Token Raises - The Next Stage in the Cryptocurrency Saga?

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In brief

In January 2019, the Australian Treasury released an Issues Paper on Initial Coin Offerings (the **Treasury Paper**), seeking industry comments as it progresses its review and consultation of the Australian regulatory and tax landscape surrounding Initial Coin Offerings (**ICOs,** or **token raises**). Token raises have been of interest to start-up blockchain (and particularly FinTech) businesses, which the Australian Government is aiming to attract and promote as part of its goal to be a global leader in financial innovation. However, the application of Australian taxation laws to token raises (particularly where businesses issue tokens to launch new digital platforms) gives rise to uncertain tax outcomes which can act as a practical deterrent to token issuers.

The innovative and ever changing nature of the tokens issued creates complexities when viewed through the lens of traditional tax law concepts, which may result in anomalous tax outcomes compared to more conventional forms of capital raising. A real risk of upfront taxation on the token raise proceeds, coupled with Australia's high corporate tax rate, may put Australian token issuers at a competitive disadvantage compared to many regimes around the world. At this stage, the issues are complex and the lack of certainty can act as a deterrent to FinTechs locating their personnel and activities in Australia.

In detail

There has been significant buzz around the concept of ICOs, or *token raises*, over the past few years. A token raise is an innovative way of raising funds *and* usership for new digital platforms. In essence, token raises involve companies (typically FinTechs or blockchain innovators) creating and issuing unique cryptocurrency tokens to participants, usually in exchange for value (e.g. fiat currency or cryptocurrency).

The design opportunities of tokens are broad and as such they vary considerably in character. In this sense, a token raise may offer some value over a traditional capital raise for technology companies, particularly in terms of being able to offer a token that will develop a community of supporters for a blockchain-based project, a network of early adopters, or simply customers.

Token raises can play a role as a relatively low cost and accessible source of capital for start-ups that are focusing on blockchain technology. However, the popularity of token raises in Australia has ebbed and flowed, and in our experience, both regulatory and tax uncertainty has become a deterrent. While regulators such as ASIC and the Australian Taxation Office (ATO) have been working to provide clarity in relation to the tax treatment of cryptocurrency, ICOs are particularly complex and should be considered separately.

No 'one size fits all' approach to characterising tokens

Under current tax law, the **nature** of an instrument is often taken as instructive on the **intention** of the issuer, thus assisting in the determination of the appropriate tax technical treatment. The tax treatment, in most instances, is one that is commercially sensible as traditional instruments are within the contemplation of existing tax law (e.g. equity raising is seen as a clearly capital transaction and non-taxable). This approach, however, is problematic when applied to token raises, and can give rise to anomalous, and disadvantageous outcomes for token issuers. The difficulty lies in the greatly varied nature of the tokens being issued.

Depending on its form, a token represents, and grants the holder, various things ranging from:

- equity rights in the issuing company (referred to as 'security' tokens)
- underlying exposure to real world assets (referred to as 'asset-backed' tokens)
- digital currency, or
- ability to access a digital platform or service (whether already built or not yet operational) (referred to as 'utility' tokens).

The tax characterisation of these different tokens (and the tax uncertainty attributed to their issue) will vary on an individual token-by-token basis across a very broad spectrum.

Given the varying nature of tokens in the market (which are only likely to increase), a case can be made that both the nature *and* the intention of the token issuer should be relevant to determining the tax treatment of a token raise, particularly utility tokens, which can have hybrid characteristics.

It is important to note that the objective of token raises is not always limited to capital raising. They can be used to fund a new idea, to build a network or community of support for a platform, or to secure actual participants on an already operational digital platform. In some cases (e.g. a security token, asset-backed token or digital currency), the intention behind a token raise is reasonably apparent, so the nature of the token may be taken as a natural proxy for its appropriate tax treatment. However, the intention behind a utility token can sometimes be wide-ranging and often more difficult to ascertain, so issuers (and experienced tax practitioners alike) should proceed with caution in determining the relevant tax treatment.

Upfront taxation a major deterrent to the token market

One of the biggest challenges faced by issuers in relation to a utility token raise is the risk that the proceeds of the raise may be subject to tax upfront (e.g. on revenue account or as trading stock).

The possibility of upfront tax on a token raise (including both income tax and potentially goods and services tax (GST)) is likely to deter investors and diminish the overall attractiveness of a project (versus a capital raise), given that a significant portion of the initial funding may not be invested into the project from the outset.

