Observations on Global VAT/GST rules regarding the taxation of digital assets

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Introduction

This document is the written submission of Vertex Inc to the Australian Government's consultation guide linked to the Board of Taxation Review of the Tax Treatment of Digital Assets and Transactions.

As a leading provider of tax automation for indirect tax, most of our comments will relate to GST and our early experience working with businesses outside of Australia who issue or provides marketplaces for NFTs. Our authors are also active in the crypto and digital assets industry and in positions within industry associations, and therefore we also offer comments on privacy, identity and compliance and potential ways to safeguard them as they relate to income tax.

GST Overview

Today, the application of VAT/GST/Sales tax to sales of digital assets is simply not on the radar of the majority of the businesses selling these digital assets. Relative to income tax, it is the "forgotten tax" as expressed in an article we wrote back in 2018[1]. A lot has changed since 2018 and Australia's Board of Taxation is to be applauded for this initiative and outreach to citizens and industry as tax authorities around the world are grappling with how to frame these sales, and the resulting taxation, of digital assets.

There has been movement on this topic in certain jurisdictions. Quite a few jurisdictions have released tax guidance updates confirming that certain digital assets are within the scope of existing VAT/GST rules. We have recently listed here[2] the ones we are aware of.

For the most part, the deliberately wide scope of digital service definitions also envelopes digital assets. Specific rules have been introduced across the globe to tax the B2C supplies of cross-border digital services. These rules, such as the January 2015 rules in the European Union (EU), left the definition of a digital service deliberately broad. This approach followed recommendations from the Organization of Economic Cooperation and Development (OECD) stating that to provide a narrow definition would be to render rules obsolete in a short timeframe.

As such, these rules – that are now in place in 90+ tax jurisdictions across the globe – give taxing jurisdictions, in our opinion, a head start on how to tax the sales of digital assets.

Spain's tax authority, for example, has already stated that a sale of an NFT, unless customized for a specific client, should be considered as a digital service subject to Spanish VAT.

In the United States, where approximately 30 states tax digital goods and services, clarifications and notices have been issued by some states (e.g. Pennsylvania, Minnesota, Washington) that sales of certain digital assets are subject to sales tax, bringing with it marketplace and out of state seller rules.

As stated in the consultation guide, for Australian GST purposes, an NFT is not a form of digital currency. The GST treatment of an NFT depends on whether the transaction meets the requirements of being either a taxable or GST-free supply under the GST rules.

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[1] See https://www.coindesk.com/markets/2018/04/03/dont-forget-the-other-cryptocurrency-tax/

[2] See https://www.linkedin.com/feed/update/urn:li:activity:6980866624685805568/

General Comments and Recommendations

To apply existing rules to the taxation of digital assets we have some general comments and recommendations built on our experience of these rapidly evolving existing VAT/GST rules. We then address the questions posed on a specific basis and include our comments relating to income tax, privacy, identity and compliance.

1. Administrative processes and requirements

1.1 Identification of the consumer – GST on online sales

The pieces of identification that a business is required to collect during an online checkout process should be closely linked to the reality of how online commerce functions.

The traditional international trend, in line with OECD guidelines, is that businesses collect two pieces of non-conflicting evidence to determine the location of the end consumer.

Acceptable, or typically accessible, pieces of evidence in an online transaction used to include the following:

- The billing address of the customer;
- The Internet Protocol (IP) address of the device used by the customer or any method of geolocation;
- Bank details such as the location of the bank account used for payment or the billing address of the customer held by that bank;
- Other commercially relevant information.

The above application of acceptable pieces of evidence is often not possible in the case of digital assets where anonymity is part of the attraction. However, legislation will continue to evolve and there will be more customer information requested even in the case of sales of digital assets. It should be recognized that compliance with existing legislation may be needed but internal business processes cannot be quick enough when businesses want to be compliant. Changing those business processes will take time as it will impact the business model and competitiveness.

There should be a tolerance level for a defined period of time to rely only on pieces of information available, such as an IP address only. This will allow companies to start being compliant without affecting their growth and sales by requesting additional personal information.

