straightforward. This can be for a number of reasons, for example where the digital token performs multiple functions at different times during the project life-cycle, or where there is a lack of detail surrounding a clearly defined business plan about the digital token and its attached rights and obligations, the project or company to which it is attached, or the broader features of the enterprise.

EXAMPLE: CRYPTOWALLABY

Consider the hypothetical company PouchTech, which aims to provide an online gaming platform called CryptoWallaby where users can breed “digital wallabies”. The company markets its WBY tokens as a ‘crypto-collectible’ exchangeable for game time on the site. PouchTech intends to sell WBY tokens through an ICO fundraising campaign ahead of launch to help with development costs. PouchTech is not offering any dividends, equity, or other financial return on WBY purchases, only the opportunity to play. The tokens are not marketed as an investment product and so, on face value, WBY appears to be a utility token.

However, speculation around the potential success of CryptoWallaby may raise expectations about the future value of WBY tokens, and incentivise purchases of WBY by investors who have no intention of using the gaming platform, but instead plan to sell WBY at a higher price after the ICO is complete. These investors expect to profit from PouchTech’s efforts to build the CryptoWallaby platform, but have no control over the direction of the company or its projects. It appears that these speculators are engaging with WBY as if it were a financial product.

To address the challenges in characterising certain digital tokens as a type of financial product, some regulators have considered factors such as: how the token is marketed, including whether the product is described as an investment opportunity; and whether the token is exchangeable for an existing good or service, or if the platform is yet to be developed.

The United States Securities and Exchange Commission (SEC), for example, has deemed that tokens are securities if they represent an investment in a common enterprise with an expectation that profit will be derived from the efforts of others - the so-called ‘Howey test’. Statements issued by the SEC have been interpreted by industry as an indication that ICO tokens will generally be treated as securities (refer to **Box 2**).

BOX 2: REGULATORY APPROACH IN THE UNITED STATES

While a number of federal and state regulators have jurisdiction in the area of cryptocurrency and ICOs in the United States, the Securities and Exchange Commission (SEC) has taken the most prominent role in responding to the rising popularity of ICOs. On 25 July 2017, the SEC published an Investor Bulletin on ICOs as well as a Report of Investigation into an individual ICO that set out how fundamental principles of United States securities law may apply to ICOs. These two publications, followed by a public statement by SEC Chairman Jay Clayton on 11 December 2017, outline the approach the SEC is currently taking to the regulation of ICOs.

This approach centres on the premise that, depending on the facts and circumstances of the individual ICO, digital tokens may be securities and, if this is the case, the offer and sale of these digital tokens in an ICO are subject to the *Securities Act 1933* and *Securities Exchange Act of 1934* (known collectively as 'federal securities laws'). The SEC has outlined some general considerations for market professionals when determining whether a token offering represents an offering of securities:

- a change in the structure of a securities offering (for example, where interests are recorded in a distributed, rather than central, ledger), does not change the fundamental requirement that when a security is being offered, the relevant securities law must be followed;
- merely calling a token a "utility" token or structuring it to provide some utility does not prevent the token from being a security; and
- tokens and offerings that incorporate features and marketing efforts that emphasise the potential for profits based on the efforts of others, and the ability to trade those tokens on a secondary market, are generally offerings of securities.

Federal securities laws require registration with the SEC (unless an exemption is obtained). The purpose of this registration is to provide investors with procedural protections as well as material information, such as a prospectus, to help them make informed investment decisions. Additionally, trading platforms for securities are required to register as a national securities exchange (unless an exemption is obtained). A number of enforcement orders have been issued by the SEC in the last 6 months against issuers of digital tokens solely for violations of the registration or exemption requirements of the federal securities law.¹⁸

Some jurisdictions have made formal determinations of sub-categories of digital tokens

Some international regulators may identify certain digital tokens as being subject to financial services and securities laws, and other digital tokens that are subject to separate rules. For example, Switzerland's financial market regulator defines three categories of tokens, including 'payment tokens' which provide access to a platform, and are therefore subject to anti-money laundering (AML) laws but not to securities laws (refer to **Box 3**).