In our view, upfront tax on certain utility token raises (e.g. where a platform is already built and operational, and the token is the revenue generating asset of the issuer) may be appropriate. However, this is counter-intuitive in circumstances where utility tokens are contingent on future events happening or where a token issuer raises funds for the purpose of building a platform, brand community or network for the benefit and future use of token holders (i.e. a capital asset), particularly where the build of the platform (e.g. a future blockchain ecosystem) is highly innovative. While this outcome may be arrived at after a detailed consideration of the laws of revenue v capital (including the *Myer Emporium case*), this is a detailed analysis and one which is costly and time consuming for many start ups. Equally, the analysis is not without risk because there is no direct case law or binding ATO guidance.

The risk of foregoing a significant portion of the initial funding for a project is likely to be a contributing factor towards token issuers funneling token design towards a *security* token, or defaulting back into more traditional forms of capital raising, thus negating the benefits that issuers may access through the token market in the first place (e.g. brand/network building, and access to different pools of liquidity).

Additional layers of tax complications

There is also a dormant GST risk for issuers (assuming the particular token is subject to GST) to the extent that once tokens are issued, they are subsequently exchanged on the secondary market, which gives rise to a GST risk where a token transfer occurs between two Australians, as holders cannot easily identify who they are buying from/selling to.

Depending on the nature of the token, there are other operational tax questions for token issuers to consider. Some of these include:

- what are the withholding tax (**WHT**) implications on certain tokens issued with a right of return (e.g. royalty WHT on utility tokens providing a right to use a platform)?
- if dividends are issued on a security token, do AIIR obligations apply?
- are FATCA/CRS rules applicable?
- would certain tokens constitute a 'financial arrangement' for the purposes of the Taxation of Financial Arrangement (**TOFA**) provisions and subject to tax accordingly?

Further, to the extent that token raises are conducted by a non-Australian entity controlled by an Australian parent, there may be Controlled Foreign Company (**CFC**) implications, or depending on the issuer's corporate structure, there may be a risk that the entity is actually centrally managed and controlled in Australia. Where the CFC rules apply, an analysis of active vs passive income is required and we expect that the answer may vary depending on the token's attributes.

In terms of practical outcome, given all the tax complexities in Australia, token issuers often do not know the quantum of pre-tax funds they need to raise, because they are uncertain of the portion that needs to be set aside to meet cash tax liabilities. Tax becomes a costly challenge for these entities, potentially *before* they have the funding necessary to address these concerns.

Solving the tax puzzle

Given the relative infancy of the Australian token market, many of the issues noted above may not have been raised with the ATO previously (e.g. through rulings), so there have been limited opportunities for guidance to be considered. In many cases, these are new issues both for the industry and ATO to tackle and the answers are not always intuitive. Collaboration is welcome and necessary.

In the long term, tax certainty could be provided to the market through a hybrid approach involving legislative reform together with a streamlined ruling process. An example of a streamlined tax regime that has proven helpful to the start-up sector is one aspect of the Early Stage Innovation Company (**ESIC**) concession, which applies "principles-based" tests to determine whether a company qualifies as an early stage investor. The ESIC rules then encourage resolution of the issue through a tax ruling with the ATO.

While there is not necessarily need for law change in a token raising context, the above process could be used to agree on appropriate "principles" for the taxation of token raises. The enshrinement of agreed principles (which could expand upon common law tests), coupled with a streamlined ruling process, could be used to provide clarity and speedy resolution of the tax treatment of token raises. This could be accompanied by relevant ATO guidance to provide a roadmap for token issuers to self-assess the key matters and prepare short form rulings around issues that are of importance to the ATO in determining the matter. This measure would operate as a channel for ATO interaction, but also set a base level of analysis/issues that token issuers should consider before they can form a view on taxation treatment.

The takeaway

The token market is a potential source of liquidity and brand support for many start-ups, in particular where their target investor base is a blockchain-literate audience. If token raises are to be an acceptable source of liquidity (where compliant with all regulations), then tax certainty is a crucial aspect of ensuring that this source of liquidity is accessible. This is particularly important given the relative complexity of the tax laws that apply versus the stage of business involved (largely start-ups).

The work that the ATO has undertaken in relation to cryptocurrency provides an admirable framework, albeit the issues relating to token raises are quite unique, and should be considered separately.

While some of these matters may simply be resolved through the passage of time, we believe that a streamlined tax regime could help to provide this certainty.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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