It is also important to provide clear guidance on what happens if, in certain cases, not enough information on the customer can be collected by the business and provided to the tax authority. Again, there is a clear need for a defined level of tolerance and fall-back procedures.

A potential solution is to accept only one piece of evidence as long as it always follows the same logic ranking, either as a transitory measure or as policy.

Tax authorities should only request commercially available information for the purposes of identifying the end consumer's location.

Privacy will underpin the decision-making of businesses that intend to comply, they will not want to compromise their consumer's privacy as it runs the risk of interrupting the consumer journey, potentially leading to a loss of sales.

Jurisdictions should encourage businesses to have a consistent, uniform approach across the board instead of mandating or referring to a piece of evidence, or proxy, which has more value than others.

1.2 Mixed basket of goods

Attention needs to be given to scenarios of mixed baskets at checkout (i.e. digital services and physical goods or services) and what will need to happen when sales of NFTs are linked to physical goods or services that can be sent/consumed at the same time or after a period of time.

The issue here is the difference of treatment between sales of digital services and sales of physical goods and services. This becomes more pressing if the value is above the low value goods threshold. There is also a need for clarity if additional tax will be due when the physical good is sent (e.g. alcohol).

In practice, an easy solution would be that GST is chargeable on the total amount of the digital asset. However, processes will need to be implemented to determine what will happen if the physical goods are sent across borders.

Such information should also include what type of invoice/documentation should join the physical item to avoid double taxation.

The taxation should also not, by default, follow that which applies to digital services. Indeed, the sale of an NFT can just be the support for another service such as a ticket for an event or an airplane ticket. The underlying product / services sold should also have an impact on the taxation of such NFT. Any legislation needs to anticipate that the uses of NFTs are going to be broader than the simple image/gaming use that we can already see.

1.3. Currencies and Foreign Exchange (FX)

Digital assets are generally sold in crypto currencies, and we know that both can be very volatile. This volatility can be exaggerated if the cryptocurrency or NFT is thinly traded.

It is absolutely key to have clarity on how conversions from cryptocurrency into Fiat should occur as the GST due will, we understand, have to be remitted in Fiat currency. Some flexibility should be offered here as long as the affected business applies their selected conversion process consistently.

Affected digital businesses should be allowed to select their foreign exchange (FX) conversion source, including conversion to Fiat currency, and in practice also USD triangulation (as the most commonly used Fiat currency for pricing), before converting into Australian Dollar (AUD).

2. Reporting obligations for online platforms

Following a June 2020 OECD report on model reporting rules for platform operators, there have been numerous rule changes bringing new obligations for online marketplaces to share information on their sellers with the relevant tax authorities.

We understand that Australia will introduce a version of such rules on July 1, 2023. We suggest delaying the application of such obligations to NFT marketplaces for at least two years and instead introduce obligations specific to this market.

While there is a need for more transparency, it is important to recognise the characteristics of this market and that it is not possible to change business processes in the short term. The required changes will be too much of a burden for stakeholders in an industry that is only emerging. These industries will also need plenty of lead-in time (2 years at least), communication, and support to be able to comply without affecting the characteristics of such industries. The data points requested should also be reviewed when taking into account such characteristics.

Responses to Specific Questions

Current tax treatment of crypto assets

1. Is the current tax treatment of crypto assets clear and understood under the Australian tax law? If not, what are the areas of uncertainty that may require clarification?

Response: While our expertise is not with Australia specifically, there is a general lack of knowledge in the industry. With respect to GST treatment, it is unclear how to characterize NFT's, utility tokens and transaction processing fees.

- The nature of supply involved when issuing (minting) or selling an NFT needs clarification as to whether the NFT itself should be the focus of the supply characterization or the underlying asset/property/right should be the focus. NFT's comprising rights to physical + digital bundles present complexity.
- Fungible utility tokens generally represent rights to consume a service, typically digital, such as file storage (e.g. filecoin). Clarity as to when a taxation event occurs for GST would be helpful as it is unclear if acquiring the token vs. redeeming the token for the service is the taxable event.
- Fees for providing services to a network or application, including transaction validation and processing (e.g. mining or validating/staking), should also be clarified with respect to GST treatment.