¹⁸ Eli Han, Richard Mertl, Chen Tang, The SEC Reiterates its Position on the Issuance, Trading and Investment in Digital Assets, King & Wood Mallesons, https://www.kwm.com/en/us/knowledge/insights/with-new-enforcement-actions-the-sec-reiterates-its-position-on-the-issuance-20181123?utm_source=insights_external&utm_medium=email&utm_campaign=global_fintech&utm_term=headline&utm_content=single_read_more.

Policymakers in Malta have enacted a new set of laws that define various categories of tokens, including ‘virtual financial assets’ which are subject to separate rules from financial products.¹⁹

Similarly, the Wyoming state government²⁰ in the United States has implemented measures to exempt utility tokens from certain financial services laws, so long as the tokens are exchangeable for goods and services, and not marketed as investments.²¹

BOX 3: REGULATORY APPROACH IN SWITZERLAND

In September 2017, the Swiss Financial Market Regulator, FINMA, published guidance setting out the applicability of existing laws for the regulation of ICOs, depending on their underlying purpose and specific characteristics. Specifically, it outlined that ICOs may be subject to provisions relating to: money laundering and terrorist financing; banking law; securities, and collective investment schemes legislation.

In February 2018, FINMA published further guidelines outlining how it will deal with enquiries regarding the applicability of the existing supervisory and regulatory framework to ICOs. FINMA argues that setting out these principles and providing tailored responses on a case-by-case basis provides clarity for market participants. The guidance sets out the regulatory principles which FINMA will apply when responding to enquiries from ICO issuers and the information FINMA requires from issuers in order to respond. Enquiries are subject to a fee based on the time required to adequately respond.

The guidance also sought to provide clarity on how FINMA will categorise digital token offerings and how it will treat those categories in a regulatory sense, albeit recognising that hybrid forms are possible:

- **Payment tokens:** synonymous with cryptocurrencies and have no further functions or links to other development projects. Tokens may in some cases only develop the necessary functionality and become accepted as a means of payment over a period of time. FINMA will not treat payment tokens as securities, consistent with their current practice. However, payment tokens are still subject to the Anti-Money Laundering Act (AMLA).
- **Utility tokens:** intended to provide digital access to an application or service, which do not qualify as securities only if their sole purpose is to confer digital access rights to an application or service and if the utility token can already be used in this way at the point of issue. Utility tokens are not subject to AMLA rules. If a utility token functions solely or partially as an investment in economic terms, FINMA will treat such tokens as securities (asset tokens).
- **Asset tokens:** represent assets such as participations in real physical underlyings, companies, or earnings streams, or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds or derivatives. As asset tokens are regarded as securities, there are securities law requirements for trading in such tokens, as well as civil law requirements under the Swiss Code of Obligations (for example, prospectus requirements).

19 Rachel Wolfson, Maltese Parliament Passes Laws That Set Regulatory Framework For Blockchain, Cryptocurrency And DLT, Forbes (5 July 2018), www.forbes.com/sites/rachelwolfson/2018/07/05/maltese-parliament-passes-laws-that-set-regulatory-framework-for-blockchain-cryptocurrency-and-dlt/#359d0e1249ed.

20 Benjamin Bain, Wyoming Aims to Be America’s Cryptocurrency Capital, Bloomberg (15 May 2018), www.bloomberg.com/news/articles/2018-05-15/wyoming-aims-to-be-america-s-cryptocurrency-capital.

21 Separately, a Bill aimed at creating a specific regulatory framework for the issuance of digital tokens has been introduced to the United States Congress. The Bill, in part, seeks to amend existing securities regulations to exclude digital tokens from the definition of a security and to direct the SEC to enact certain regulatory changes regarding digital units secured through public key cryptography. See United States Cong. House of Representatives. Token Taxonomy Act. 115th Congress. 2nd Sess. H.R. 7356 <https://www.congress.gov/bill/115th-congress/house-bill/7356/text>.

However, costs and benefits must be weighed

Anecdotal evidence suggests that while formal determinations of what regulatory obligations apply to digital tokens has reduced uncertainty for some businesses, it has created a significant regulatory burden. For example, some industry participants have reported that a determination from Switzerland's financial regulator can take up to six months.

