

Australian Digital Currency Commerce Association

Submission to the Senate Economics References Committee
Inquiry into Digital Currency

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Executive summary

The Australian Digital Currency Commerce Association (ADCCA) was founded in April 2014 and its membership comprises Digital Currency businesses, merchants and service providers that trade and accept Digital Currencies as payment, and Australian and international professional association partners. ADCCA represents its members on policy, regulatory and financial system issues.

Digital Currencies and their enabling technology have enormous future potential, not only in financial services but other industries. The expansion of Digital Currencies and the innovative, high value-add industry around them present an opportunity for Australia to become a global leader and hub for financial technology (FinTech).

In order to achieve this, it is critical to appropriately acknowledge Digital Currencies in legislation and ensure they are taxed in the same way as fiat currency. If the regulatory settings are not supportive, Australia will miss an opportunity to capture the benefits of a thriving FinTech industry and develop a strong comparative advantage in Digital Currency.

ADCCA believes a self-regulatory model enforced through its industry Code of Conduct, to which ADCCA members must adhere, is the ideal regulatory environment to support the Digital Currency industry. This framework will enable customers to have greater confidence in the entities providing Digital Currency FinTech services. The Code of Conduct comprises several best practice requirements benchmarked against requirements for Australian financial services institutions.

ADCCA recommends deeming Digital Currencies as 'currency' for tax treatment purposes, not a commodity, good or service subject to value-added tax.

ADCCA recommends amending the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF) to specifically include Digital Currencies and to take a more technology-neutral approach, noting that Digital Currencies were not invented when this Act was first introduced in 2006.

Recommendations

1. ADCCA recommends the adoption of its self-regulatory model for Digital Currency in line with its Code of Conduct.
2. ADCCA recommends deeming Digital Currencies as 'currency' for tax treatment purposes, not a commodity, good or service subject to value-added tax.
3. ADCAA recommends amending the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF) to specifically include Digital Currencies and take a more technology-neutral approach.
4. ADCAA recommends giving Digital Currency businesses access to the Document Verification Scheme in order to better facilitate Know Your Customer (KYC) operations.

Introduction

The Australian Digital Currency Commerce Association (ADCCA) welcomes the opportunity to provide a submission to this inquiry into Digital Currency.

ADCCA was founded in April 2014 and its membership comprises Digital Currency businesses, merchants and service providers that trade and accept Digital Currencies as payment, and Australian and international professional association partners. ADCCA represents its members on policy, regulatory and financial system issues.

Though decentralised money is not a new concept, it has only emerged into mainstream use in virtual form – Digital Currency – in the last five years, and grown rapidly into a major innovative industry. As the use of Digital Currencies has expanded, Australia's financial technology (FinTech) industry has developed significantly around them, involving end-to-end facilitation of creation, storage, trade, and payment systems for Digital Currency.

Digital Currencies and their enabling technology have enormous future potential, not only in financial services but other industries. The expansion of Digital Currencies and the innovative, high value-add industry around them present an opportunity for Australia to become a global leader and hub for FinTech.

In order to achieve this, it is critical to appropriately acknowledge Digital Currencies in legislation and ensure that the tax law is modernised to approach Digital Currency in the same way as fiat currency. If the regulatory settings are not supportive, Australia will miss an opportunity to capture the benefits of a thriving FinTech industry and develop a strong comparative advantage in Digital Currency.

ADCCA acknowledges that the advance of Digital Currency, along with its current and potential future applications, create many regulatory challenges for industry and government, including law enforcement, tax treatment, consumer safety and business compliance. As an example, it has been reported that the anonymity afforded by Digital Currencies makes them an attractive payment method for criminal activity. However, as with traditional currency, in reality the vast majority of Digital Currency users and businesses operate within the law.

In order to meet the law enforcement and other challenges of Digital Currencies, while simultaneously nurturing their economic benefits and potential, ADCCA proposes to work with government to develop effective regulation and ensure industry compliance.

Digital Currency explainer

Digital Currencies are a virtual form of money. Units of a Digital Currency are as real and valuable as a physical government-issued banknote or coin (fiat currency), but rather than being a physical item are stored in a secure digital wallet. They can be traded and spent in exactly the same way as fiat currency. Though they are typically decentralised – not issued by a central bank – in most cases, Digital Currencies qualify for classification as money by meeting the three conventional functions of money criteria:

- 1. medium of exchange;** exchanged for goods or services
- 2. unit of account;** a fungible measure of value able to be divided into smaller units
- 3. store of value;** reliably and predictably saved, stored and retrieved

While fiat currency is issued by a central bank, this process is naturally constrained by the productive capacity of an economy and the forces of supply and demand. The value of fiat currency changes depending on how much of it is made available (supply) in order to purchase (demand) a country's economic output. In advanced economies, this is a finely balanced equation managed by politically independent central banks.

