22 February 2021

Senate Select Committee on Financial Technology and Regulatory Technology
Department of the Senate
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee,

Thank you for the opportunity to address the committee on 11 February 2021.

Senator Bragg asked us to provide further details about two of our recommendations: 1) changes to the capital gains taxation regime so that it better suits cryptocurrency transactions, and 2) changes to the managed investment scheme framework to facilitate Australian innovation in new financial products.

The capital gains taxation regime as it applies to cryptocurrency is no longer appropriate

The Australian Taxation Office's position that cryptocurrency is an asset for capital gains tax purposes[1] and that every exchange between two cryptocurrency tokens should be treated as a "disposal" creates substantial regulatory compliance burdens on taxpayers, hinders fintech adoption, and achieves no policy objective.[2]

This treatment of tokens poses unique challenges for cryptocurrency users. As each token-to-token exchange is treated by the ATO as a capital gains tax event, taxpayers are required to record gains or losses in the Australian dollars.[3] However, token-to-token exchanges often occur at multiple times removed from Australian dollar-denominated markets. For many cryptocurrency tokens, liquid token-AUD exchange markets do not exist. In addition, the volume and complexity of some of these token exchanges make precise accounting of gains and losses on a per-transaction basis unrealistic, even for honest taxpayers seeking to fully ensure compliance.

[1] Unless for example where cryptocurrencies are acquired for the purpose of sale or exchange in the course of carrying on the business and therefore treated as trading stock: TD 2014/27 Taxation Income tax: is bitcoin trading stock for the purposes of subsection 70-10(1) of the Income Tax Assessment Act 1997?
[2] We would like to thank our colleague Dr Elizabeth Morton for her guidance in this recommendation.
[3] A parallel regime allows for cryptocurrency to be held as "personal use assets". This regime does not solve the problems outlined here. Current ATO guidance states that this regime only applies to tokens "acquired and used within a short period of time, to acquire items for personal use or consumption,". This excludes much activity in the cryptoeconomy, not least because it puts the burden on users to dispose of tokens rather than for retain them for otherwise personal use or consumption (such as the payment of gas fees) at a future date. Anything but the complete disposal of tokens risks personal use tokens being reclassified by the ATO.

Token-to-token exchanges of cryptocurrencies and other digital assets are foundational to the development of the digital economy, contributing to price and business model discovery. The current capital gains tax treatment to token-to-token exchanges imposes significant and unnecessary uncertainty and regulatory burden on cryptocurrency users, investors and the blockchain industry more generally.

The capital gains tax regime may have been appropriate five years ago when the cryptoeconomy was smaller, less complex and when there were relatively few places to make token-to-token exchanges. However, recent developments make the current policy regime inappropriately narrow and imposing. For example, the rise of decentralised finance ('defi') means that token-to-token exchanges are now commonly occurring through a vast ecosystem of decentralised protocols that operate at multiple levels removed from Australian dollar-denominated markets and provide no easy-to-use tools for the granular record keeping required by the ATO.

Additionally, the tokens that are being exchanged are also changing as the cryptoeconomy has developed. Defi activity can result in tokens being locked up in exchange for 'governance' tokens. Tokens that represent claims on other tokens through smart contracts – often necessary to acquire in order to participate in economic activity across multiple blockchains – can trade at a premium or discount. Treating these token-to-token swaps as capital gains events serves no policy purpose, and adds significant ambiguity and uncertainty to the Australian tax system.

The current regime also risks cryptocurrency users accumulating an Australian dollar-denominated tax liability that might be tied up in illiquid tokens.

The committee should understand that compliance with this regime in the Australian public is likely to be very low and the risk of taxpayers making errors in attempting to comply with the current legislation is very high.

Recommendation:

We recommend that CGT events be limited to exchanges where it is reasonable to comply with the capital gains tax regime. These would be when:

- Cryptocurrency is exchanged with fiat currency (most commonly the Australian dollar),
- Cryptocurrency is used in the acquisition or disposal of a tangible good or service, or a non-fungible token (such as a piece of digital art). Depending on the CGT classification of the respective token (for example a personal use asset or collectable), these transactions may yield the normal concessional treatments.

The burden of demonstrating compliance with these rules would remain with the taxpayer. This approach would significantly simplify the capital gains tax regime while reducing regulatory burdens, encourage innovation and the expansion of blockchain and cryptocurrency jobs in Australia, and be revenue neutral to the Commonwealth government.