Rather than distinguishing between financial product tokens and other types of digital tokens, some jurisdictions apply frameworks that allow all ICO fundraising to take place outside of financial services or securities laws. This means that tokens are sold without the disclosure and reporting requirements that traditionally accompany a financial product, regardless of the token's structure.

For example, the Isle of Man's financial regulator has determined that tokens are not investments for regulatory purposes and that virtual currency businesses are not subject to supervision or regulation by the regulator, other than compliance with AML laws.²² While this is a straightforward approach that provides certainty for digital token issuers, it may skew incentives towards ICO fundraising over other forms in order to avoid regulation. On the other hand, it could discourage some participants that may consider unregulated ICOs highly risky compared to regulated forms of investment.

It should be noted that regulations in the consumers' jurisdiction may apply even if the ICO is hosted in a different jurisdiction.

Regulatory frameworks in Australia

The emergence of ICOs as a new mechanism for capital raising has increased interest in the applicability of Australian financial services law to ICOs, and industry participants are seeking clarity on when and how to apply financial product law.

Protection of consumers and investors

The *Australian Consumer Law* is the principal consumer protection law in Australia. It sets out prohibitions that apply generally to all businesses that operate in Australia. These prohibitions cover unfair contracts, unfair practices, unconscionable conduct and misleading or deceptive conduct. With respect to financial products and services, similar protections are afforded by the *Australian Securities and Investments Commission Act 2001* (ASIC Act). Consumer protection law for financial products and services is supervised by ASIC, while consumer protection law for non-financial products is generally supervised by the Australian Competition and Consumer Commission (ACCC).

The overarching policy intent of these provisions is to protect consumers and investors from misleading and deceptive conduct, representations and practices across a broad range of consumer and financial products and services. The prohibition against misleading and deceptive conduct is also intended to influence norms for business conduct in the marketplace.

²² See www.iomfsa.im/consumer-material/initial-coin-offerings-questions-and-answers/.

In the case of ICOs subject to consumer law (that is, not financial products), the ACCC has delegated its powers to take action against misleading and deceptive conduct to the Australian Securities and Investments Commission (ASIC). Consumer protection provisions apply to ICOs whether or not they are financial products, consistent with the broad policy intent of the provisions. Feedback from industry groups in Australia suggests that the application of consumer law to ICOs is currently appropriate.

Regulation of financial products

Additional provisions apply to financial products and services as outlined in the *Corporations Act 2001* (Corporations Act) which is administered by ASIC. These laws set out the compliance and reporting obligations that companies have when they form, operate and cease and the obligations applying to the provision of financial products and services.

A financial product under the Corporations Act includes a managed investment scheme (MIS), share offering, derivative, or a non-cash payment facility (refer to **Box 4**, below). The Corporations Act can require those that deal in such financial products to be licensed (subject to some exemptions) and to comply with disclosure, registration and other obligations in relation to offering a financial product. **Box 4** also provides some general information on the obligations which may apply to issuers of financial products. More detailed information on when an ICO token might be a financial product and the obligations which may apply can be found in ASIC guidance: Information Sheet 225.²³

BOX 4: REGULATORY TREATMENT OF ICOS IN AUSTRALIA

The Australian Securities and Investments Commission (ASIC) published updated guidance (Information Sheet 225) on the regulatory treatment of ICOs in Australia in May 2018, and will be further updated in Q1 2019. The particular law that applies rests on whether the ICO token is a financial product. If the ICO token is a financial product, consumers are protected by the relevant provisions for those financial products under the *Corporations Act 2001* (Corporations Act).

Alternatively, if the ICO is not a financial product, ICO issuers are still subject to general law and the misleading and deceptive conduct prohibitions under the *Competition and Consumer Act 2010 (Cth) Schedule 2* (Australian Consumer Law). ASIC has received a delegation of power from the Australian Competition and Consumer Commission (ACCC) that enables it to take action under the Australian Consumer Law relating to ICOs if required. Australian law can also apply to an overseas entity that issues financial products to Australian investors.

Information Sheet 225 provides guidance for potential issuers to assist with determining whether an ICO token is likely to be a financial product, and thus subject to the relevant provisions of the Corporations Act, based on the attributes of some typical forms of offering. Specifically, a digital token that is a financial product could be a:

- **Managed investment scheme:** The digital tokens issued under an ICO may constitute an interest in a managed investment scheme, if investors contribute money or money's worth and those contributions are pooled or used in common enterprise to produce financial benefits or interests in property but where investors do not have day to day control but may have voting rights (see s9 of the Corporations Act). ICO issuers must comply with Chapter 5C and 7 of the Corporations Act.