As Digital Currencies are denationalised and not linked to the productive capacity of a nation's economy, their value must be moderated by supply and demand using other methods. This challenge is addressed by making the process of producing units of Digital Currency exceptionally difficult (see Bitcoin explainer over the page). Scarce supply meeting demand in private markets then determines their value and exchange rate with other currencies.

Digital Currencies that operate in the same way as fiat currencies incorporate heightened security measures and are alternately referred to as cryptocurrencies. Cryptographic signatures are used to ensure that transactions are secure and that units cannot be infinitely duplicated.

Digital Currencies typically operate at the peer-to-peer level, meaning that they require no third party intermediary such as a financial institution to facilitate their exchange. This is what makes them a truly disruptive technology, as they can eliminate the associated costs and fees of an intermediary.

There are a number of Digital Currencies that are commonly used in Australia and around the world in exactly the same way as fiat currency. The most recognised of these is Bitcoin, which has over 90 per cent of the Digital Currency market worldwide and other examples are Namecoin, Litecoin, Peercoin, Mastercoin and Auroracoin.

Bitcoin

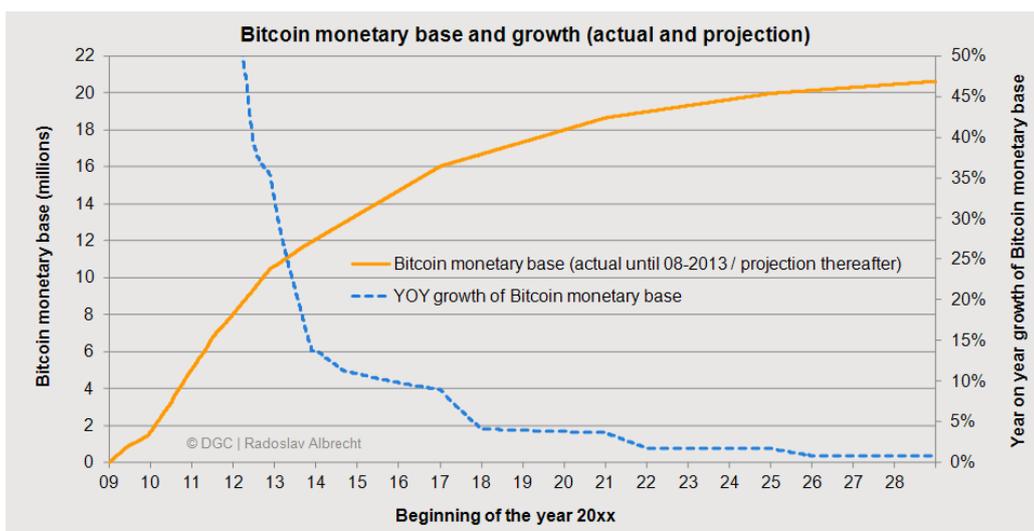
Bitcoin is a cryptocurrency based on code, first appearing online in 2009 after being proposed in a research paper written under the pseudonym Satoshi Nakamoto.

The metadata for every Bitcoin transaction is completely transparent and recorded publically. Information such as the date, time, value and which peers (users who generally use pseudonyms) were involved in the exchange are recorded in a single open source log known as the block chain.

Bitcoins are created through a ‘mining’ process within the block chain. When a Bitcoin transaction takes place, it is verified by other users in the peer-to-peer Bitcoin network who determine that it has not been electronically duplicated. Complex mathematical problems must be solved by powerful computers in order to verify a Bitcoin transaction. As payment for hosting the computing power necessary to solve Bitcoin mathematics, users who verify transactions receive new Bitcoins. The mathematical problems become more and more complex over time, making it harder to mine Bitcoin, and which will eventually lead to a pre-programmed finite number of 21 million Bitcoin in circulation. The last Bitcoin will be generated around 2140.

Bitcoin transactions can take place either between two individual entities (peer-to-peer) or be traded through Bitcoin exchanges. Additionally, many mainstream businesses in Australia are accepting Bitcoin as a valid method of payment for goods and services.

Because Bitcoin is the most widely-used Digital Currency, it is a term often used interchangeably with Digital Currency.



Source: blockchain.info

The need for effective regulation

Simple changes to existing Australian laws will provide the framework required for Digital Currency and supporting industries in Australia to continue to grow, add value to Australia's economy and bring about substantial productivity gains through innovation in FinTech.

In Australia the vast majority of Digital Currency businesses and users are law-abiding and desire the enhanced legitimacy of appropriate legal oversight and recognition.

Incorporating Digital Currency into law enforcement legislation, particularly through the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, is a necessary step toward guaranteeing the security and legitimacy of Digital Currencies in Australia.