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?

Response: As noted in the Consultation Guide, the pseudo-anonymous nature of blockchain based interactions presents a particular challenge as does the overall price volatility and lack of valuation data for thinly traded tokens. In the GST area the individual identities of the buyers and sellers are not required for correct taxation, just the jurisdiction of the buyer as all transactions are by definition e-commerce and digital. However, as noted in our comments above, even this level of detail can be particularly difficult to obtain when transactions are occurring on open, permission-less networks and there may be a need for alternative and fallback mechanisms when details are not available.

Awareness of the tax treatment of crypto assets

3. Do entities which carry on a business in relation to crypto assets or accept crypto assets as a form of payment, have a comprehensive awareness of the current tax treatment of crypto assets and their tax obligations?

Response: Not with respect to transaction taxes. We have found that as we engage the market participants, we first have to educate prior to having reasonable conversations with potential clients. Beyond NFTs and certain other digital/crypto assets being subject to transaction taxes, marketplace liability, including thresholds and taxation based upon buyer's usual residence are particularly unknown concepts to industry participants.

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

No response as we only serve businesses and not related to investments/investors.

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

No response as we only serve businesses and not related to investments/investors.

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

Lessons learned from the emergence of e-commerce taxation should be applied along with appropriate timeframes for the industry to adapt. We refer ATO to the Business Industry Advisory Coalition to the OECD as we are members and participated in the creation of the *Principles for Digitization in the area of Tax* document which should be released by mid October 2022. It goes into some detail on how to introduce change like this into business successfully.

Characteristics and features of crypto assets

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

Note: Our response below departs from our primary focus on GST and relates to income tax unless otherwise noted. We structure our response to address today, tomorrow which we believe is only a few years away, and alternatives to address the challenges of both.

Today: Most crypto assets reside on blockchain networks with transparent ledgers today. The issue is identifying beneficial ownership as wallet creation is an open and permissionless software only process. The path to compliance the OECD, via CARF, and a variety of other tax administrations appear to be pursuing is rooted in mandatory KYC and 3rd party reporting for both centralized and decentralized virtual/crypto asset service providers. It is proposed that CASP/VASP's refuse service to users who will not undergo KYC procedures, a process that will work fine for centralized entities but will meet significant resistance from decentralized organizations. Analytics to trace account linkages along with collection of account and ownership info from centralized exchanges and the travel rule information will provide the connective tissue into unhosted wallet ownership, with open source intelligence solutions like Januus.io to fill the gaps.

Tomorrow – what ATO needs to know: The above approach is tried and true and leverages AML/CTF efforts, but it is premised upon existence of a world of identifiable intermediaries through which to enforce compliance. This is the case with centralized VASP/CASP's, but not in the new world of technology and decentralization that may challenge and invalidate the premise of an intermediary for blockchain native firms.

We are seeing the industry innovate around these approaches and by the time legislation gets enacted it may be made ineffective by rapid innovation in the domain of unhosted wallets and open, permissionless decentralized VASP/CASPs. Specifically, efforts are underway to enable full decentralization of VASP/CASPs including management/control/ownership and in all layers of the technology stack. This decentralized focus is occurring as privacy preserving technologies that can mask wallet IDs and transaction amounts yet still provide transaction validity have become useable as part of transactions on major networks like Ethereum (beyond Zcash and Monero, see Espresso Systems, Secret, Aztec and many others). The privacy technologies extend to the blockchain networks themselves (miners, validators, relayers, etc.) and the applications built on top (exchanges, lending, borrowing, investing) which would not be able to see the account/wallet identifiers yet still will be able to perform services.

Combined rapid innovation in these areas may blunt the effectiveness of the KYC + 3rd party reporting efforts. Unhosted (self hosted) wallet users in areas like Defi will be able to simply push a button and achieve privacy while tax administrators find no organization to pursue enforcement. Governments will have to outlaw interacting with unstoppable code running on distributed networks to stop users from taking advantage of these features. This has been attempted by US OFAC with Tornado Cash. Yet Tornado Cash is still running today and now there are dozens of clones and a lot of smart developers around the world working on new and improved replacements.