²³ See www.asic.gov.au/regulatory-resources/digital-transformation/initial-coin-offerings-and-crypto-currency/.

BOX 4: REGULATORY TREATMENT OF ICOS IN AUSTRALIA (CONTINUED)

- : ASIC has released a suite of regulatory guides to provide comprehensive guidance to the industry. These regulatory guides provide advice on a range of issues related to establishing and running a management investment scheme. In particular, they detail licensing, registration and product disclosure obligations for issuers and operators of a managed investment scheme.
- **Share offering** if the rights attached to the digital token are similar to rights commonly attached to a share. These include ownership, voting rights or some right to participate in the profits of the issuer.
 - : Where it appears that an issuer of an ICO is actually making a public offer of a share, the issuer will need to prepare a prospectus. Such offers of shares are often described as initial public offerings (IPOs). By law, a prospectus must contain all information that consumers reasonably require to make an informed investment decision.²⁴
- **Derivative offering** if the price of the digital token is based on, for example, another financial product, underlying market index or asset price moving in a certain direction before a time or event, which in turn triggered a payment under the rights or obligations of the digital token.
 - : A derivative offering requires a product disclosure statement that contains sufficient information so that a retail client may make an informed decision about whether to purchase the financial product.²⁵ The product disclosure must contain detail such as: fees payable, risks and benefits and significant characteristics of the derivative offered.
- **Non-cash payment facility** if there is an arrangement where the digital token may be used to make payments to a number of payees or for payments to begin in the form of the digital token and be converted to fiat currency to complete the payment.
 - : Many non-cash payment facilities are regulated as financial products under the Corporations Act, and issuers must comply with the licensing, conduct and disclosure requirements for financial services. ASIC has provided some exemptions for classes of non-cash payment facilities.²⁶ Some of these exemptions contain conditions – for example issuers may be required to prominently display any expiry date and any rights the issuer retains to unilaterally change the terms and conditions of the facility.

In addition to the regulation of digital tokens at the initial offering stage, regulations also apply to the secondary market trading of digital tokens. Operators that offer the ability to trade digital tokens may be operating a 'financial market' as defined under the Corporations Act, if their platform enables customers to buy, be issued or sell these tokens. Anyone who operates a financial market in Australia is required by law to obtain a licence to do so or otherwise be exempted.²⁷

Obligations under anti-money laundering and counter-terrorism financing (AML/CTF) laws for digital currency exchanges came into effect on 3 April 2018, including requirements for exchanges to identify and verify their customers and consider the risk posed by each customer, and to report certain transactions to the Australian Transaction Reports and Analysis Centre (AUSTRAC).

24 More information on the information a prospectus should contain can be found at www.asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-228-prospectuses-effective-disclosure-for-retail-investors/.

25 See <https://download.asic.gov.au/media/1240931/rg168-published-28-october-2011.pdf>.

26 More information on ASIC's requirements can be found at www.asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-185-non-cash-payment-facilities/.

27 See www.asic.gov.au/for-finance-professionals/market-infrastructure-licensees/licensed-and-exempt-market-operators/.

Industry-led initiatives

In addition to formal regulation, the industry has a collective role in establishing minimum standards and raising governance levels in order to foster consumer and investor confidence. One prominent international example is the Simple Agreement for Future Tokens (SAFT) project, which was formed with the aim of developing an industry standard for digital token sales that are compliant with regulatory frameworks in the US and elsewhere. Similarly, a Code of Conduct has been developed by an industry body for digital finance, Global Digital Finance, setting out principles for token issuance and other cryptoasset activities.

While industry-led initiatives can play a role, many in the industry believe that an appropriate level of regulation is welcome and that self-regulation alone is not an optimal path forward. It has been noted that where government and regulators are clear on how legal frameworks apply to ICOs, and are willing to accommodate innovation, this provides certainty and contributes positively to development of the industry, particularly given the ‘wild west’ notoriety the sector has gained in its infancy.

