FINANCIAL SERVICES COUNCIL

Tax treatment of digital assets and transactions

FSC Submission to Board of Taxation

October 2022

Contents

1 About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pool of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and
- to advocate for financial literacy and inclusion.

2 Introduction and summary

The FSC thanks the Board of Taxation (**the Board**) for the opportunity to make a submission to the Board's Review of the Tax Treatment of Digital Assets and Transactions in Australia (**the Review**).

This submission is focused on the tax issues relating to the holding of digital assets (or crypto assets) as investments, which is the area of interest to FSC members. The submission does not cover the creation of digital assets (including mining), or the use of digital assets as part of a larger transaction, such as accepting a digital currency in exchange for a sale of goods.

There are many types of investors, including workers accumulating retirement savings, retirees making use of retirement savings, and people saving for future expenses or purchases (such as a home). Investors also include the intermediaries that investors delegate to, such as managed funds, listed investment companies, superannuation funds and life insurance companies.

The nature of investing is dealt with in section 3.1 below.

3 The law on digital assets is not clear

The Board's Consultation Guide asks two questions under the heading 'Current tax treatment of crypto assets' (page 13):

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?
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 FSC's submission is that the tax treatment of holding digital assets as investments is far from clear and significant changes are required to remedy this issue.

The FSC submits this result is not because of the innovative characteristics of digital assets. Instead, it is because of difficulties with the current tax law for investments.

3.1 Current tax treatment of digital assets held as investments – CGT

The Board's Consultation Guide says "Crypto assets … generally fall under the Capital Gains Tax (**CGT**) provisions" (page 9). We note that the consultation guide uses the word "generally" – we submit this is because the outcome is not clear.

This lack of clarity is demonstrated in current and historical text on the ATO website, and in the ATO's formal rulings and determinations.

The ATO had a similar statement containing the word "generally" on its website (see Appendix 1), but at the time of writing this is not the case. The website is now much more comprehensive and contains multiple hyperlinks.[1] The website describes the CGT rules and has a statement that "Other rules may apply depending on how you're using crypto assets for business transactions". An investor may consider that these 'other rules' do not apply to them on the basis that the word "business" has its ordinary meaning.

However, the ATO's view is more complex. The ATO website elsewhere states that an individual is carrying on a business if they repeat an action. So the website is indicating that an investor may find themselves outside of the CGT rules by making multiple investments in a digital asset or by making investments in multiple digital assets.

The website follows with a statement that an indication that an investor is carrying on a business is if they "intend to make a profit or genuinely believe that you will make a profit". Importantly, every investor intends to make a profit and genuinely believes that they will do so – otherwise they would not be investing.

As a result, the investor who reads all of the ATO's explanation will conclude that they are always outside of the CGT rules whereas those who stopped reading early will draw the opposite conclusion.

The conclusion that digital assets are outside CGT is consistent with paragraphs 22 to 25 of Taxation Determination TD 2014/26 about bitcoin. Those paragraphs state the following occasions when a bitcoin investment is ordinary income (ie outside of the CGT rules):

- an isolated transaction … is ordinary income where the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain, and the transaction was entered into in carrying out a commercial transaction.
- where a taxpayer acquires bitcoin with the purpose of profiting from it upon a commercial transfer, a gain made on its disposal will be assessable as ordinary income.

An investor might conclude that they do not meet these tests due to the inclusion of the word "commercial". Again, the ATO's view is more complex.

An isolated transaction can move an 'investor' out of the ordinary income rules and into the CGT rules. This is explained in Taxation Ruling TR 92/3. An 'isolated transaction' is a one-off transaction that is quite unlike the transactions that the taxpayer is normally taxed on. As a result, anyone with a diversified portfolio of investments built over time has gone far beyond an isolated transaction and cannot escape the ordinary income rules, according to this Ruling.

Paragraph 49 of TR 92/3 provides the list of factors that determine whether a transaction amounts to a commercial transaction and is therefore caught by the ordinary income rules. Eight factors are listed but it is indicated that there are other additional factors. If a statement of law requires a list of factors to be weighed up, it cannot be said that the law is clear. If it requires a taxpayer to also guess at unstated factors, it is even less clear.

[1] See: https://www.ato.gov.au/individuals/investments-and-assets/crypto-asset-investments/

The seventh of the eight factors listed in TR 92/3 says that for the acquisition and disposal of an asset where that asset "has no use other than as the subject of trade, the conclusion… that the transaction was commercial in nature, would be readily drawn." As digital assets have no use other than trade, this strongly indicates that digital assets are not subject to the CGT rules.