Seeking financial privacy is not a crime. Many may choose privacy for purposes beyond tax evasion - no investment firm or company wants its full portfolio or supply chain exposed to the entire world in real time. Indeed, tax administrations should encourage financial privacy, yet also require taxpayers to be able to prove compliance while minimizing privacy loss.

Alternatives: Allow decentralized VASP/CASP's to enable user compliance through use of a pay as you go approach rooted in selective information disclosure and variable withholding. In the simplest form VASP/CASP's withhold taxes, taxes which users/taxpayers can claim by presenting necessary information to the tax administration, all of which is done on the native blockchain networks.

Decentralized applications would remain available to any user, as opposed to the CARF proposal that would deny service to users who refuse to undergo KYC. For users unwilling to present identity information, withheld funds are forfeit. Forfeiture is a choice by the user. Identity information is presented and withheld funds claimed over the native blockchain networks upon which transactions occurred where tax administrators are now participants. Identity is exposed through use of verifiable credential backed identity (see W3C standards for DID and VC)and makes use of zero knowledge proofs for minimal and selective disclosure to maximize user privacy. There are emerging approaches that allow these to cryptographically bind to myGovID, enabling DID's to prove a verified credential from myGovID and others. In exchange for this information users get the right to claim withheld funds or have them applied to their taxes due when filing. Tax administrations ensure full compliance, decentralized VASP/CASP's get out of the game of denial of service and 3rd party reporting. This approach is also future proof as it works with privacy preserving technologies as they allow selective disclosure after the fact of transaction details to selected parties, in this case the relevant tax administrator(s).

This is a potential alternative that will need to be discussed at the industry level. It may present a more acceptable alternative to refusal of service and outlawing code, two areas the industry is likely to fight very hard against.

International tax treatment of crypto assets and experience

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

Response: Estonia's agreement with Uber for pay as you go taxation of drivers may be a good example to explore.

Changes to Australia's taxation laws for crypto assets

9. What changes, if any, should be made to Australia's taxation laws in relation to crypto assets, whilst maintaining the integrity of the tax system? If changes are required, please specify the reasons.

Response: See proposal above. The crypto industry will fight very hard and innovate around any proposals that require all users to undergo KYC in order to interact with these networks and decentralized applications running thereupon.

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

Response: We believe the two biggest changes we will see that should be considered are the emergence of privacy preserving technologies and user controlled digital identities. The first presents a challenge for tax administration, and the second perhaps provides the remedy.

Administration of Australia's taxation laws for crypto assets

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

No response

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

No response

13. Are there intermediaries (such as exchanges) that are involved in particular crypto asset transactions that could play a role in the administration of the tax laws? If so, what would their involvement look like?

Response: We are participants in the BIAC discussions around Tax Administration 3.0 which portends a future of certified providers and tax compliance by design. We believe taxation of digital assets provides the perfect opportunity for these concepts to be put into practice and are of the belief that new certified intermediaries can emerge to manage the pay as you go technologies and processes discussed above. As this represents stewardship of code residing on blockchains as well a process involved therein, a specialized form of techno-intermediary may be necessary.

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

Response: With respect to GST, coordinated efforts across tax administrations to ensure the industry becomes aware of its obligations would be much more beneficial that spot activities by individual administrations.

15. What additional support can be provided to the tax adviser community to assist them in advising their clients in relation to the tax treatment of crypto assets?

No response

About the submission authors

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He is active in BIAC's interactions with OECD working party 9 on transaction taxes and in the International Telcom Unions Global Central Bank Digital Currency Initiative.

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Iman is the Senior Director International Tax Innovation at Taxamo – a Vertex company, a leading European technology firm providing a comprehensive global ecommerce solution.

Since 2013 Iman has been focusing on the new place of consumption rules regarding VAT/GST/Sales tax on digital services worldwide that impacts more than 90 countries today.

Iman is also focusing on the new obligations (with a particular interest in platform roles) such as reporting, exchange of information, DSTs, taxation of NFTs, and streaming taxes.