New regulatory frameworks

Some industry participants have suggested that a new regulatory framework, separate from current financial services law, would best support the development of an ICO market in Australia. A recent comparable example is the *Corporations Amendment (Crowd-sourced Funding) Act 2017*, which established a new legislative framework for fundraising via crowdsource platforms. Such bespoke frameworks have the potential to provide clarity of the application of relevant laws and regulations and encourage economic activity.

However, the costs of introducing a new regulatory regime must be weighed against any potential benefits, particularly if the existing regime may be generally sufficient or where other measures could be taken to achieve policy goals. Disadvantages could include adding unnecessary legislative complexity and stifling future innovation by locking in particular ICO models. In addition, there can be a significant lead time involved in setting up a new legislative framework, and this should be taken into account given the rapid pace of change in ICO and DLT-based businesses.

Some adjustments to the current regime could be considered in order to provide more regulatory certainty and remove any impediments to legitimate ICO fundraising. For example, an area where more certainty might be beneficial is the distinction between security and utility tokens, and the associated application of consumer and financial services laws. Such clarity could potentially be provided through further regulatory guidance, or via legislative change.

KEY QUESTIONS

- 4.1 Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?
- 4.2 Do current regulatory frameworks enable ICOs and the creation of a legitimate ICO market? If not, why and how could the regulatory framework be changed to support the ICO market?
- 4.3 What, if any, adjustments to the existing regulatory frameworks would better address the risks posed by ICOs?
- 4.4 What role could a code of conduct play in building confidence in the ICO industry? Should any such code of conduct be subject to regulator approval?
- 4.5 Are there other measures that could be taken to promote a well-functioning ICO market in Australia?

Tax treatment of ICOs

The current tax treatment of ICOs follows from the attributes of the tokens that are issued. This tax treatment is consistent with taxation of other commercial transactions, financial instruments and capital raising mechanisms, where the tax implications flow from the underlying nature of the rights and obligations attached to the instrument, and not the form in which the instrument is issued.

For example some ICOs offer tokens with equity-like characteristics in the form of voting rights or profit participation, while other ICOs offer tokens that give rights to the future use of a DLT platform. As a result, how proceeds from ICOs are taxed in the hands of the issuer will depend on a number of factors, including whether they are issued in the form of a managed investment scheme, an offer of shares or other forms of equity, an offer of a derivative, or non-cash payment facility (potentially for future services to be provided by the issuer), in the same way as any other transaction or event.

Tax law contains tests to determine whether a particular interest is a debt interest or an equity interest (or neither) for tax purposes. These 'debt and equity tests' may impact the tax treatment of the proceeds of the ICO (both in the hands of the issuer and the investor), including whether a return on an interest in an entity may be frankable and non-deductible to the issuer (like a dividend), or whether it may be deductible to the issuer and not frankable (like interest).

Tax implications for issuers

Given the variety in how these arrangements can be structured, there is no single manner in which ICO proceeds are taxed. The following non-exhaustive list of scenarios outlines a range of possible tax outcomes:

- Where the tokens are issued in respect of a debt or equity instrument, the issue proceeds may not be assessable up front to the issuer.
- Where the tokens are issued in respect of a prepayment for a service, the issue proceeds are likely to be assessable to the issuer.
- If the issuer of the tokens makes regular transactions in tokens, it is possible that the proceeds could be seen as forming part of some trading activity such that the ICO proceeds could be taxed as ordinary income.
- Proceeds from tokens that are issued as an offer of a derivative could be subject to tax under the taxation of financial arrangement rules.

Tax implications for token holders

For the token buyer or recipient, tokens acquired through an ICO are considered an asset for tax purposes, and any capital gains arising may be subject to capital gains tax (GST). Alternatively, gains can be taxed as ordinary income, depending on the purpose of the acquisition.

Tokens that are acquired and used solely for the purchase of goods and services for personal use or consumption may be considered a personal use asset. Capital gains on personal use assets acquired for less than \$10,000 are disregarded for tax purposes. All capital losses made on personal use assets are disregarded.

Like other assets within the CGT regime, a token is considered to be disposed when it is sold, traded or exchanged. For example, this can include converting cryptocurrency to a fiat currency such as Australian dollars, using it to obtain goods and services or exchanging one cryptocurrency for another cryptocurrency.