The managed investment scheme regime doesn't suit autonomous (algorithmic) financial products

A managed investment scheme (MIS) is an investment structure where a "responsible entity" manages investments for unit holders. In summary, the *Corporations Act* 2001 (Cth) provides that a MIS will exist where (i) members contribute money or money's worth as consideration to acquire rights to benefits produced by the scheme; (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the members; and (iii) the members do not have day-to-day control over the operation of the scheme.[4] Generally, a MIS is required to be registered with ASIC if it has more than 20 members.[5] A registered entity is required to be a public company and hold an Australian Financial Services License.[6]

There is a significant risk facing blockchain companies in Australia that the MIS regime will be inappropriately applied, particularly as it pertains to decentralised finance ('defi') products.[7] There is approximately US$41.5 billion worth of tokens in the defi ecosystem.[8] Inappropriate and high cost regulation threatens the viability of the defi industry in Australia and will send entrepreneurs and job-makers overseas.

For example, popular defi applications include a class of automated market makers (AMMs) that allow users to make token-to-token exchanges outside 'traditional' centralised exchanges like Binance or Coinbase. Investors pool tokens in these automated exchanges, earning profit through fees. The pool automatically prices exchanges in a way that rebalances the pool, guaranteeing that each asset is always available.

It is likely an AMM would be considered a MIS within the legal definition outlined above. However, there are several regulatory problems in applying the MIS regulatory framework to defi products like AMMs:

- These schemes have no *manager* – that is, there is no responsible entity on whom the obligations of a financial services licence could be meaningfully imposed or exercised. The scheme – and thus the return on the investment – is determined entirely algorithmically.
- Automated market makers like this have no responsible agent. Amendments to the protocol (for example, varying the fee for investors) are entirely controlled by the voting behavior of governance token holders (typically investors).

Applying the rules governing managed investment schemes to these autonomous and algorithmic financial products is a category error.

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[4] Section 9 *Corporations Act* 2001 (Cth). We note that a "time-sharing scheme" is also a MIS but this is not relevant to our submission.
[5] Section 601 ED *Corporations Act* 2001 (Cth).
[6] Section 601FA *Corporations Act* 2001 (Cth).
[7] These products are distinct from Initial Coin Offerings, which ASIC considers should usually be regulated within the MIS framework. We strongly support the committee's recommendation that the Treasury release its final report into the regulation of ICOs as soon as possible.
[8] See: https://defipulse.com (19 February 2021).

In any case, treating a defi product as an MIS would not achieve the government's policy goals. Defi products are censorship resistant and fully digital. Australian investors are able to interact with defi products developed around the world at almost zero cost. Regulatory avoidance is trivially easy because these products can be freely "forked" (that is, their code copied, modified, and re-deployed permissionlessly). Applying the MIS framework to Australia-built defi products means that Australian companies are highly reluctant to innovate in this frontier fintech field.

The committee might consider amending the government's enhanced fintech sandbox or develop a new blockchain technology specific sandbox to deal allow for defi products. However, we do not recommend this approach. One problem is that the current sandbox rules (such as limitations on the amount of money invested, or persons involved) would be inappropriate for defi because of the absence of centralised management, the ease of forking, and the quantum of funds. For example, automated exchanges have no mechanism to limit the size of the total pool (doing so would potentially reduce the stability of the pool) and even if limits were implemented they could be avoided through forking the pool and re-deploying it. Furthermore, if regulators were to determine that the defi product no longer compliant with the sandbox rules, given the uncensorable nature of blockchain, there would be no mechanism by which regulators could insist that the product could cease trading.

Recommendation:

We recommend that the Corporations Act be amended to exempt "autonomous financial products" from the existing definition of a MIS. To qualify as an autonomous financial product, the product needs to be:

- Fully algorithmically deterministic (that is, all investment decisions are made by an algorithm rather than a responsible human entity);
- Governance decisions are sufficiently decentralised and made solely by those who have invested; and
- Fully open source, with its code published on a recognised platform (such as GitHub), allowing investors to scrutinise the code themselves.

This change would be straightforward and is consistent with the existing legislative approach of the Act.[9] While legislative change is preferred to provide certainty, we note that this approach could also be achieved through regulation as section 9 of the Act provides a mechanism for the Regulations to declare that a scheme is not a MIS.

We are at the committee's disposal if they would like any further information on these or any other relevant matters.

Kind regards,

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RMIT Blockchain Innovation Hub

[9] There are already 13 specific exemptions to the definition of a MIS in the Corporations Act.