Applying the explanation on the ATO's website and in their Tax Determination and Tax Ruling, the conclusion is that the application of the CGT rules to digital assets is a very small exception rather than the general case, and mostly digital assets are outside CGT rules (and taxed as ordinary income). This conclusion can be reached even though the frequent presentation is that it is the other way around.

The ATO's analysis is based in the case law and they are not going to be able to interpret their way out of this problem.

The legal cases on profits on the sale of assets, before CGT was introduced, required taxpayers to argue that the profits were not "income", not "trading stock" and outside of concepts such as "profit-making undertaking or scheme". This required taxpayers to present several debatable positions about investing:

- that investing involved very little activity
- that investing was done without any sort of commercial sense
- that investors were ignorant of the fact that shares and real estate would significantly increase in value over time
- that investors stopped thinking about their investment assets once they had been bought, only selling when an unexpected event forced them to change their plans.

It is hard to justify these points. Investing is the profit motive exercised through asset ownership rather than through providing goods and services. These cases created a false dichotomy between investing and seeking asset price increases when in fact they have always been synonymous. The concept of investing without seeking a price increase cannot be found anywhere outside of the tax law.

It cannot be argued that investors have become more sophisticated since these cases were decided, as there was substantial document investment strategy at the time of the cases.[2]

It also cannot be argued that digital assets are presenting a new problem because they are assets that do not produce an income stream like interest, dividends or rent. Australians have a long history of investing in resource companies that do not pay dividends (and more recently tech companies that pay minimal or no dividends).

[2] One of today's often-quoted writers on investment strategy is Benjamin Graham whose still-influential texts were written in 1934 and 1949 and Graham was merely documenting principles that had been known for a long time. *Security Analysis* (1934) co-written with David Dodd and *The Intelligent Investor* (1949).

The tax law for investors has been so nebulous that there has been a need for statutory overrides, which have been delivered on a piecemeal basis. Key examples are:

- Section 295-85[3] decrees that superannuation funds are to use the capital gains tax rules for assets like land and shares.
- Section 320-45 does the same thing for the statutory funds of life insurance companies where the policies are issued to superannuation funds.
- Section 275-100 does the same thing for Managed Investment Trusts.
- Division 230 codifies the treatment of bonds, derivatives and other financial arrangements.
- Division 775 codifies the treatment of foreign exchange gains and losses.

These overrides were introduced to produce clarity and appropriate outcomes.

Importantly, there are no statutory overrides for individual investors investing in land or shares. These investors use the CGT rules and ignore the complexities of the tax law at the grace of the ATO, which could be amended at any moment. This is the unstable position that digital asset investors are in.

3.2 Income generated

Bitcoin, the digital asset that people know the most about, does not produce any income flow that would be analogous with dividends. Investors just buy and sell bitcoin.

Some current digital assets though do produce such a flow, although the income flow is small and can never be the primary reason for buying the asset. For example, there is a digital asset called ATOM where those who participate in validation are paid fees as additional ATOM tokens.[4] From a tax perspective, the additional tokens are income derived, but many investors in ATOM are likely to not even identify this as a possibility. There is no ATO guidance on this issue and the Board's Consultation Guide has not identified this as a characteristic of digital assets.

This is just one example. There will be many variations involving digital assets.

In addition, when there is assessable income on a digital asset, the source of that income needs to be determined. If a Managed Investment Trust has non-resident members, the Trust needs to withhold tax from Australian sourced income. Advances in communications technology having been making the determination of source less and less clear for many decades. Digital assets are making the situation worse.

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[3] References to legislation are to the *Income Tax Assessment Act 1997* unless otherwise specified
[4] Digital assets use decentralised technologies. The validity of the record keeping is performed by the hardware of the holders of the assets. Holders of ATOM can choose to participate in the validation or to not participate. Those who choose to participate are paid for doing so out of fees paid by new users of ATOM's underlying technology. These returns are paid in additional ATOM tokens.

3.3 Eligible Investment Business

Managed funds are typically unit trusts, taking advantage of the simpler and more equitable attribution taxation regime, rather than using the franking regime that would apply if the fund were a company.

Using this simpler regime comes with a restriction on the assets that the unit trust can hold. The assets that are allowable are called 'eligible investment business' and are listed in section 102M of the Income Tax Assessment Act 1936 (**ITAA36**).

If digital assets such as bitcoin do not qualify as eligible investment business, then they are not able to be part of the portfolios of managed funds. This consequently blocks other investors such as superannuation funds from the efficiency of accessing such assets via specialist managed funds.

The list in section 102M contains a number of very specific asset descriptions, not including digital assets, but finishes with "any similar financial instruments".

The ATO has not expressed a view on whether or not digital currencies fit into the phrase "any similar financial instruments".