There may also be tax consequences that arise in relation to returns or flows of value that may be received by taxpayers who hold tokens acquired through an ICO. The tax treatment will depend on the nature of the returns (that is, whether the returns have characteristics similar to dividends, interest or income), and the purpose of the holder in acquiring the tokens.

GST treatment of digital tokens

The GST treatment of sales and purchases of tokens as part of an ICO primarily depends on whether it meets the definition of a digital currency, a security or something else. Generally speaking, if the token is:

- a digital currency, it is treated the same way as money, and no GST will apply to sales of the token;
- a security (for example, it is a share, derivative or managed investment scheme), no GST will apply to sales of the token; or
- neither a digital currency nor a security, GST may apply to sales of the token. Other circumstances, including whether the parties are, or are required to be, registered for GST, will determine the GST treatment.

Further information on the tax treatment of ICOs is set out in **Appendix A**.

KEY QUESTIONS

- 5.1 Does the current tax treatment pose any impediments for issuers in undertaking capital raising activities through ICOs? If so, how?
- 5.2 Is the tax treatment of tokens appropriate for token holders?
- 5.3 Is there a need for changes to be made to the current tax treatment? If yes, what is the justification for these changes?

CONSULTATION QUESTIONS

Definitions and Token Categories

- 1.1. What is the clearest way to define ICOs and different categories of tokens?

Drivers of the ICO Market

- 2.1. What is the effect and importance of secondary trading in the ICO market?
- 2.2. What will be the key drivers of the ICO market going forward?

Opportunities and Risks

- 3.1. How can ICOs contribute to innovation that is socially and economically valuable?
- 3.2. What do ICOs offer that existing funding mechanisms do not?
- 3.3. Are there other opportunities for consumers, industry or the economy that ICOs offer?
- 3.4. How important are ICOs to Australia's capability to being a global leader in FinTech?
- 3.5. Are there other risks associated with ICOs that policymakers and regulators should be aware of?

Regulatory Frameworks in Australia

- 4.1. Is there ICO activity that may be outside the current regulatory framework for financial products and services that should be brought inside?
- 4.2. Do current regulatory frameworks enable ICOs and the creation of a legitimate ICO market? If not, why and how could the regulatory framework be changed to support the ICO market?
- 4.3. What, if any, adjustments to the existing regulatory frameworks would better address the risks posed by ICOs?
- 4.4. What role could a code of conduct play in building confidence in the ICO industry? Should any such code of conduct be subject to regulator approval?
- 4.5. Are there other measures that could be taken to promote a well-functioning ICO market in Australia?

Tax Treatment of ICOs

- 5.1. Does the current tax treatment pose any impediments for issuers in undertaking capital raising activities through ICOs? If so, how?
- 5.2. Is the tax treatment of tokens appropriate for token holders?
- 5.3. Is there a need for changes to be made to the current tax treatment? If yes, what is the justification for these changes?

ATTACHMENT A: TAX TREATMENT OF DIGITAL TOKENS

Income tax treatment for investors

This section considers the tax treatment applying to cryptocurrency (or tokens) that may be issued as part of an ICO to individual investors.

This tax treatment is not specific to ICOs, but applies generally to the acquisition and disposal of cryptocurrency, and may differ depending on the cryptocurrency's characteristics and use. There may also be tax consequences that arise in relation to returns or flows of value that may be received by taxpayers who hold tokens that have been acquired through an ICO. The tax treatment in these circumstances will depend on the nature of the returns (for example, whether they have characteristics similar to dividends, interest or income), and the purpose of the holder in acquiring the tokens.

Cryptocurrency acquired as an investment

In general, cryptocurrency (including when acquired through an ICO as a coin or token) is considered an asset for tax purposes, and any capital gains arising may be subject to capital gains tax (CGT) at marginal tax rates on disposal. Cryptocurrency is considered to be disposed when it is sold, traded or exchanged. For example, this can include converting cryptocurrency to a fiat currency such as Australian dollars, using it to obtain goods and services or exchanging one cryptocurrency for another cryptocurrency.