Including a definition of Digital Currency, and classifying it in the same way as foreign currency in Australian tax law will ensure that the use of Digital Currency as a method of payment alongside fiat currency is not rendered obsolete before it has had a chance to enter the mainstream payment system and be tested by the market.

Law enforcement

Digital Currency is not currently acknowledged in the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (AML/CTF Act). Digital Currencies were not in wide use when this Act was first introduced in 2006.

The Australian AML/CTF Act regulates entities that provide one or more 'designated service', which are the activities specified in section 6 of the Act, including financial services, trading in bullion, and gambling activities, but do not currently cover businesses offering Digital Currency services.

The AML/CTF Act could be amended such that it included Digital Currency in the classification of a 'designated service', which would mean businesses providing these designated services would then be subject to the compulsory reporting requirements of the AML/CTF Act, including customer identification and verification, maintenance of statutory compliance programs, and risk assessments and reporting of suspicious or high value transactions.

The regulation of the Digital Currency industry would support the objectives of the AML/CTF Act in respect of countering international money laundering and financing of criminal activities, and would likely alleviate concerns over the use of Digital Currencies being used for such purposes.

Amending the scope of the AML/CTF Act to cover Digital Currency would be consistent with evolving international practice and standards under the international AML/CTF body the Financial Action Task Force (FATF). Notably, Canada has recently amended its equivalent AML/CTF Act (*The Proceeds of Crime (Money Laundering) and Terrorist Financing Act 2000*) to regulate entities that are "dealing in virtual currencies" (e.g. Digital Currency exchanges).

Under Canadian law, such entities must comply with obligations applicable to other “money services businesses”, including registration with the regulator, adopting compliance, risk assessment and reporting programs, and customer identity verification.

Tax treatment

ADCCA recommends that Australian taxation law should be modernised to appropriately deal with Digital Currencies by bringing them within the comprehensive framework for the taxation of currency-based transactions under the current taxation system. The changes required are simply definitional, and present no need for new taxation provisions or exemptions.

The Australian Tax Commissioner has reached the preliminary view, in draft rulings issued on 20 August 2014, that Digital Currencies such as Bitcoin cannot be taxed as currency under the currently operative definitions. Addressing this issue is straightforward.

Firstly, a new definition of Digital Currency should be incorporated into GST law and income tax law along the following lines:

Digital Currency means Bitcoin and other similar cryptographic currencies that are broadly accepted as a means of exchange, the ownership or trading of which is not limited by reason of membership of a group or agreeing to a predetermined set of terms and conditions and such other forms of Digital Currency that may be included by the regulations.

Second, the definition of a foreign currency would need to be expanded in section 995-1 of the *Income Tax Assessment Act 1997*. It currently reads:

Foreign currency means a currency other than Australian currency.

The Tax Commissioner’s preliminary view that foreign currency does not currently include Digital Currencies can be addressed by simply adding:

Foreign currency means a currency other than Australian currency **and includes Digital Currency**

This expanded definition of foreign currency would then also need to be adopted in GST law, which does not currently provide a definition for this term. The GST law definition of ‘money’ refers to:

"currency (whether of Australia or of any other country)."

Following the inclusion of the definitions of Digital Currency and foreign currency into the GST law, it would be appropriate to ensure that the definition of ‘money’ is expanded to include Digital Currency. This could be achieved by amending the above (paragraph (a) of the definition of money in section 195-1 of the GST Act) to refer to

"currency (whether of Australia or foreign currency)."

Treating Digital Currency as a commodity or other good subject to value-added tax would impose tax on every transaction completed using Digital Currency and therefore guarantee its rapid demise. ADCCA is concerned about this potential outcome.

Benefits and future applications of Digital Currency

Digital Currencies offer innumerable productivity and efficiency benefits for government, industry, consumers and the macro economy. In particular the block chain technology used by Bitcoin – digital security, records management and secure authentication – has endless potential applications across a range of industries. Some suggestions are included below.

Productivity gains

Removing the need for a third party payments clearing house has the potential to deliver productivity gains, especially through the acceleration of payments. Instead of taking up to two or three days, Digital Currency payments can be made instantaneously. This is especially promising in the field of international remittances – both corporate and private – where transactions can take days to clear and be subject to high fees.

Macroeconomic

Denationalised Digital Currencies may deliver stabilising benefits for the international monetary system and global macroeconomics. Removing the direct link between national, politicised macroeconomic settings would limit international currency speculation, capital flight, interest rate and currency manipulation, and anti-competitive monetary policies that destabilise national economies.

Government

There is potential for the use of block chain technology across the breadth of government service delivery in order to realise efficiencies and rein in expenditure. For example, identification authentication, renewals, payments, individual income tax returns and other customer-focussed functions of government could be completed utilising the block chain.