A view of some tax advisers is that digital currencies are not 'financial instruments' for the purposes of section 102M because international accounting standards treat them as not being 'financial instruments' for accounting standard purposes. However, the accounting standard interpretation turns on their definition limiting the expression 'financial instrument' to assets that arise under contracts. Arguably, that is a point of distinction that is not relevant to the purposes of section 102M.

As a result, there is no decisive argument either way on whether digital currencies are eligible investment business. The position is unclear.

Arguments in favour of digital currencies being 'financial instruments' similar to traditional currencies include:

- Their original purpose was to be a substitute for traditional currencies.
- If their primary use has turned out to be as an investment rather than as a currency, they should be seen as now being mainstream investment assets, which is what eligible investment business is all about.
- Australia's GST legislation was amended to treat digital currencies like money.
- Australia amended the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (AMLCTFA) to put digital currencies on the same footing as traditional currencies.
- the Reserve Bank of Australia is "actively researching central bank digital currency … as a complement to existing forms of money".[5]

[5] See: https://www.rba.gov.au/payments-and-infrastructure/central-bank-digital-currency/

As a result, digital currencies are part of the financial system alongside traditional currencies, and their role could easily increase.

3.4 Foreign currency

As the Consultation Guide notes, the ATO issued Tax Determination TD 2014/25 concluding that bitcoin was not a foreign currency for the purposes of Division 775, on the basis that it had not been adopted as a monetary unit of any sovereign State.

This approach was invalidated in 2021 when El Salvador adopted bitcoin as one of its monetary units. The Government has responded by releasing draft legislation to restore the ATO's position stated in the Tax Determination.[6]

While this may deliver simplicity in removing the burden of taxpayers working their way through Division 775, it should be noted that Division 775 was introduced because the case law on foreign exchange gains and losses was unclear and delivering inappropriate outcomes.

As noted in the previous section, the GST legislation, the AMLCTFA and the Reserve Bank of Australia see digital currencies as currencies, so it is questionable whether this new legislation is going in the right direction.

4 Changes that are required

4.1 There is no simple fix

The above sections have demonstrated above the lack of clarity in the tax law relating to investment assets. The FSC submits this should be fixed.

Australia needs to move on from the principles established before CGT. This has been partly addressed by codifying some rules, as noted in 3.1 above, and perhaps the answer is to complete this job.

There is no clear solution to this issue, as it is a challenging question.

One possibly for large investors could be to codify which assets fitted into which of the following three well-developed complementary regimes:

- the capital gains tax rules;
- the taxation of financial arrangements rules in Division 250; and
- the foreign exchange gains and losses rules in Division 775.

If assets were allocated into these regimes (with no gaps or inappropriate overlaps) and stopped the ordinary income rules from overriding the CGT rules, this could be an equitable system that is relatively clear to the large investors.

[6] See joint media release by The Hon Dr Jim Chalmers MP and The Hon Stephen Jones MP, 22 June 2022.

Smaller investors are carved out of Division 250, and it appears that the Government would like them carved out of Division 775 as well. There would then be a need for codifying a simpler regime for smaller investors in place of these detailed rules. Smaller investors should not be left to deal with the ordinary income rules.

4.2 Digital is more than just a new asset class

We note that 'digital asset' is not necessarily an identifiable type of asset. The technological change we are experiencing is more than the invention of new assets. It is the invention of a new way for assets to exist. New assets are being created, and traditional assets are appearing in new forms.

There is already the early stages of 'smart contracts' where legal rights are executed and controlled digitally, cutting out the intermediaries that are currently needed.

ASX is replacing its current system with one that uses blockchain technology. It seems inevitable that at some point traditional assets like shares in a company could exist as smart contracts, removing the need for a share register.

In other words, one day shares in a company could be digital assets. As a consequence, the law needs to deal with asset sales without creating a new false dichotomy between digital assets and non-digital assets.

Appendix 1 Screenshot of the ATO's former website

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Cryptocurrency - investment or personal use asset

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Cryptocurrency – investment or personal use asset

We treat cryptocurrency like shares and many other investments, so it is generally regarded as a capital gains tax (CGT) asset.

A CGT event occurs when disposing of cryptocurrency. Events can include selling cryptocurrency for a fiat currency, exchanging one cryptocurrency for another, gifting it, trading it or using it to pay for goods or services.

On this page:

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Investing in cryptocurrency

Most people hold cryptocurrency as an investment, which they hope grows in value over time to give them capital gains.

Each cryptocurrency is a separate asset for CGT purposes. When your client disposes of one cryptocurrency to acquire another, they are disposing of one CGT asset and acquiring another CGT asset.

If your client holds cryptocurrency for 12 months or more, they may be entitled to a 50% CGT discount to reduce any capital gains made when they dispose of it.