If a capital gain is made on disposal, the 50 per cent CGT discount may apply to capital gains on cryptocurrency held for a period of 12 months or longer. The CGT discount means that any capital gains made on disposal of cryptocurrency (after offsetting any capital losses, including any net capital losses from previous years) are reduced by 50 per cent, so that tax is only paid by the individual at marginal rates on the balance.

EXAMPLE: CRYPTOCURRENCY INVESTMENT

Terry is interested in an investment opportunity in a small start-up that is seeking to create a new cryptocurrency. The terms of the initial coin offering state that for a \$100 investment, the investor will receive a token which represents a right to one of the new digital coins when the new blockchain is operational. Terry considers that it may be quite lucrative to move into this space early before others follow so he invests \$1,000 and receives 10 tokens which he has added to his investment portfolio.

If Terry sells any of these tokens, or waits until the blockchain is operational and sells the cryptocurrency, the proceeds would be subject to CGT. He has acquired and held his cryptocurrency as an investment.

Cryptocurrency acquired through a chain split

Cryptocurrencies may undergo what is often known as a 'fork', or what we refer to in this appendix as a chain split. A chain split occurs when the blockchain for a cryptocurrency diverges into two paths, resulting in the creation of a new cryptocurrency and associated blockchain. The creation of Bitcoin Cash from Bitcoin is an example of a chain split.

A chain split may result in holders of cryptocurrency receiving a new cryptocurrency. This new cryptocurrency is in addition to their existing holdings of cryptocurrency, and is a direct result of the chain split. If individuals hold cryptocurrency as an investment and receive a new cryptocurrency as a result of a chain split, they will not derive ordinary income or make a capital gain at the time they receive the new cryptocurrency. However, they will make a capital gain when they dispose of the new cryptocurrency. For the purposes of working out the capital gain, the cost base of the new cryptocurrency received is zero.

If the new cryptocurrency is held as an investment for 12 months or more, individuals may be entitled to receive the 50 per cent CGT discount.

EXAMPLE: BITCOIN IS SPLIT INTO BITCOIN CASH

Alex held 10 Bitcoin on 1 August 2017 as an investment, when Bitcoin Cash split from Bitcoin. Immediately after the chain split, Alex held 10 Bitcoin and 10 Bitcoin Cash. Alex does not derive ordinary income or make a capital gain as a result of the receipt.

On 25 May 2019, Alex sold the 10 Bitcoin Cash for \$4,000. Because the cost base of the Bitcoin Cash was zero, Alex makes a total capital gain of \$4000 in the 2018-19 income year from the sale of the Bitcoin Cash.

As Alex held the Bitcoin Cash for more than 12 months, the CGT discount can be applied in calculating Alex's net capital gain. Assuming Alex had no capital losses available to be offset in the 2018-19 income year, or any net capital losses from previous income years, the net capital gain from the sale of the Bitcoin Cash would be \$2,000.

Cryptocurrency held as a personal use asset

Cryptocurrency that is acquired and used solely for the purchase of goods and services for personal use or consumption may be considered a personal use asset. Capital gains on personal use assets acquired for less than \$10,000 are disregarded for tax purposes. However, all capital losses made on personal use assets are disregarded.

EXAMPLE: CRYPTOCURRENCY AS A PERSONAL USE ASSET

Brian's local café offers discounts to clients who purchase their meals using Bitcoin. Brian purchases an amount of Bitcoin (\$250) to pay for his weekly dinner at the café and uses the purchased Bitcoin accordingly. In this circumstance, because Brian acquired and used the cryptocurrency for the purpose of dining out at the café, the cryptocurrency is a personal use asset. As the cost of acquiring the cryptocurrency was less than \$10,000, any capital gain Brian made on the disposal of the cryptocurrency would be disregarded.

Income tax treatment for issuers

This section considers the current tax treatment applying to cryptocurrency (or tokens) that may be issued as part of an ICO from the issuer's perspective. The tax treatment would ordinarily follow the attributes of the offering. For example, ICOs could be undertaken in the form of a managed investment scheme, in the form of an offer of shares, offer of a derivative, or non-cash payment facility (potentially for future services to be provided by the issuer).