Industry

Similar to government, service delivery and security in the private sector can be significantly enhanced using fast, secure block chain technology.

Competition and consumer

The peer-to-peer system and block chain authentication process of Digital Currencies is a competition game-changer not only for the financial services industry but a range of other industries. Lower fees and new financial services business models would be the hallmark of the Digital Currency industry, along with a wider range of choice for completing transactions.

International development

The peer-to-peer system offers a viable remittance method for citizens of developing countries who wish to send funds domestically and internationally but currently have very few options for doing so. Levels of financial inclusion in developing countries are typically very low, and Digital Currencies are easy to set up and bypass the need for membership of a financial institution.

Global comparisons

There is an opportunity for Australia to become a global Digital Currency leader as the world's best practice, business friendly Digital Currency jurisdiction. Current international regulatory responses to Digital Currency are either non-existent or hesitant to acknowledge its benefits and draw it into the mainstream with effective policies. Canada is a notable counterpoint to this rule; it recently passed legislation recognising Digital Currencies in its anti-money laundering legislation. A handful of other international jurisdictions have proactively and positively responded to Digital Currencies, example of which are detailed below.¹

Canada

In June 2014 the Canadian Parliament passed a bill recognising Digital Currencies as "money service businesses" in its Proceeds of Crime (Money Laundering) and Terrorist Financing Act.

United Kingdom

HM Revenue and Customs recently classified Digital Currency as money for tax purposes, and it is not subject to value-added tax. Additionally, HM Treasury is currently undertaking an open consultation into Digital Currencies, and the Bank of England recently released a research paper acknowledging the potential advantages and applications of the Bitcoin block chain.²

Finland

Vero Skatt (Finish Tax Authority) has ruled that when transferring Bitcoin to another currency, the rules on taxation of capital gains apply. When the currency is used as a form of payment for goods and services, it is treated as a trade, and the increase in value that the currency might have gained after it was obtained is taxable.

Sweden

The Swedish Skatterättsnämnden (Swedish Tax Board) has made a preliminary ruling stating that Bitcoin is not subject to Swedish value-added tax (VAT), but is instead subject to the Finansinspektionen (Financial Supervisory Authority) regulations and treated as a currency. The decision has been appealed by the Swedish Tax Authority.

¹ Otherwise uncited information in this section has been drawn from the United States Law Library of Congress, which recently conducted a review of Bitcoin legislation in selected international jurisdictions. The review can be found at <http://www.loc.gov/law/help/Bitcoin-survey/regulation-of-Bitcoin.pdf>

² Robleh Ali, John Barrdear, Roger Clews and James Southgate, 2014, *Innovations in payment technologies and the emergence of Digital Currencies*, Bank of England, available: <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q3digitalcurrenciesBitcoin1.pdf>

Brazil

In 2013 the Brazilian government passed a law (No. 12,865) enabling the normalisation of electronic payment systems and the creation of Digital Currencies. While a step in the right direction, the legislation does not completely fulfil the supportive regulatory conditions necessary to enable Digital Currencies to flourish.

European Union

There is no specific governance of Digital Currency in the EU and there is currently much debate surrounding the correct interpretation of existing law.

Conclusion

There is an opportunity for Australia to become a global Digital Currency leader as the world's best practice, business friendly Digital Currency jurisdiction. Digital Currencies and their enabling technology have enormous future potential, not only in financial services but also in other industries.

In order to support the growth of Digital Currency in Australia, it is critical to appropriately acknowledge it in legislation and ensure that the tax law is modernised to approach Digital Currency in the same way as fiat currency. If the regulatory settings are not supportive, Australia will miss an opportunity to capture the benefits of a thriving FinTech industry and develop a strong comparative advantage in Digital Currency.

Simple changes to existing Australian laws will provide the framework required for Digital Currency and supporting industries in Australia to continue to grow, add value to Australia's economy and bring about substantial productivity gains through innovation.

In Australia the vast majority of Digital Currency businesses and users are law-abiding and desire the enhanced legitimacy of appropriate legal oversight and recognition. Incorporating Digital Currency into law enforcement legislation, particularly through the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*, is a necessary step toward guaranteeing the security and legitimacy of Digital Currencies in Australia.

In addition, including a definition of Digital Currency, and classifying it in the same way as foreign currency in Australian tax law will ensure that the use of Digital Currency as a method of payment alongside fiat currency is not rendered obsolete before it has had a chance to enter the mainstream payment system and be tested by the market.

ADCCA acknowledges that the advance of Digital Currency, along with its current and potential future applications, create many regulatory challenges for industry and government, including law enforcement, tax treatment, consumer safety and business compliance.

In order to meet the law enforcement and other challenges of Digital Currencies, while simultaneously nurturing their economic benefits and potential, ADCCA proposes to work with government to develop effective regulation and ensure industry compliance.