Just like any other transaction or event, the existing tax rules will apply to ICO arrangements. The tax treatment of the ICO will depend on how the ICO is structured and operated, the characteristics of the token, products and/or services being offered and the rights and obligations between the parties. Factors potentially impacting the tax treatment can include whether there are voting rights, rights to share in profits, rights to receive certain products or services, or a right to repayment of the investment. As such, there is not a single tax outcome that will apply to all ICOs.

Tokens economically equivalent to debt or equity interests

The tax law contains tests to determine whether a particular interest is a debt interest or an equity interest (or neither) for tax purposes. These 'debt and equity tests' may impact on the tax treatment of the proceeds of the ICO (both in the hands of the issuer and the holder), including whether a return on an interest in an entity may be frankable and non-deductible to the issuer (like a dividend), or whether it may be deductible to the issuer and not frankable (like interest).

Broadly, in order for an interest to be classified as an equity interest, the interest must carry a return that is contingent on the economic performance of the issuer. Conversely, if the interest carries an obligation that the issuer is required to return to the holder an amount at least equal to the amount invested, then the interest may be treated as a debt interest.

Treatment as capital or trading stock, and other considerations

In certain circumstances, the proceeds could form the principal of a debt or equity interest (and not taxed upon receipt), whereas in other circumstances tax will be payable upfront on the proceeds of the ICO if the proceeds are ordinary income.

If the issuer of the tokens makes regular transactions in tokens, it is possible that the proceeds could be seen as forming part of some trading activity such that the ICO proceeds could be taxed as ordinary income.

Depending on the attributes of the arrangement, other tax consequences may arise for the issuer of the tokens, for example:

- Where the tokens are issued in respect of a prepayment for a service, the issue proceeds are likely to be assessable to the issuer.
- Proceeds from tokens that are issued as an offer of a derivative could be subject to tax under the taxation of financial arrangement rules and may form part of the cost base of the financial arrangement.
- Where the tokens are issued to employees of the issuer in relation to their employment, those tokens may constitute to be a benefit that could be subject to the fringe benefit tax provisions.

Given the variety in how these arrangements can be structured, there is no single manner in which ICO proceeds are taxed.

EXAMPLE: TOKENS ISSUED FROM AN ICO ECONOMICALLY EQUIVALENT TO AN EQUITY INTEREST

ABC co undertakes an ICO to raise capital and issues tokens to investors. ABC co prepares and releases a prospectus document inviting investors to invest in the ICO. The prospectus document contains all information that consumers reasonably require, under the law, to make an informed investment decision.

There are certain rights attached to the tokens issued by ABC co. The rights attached to the tokens are similar to the rights commonly attached to a share, that is, voting rights in decisions of the company, right to participate in profits of the company and a claim on the residual assets of the company if it is wound up.

In these circumstances, such a capital raising may create equity interests in the company, and the tax treatment of the ICO would follow that of an IPO (that is, the receipts would not be taxable to the issuer).

Alternatively, if ABC co makes regular transactions in tokens as part of its business, then those proceeds received from tokens issued as part of an ICO could be treated as ordinary income and taxed upfront.

GST on sales of cryptocurrency

The GST treatment of sales and purchases of cryptocurrency as part of an ICO primarily depends on whether it meets the definition of a digital currency, a security or something else. Whether parties are registered for GST, or are required to register for GST, will also affect the GST treatment. Generally speaking, if the cryptocurrency is:

- a digital currency, it is treated the same way as money, and no GST will apply to sales of the cryptocurrency;
- a security (for example, it is a share, derivative or managed investment scheme), no GST will apply to sales of the cryptocurrency; or
- neither a digital currency nor a security, GST may apply to sales of the cryptocurrency. Other circumstances, including whether the parties are, or are required to be, registered for GST, will determine the GST treatment.

EXAMPLE: PURCHASE OF CRYPTOCURRENCY

Joel, an Australian consumer, acquires 200 Koalacoins (a cryptocurrency) from Koalaco, an Australian resident company that is registered for GST, paying in Australian dollars.

The sale of the Koalacoins by Koalaco to Joel is a supply of digital currency for money – meaning, the supply would be an input taxed financial supply. As such, no GST will apply. Specifically, Koalaco cannot charge GST on the supply, and generally cannot claim any GST credits on costs incurred in relation to that supply.

As Joel is neither registered nor required to be registered for GST, there are no GST consequences for him.