Tax in the Age of Blockchain

Blockchain is the biggest invention of the 21st century and it will radically change everything you currently know and do and the way you do it. Or maybe not. The hype surrounding blockchain is perhaps understandable – some people are devoted acolytes and others are very frightened – but just at the moment it would be more than a little brave to predict what blockchain will mean for our future or the future of the tax world, though that hasn’t stopped people trying. This Tax Brief is our ruminations on the future.

In the popular imagination, blockchain is connected with Bitcoin and other digital currencies but it has far wider application. Blockchain is usually described as distributed ledger technology, which is another way of saying multiple people are verifying the authenticity of a transaction and they are doing so relying on the history embedded in the recorded chain of prior transactions. And once they have validated the title to date, they will confirm this transaction. That’s it.

Once upon a time, real estate conveyancing worked this way – conveyancers interrogated the documents which established the chain of title (conveyances and wills and deeds and mortgages and leases and marriage certificates and more, only some of which would be on public registers) to establish whether or not the vendor could really convey unfettered title to Blackacre. Once satisfied, they would draft the documents to effect the next transaction, and hope the next conveyancer would be satisfied with their handiwork. Blockchain is like old system conveyancing but with a world-wide team of ‘conveyancers’ examining the transaction to see if they agree the title is good. Sir Robert Torrens worked out in the early-1800s that conveyancing could be made simpler if buyers didn’t have to verify title all the way back to the Crown grant and could rely unquestioningly on a single government-operated ledger instead. Blockchain allows us to do what the Torrens system dispensed with.

That description sells blockchain technology a little short because it seems clear blockchain will disrupt those bits of the world where title and provenance are important, and this will matter for the entities that currently verify or convey title, or make and receive payments from transactions. It will matter both for the principals and for entities that are intermediaries in those processes. It may also disrupt registration regimes and record-keeping – information may end up being authenticated by multiple entities which hold the relevant data, rather than having a single record located at one place on a database operated by a single trusted agency.

So, for example, banks and others in the finance industry are trying to see if blockchain technology can improve the execution of transactions and accelerate payment systems. The proposed New Payments Platform is an example of an Australian mainstream financial activity platform that will be similar to blockchain's distributed ledger system. The ASX has already identified that its business could be harmed if the ownership of shares is verified and passage of title shifts to blockchain technology not under its control. Presumably custodians, brokers and other clearing houses would share these concerns. Real estate conveyancing and dealings with tangible assets could go the same way, though buyers might still need to involve government if government registers remain a crucial aspect of
perfecting title (for land holdings or security interests, for example) or a regulatory requirement (for ownership of motor vehicles or aeroplanes, for example). Verifying the existence of patents or copyrights or insurances or security interests or bank balances or professional qualifications or the fact of incorporation or even criminal records might be done using blockchain technology. At the moment we often rely on a single trusted repository (typically, a government agency) to maintain and disseminate this information securely, accurately and at minimal cost – Robert Torrens’ system has served us well for 200 years – but that may not always be the case. The current debate about whether the government should privatise the corporate registry function undertaken by ASIC may be just the start.

Two newish developments in this space are ‘smart contracting’ (the terms of contracts are standardised and then encoded to allow them to be entered, verified and settled automatically) and decentralised autonomous organisations (a kind of joint venture formed online that undertakes transactions based on programmed instructions involving little ongoing human intervention). This moves the use of blockchain from just validating and recording transactions to executing the transactions and doing so in a more efficient way.

But does any of that matter for the tax world? Clearly governments and regulators have to pay attention, commercial lawyers have to be able to accommodate deals done in new ways, advisers need to ensure their clients meet the regulatory obligations of this new world, businesses should consider the commercial ramifications of these developments for their future viability – and this is where most attention has been focussed. But if blockchain is simply a better way of selling mousetraps, do tax people need to ponder further? It does seem that blockchain will raise some new tax problems, but at the moment they look like variants on problems tax people have had to grapple with already.

In the income tax world, advisers have to be clear about the identity of the proper taxpayer, their residence and the source of their income. Having the operators of distributed ledgers examine, validate and record transactions doesn’t change what the income tax questions are, nor does it obviously change the answers though there may be some nuances which warrant closer scrutiny when the parties to the transaction are in different countries. So for example, if as seems likely, a decentralised autonomous organisation is not created by national law as an entity with a separate legal personality, the proper taxpayer and the allocation of tax liabilities on income generated could be difficult to determine – is the arrangement between the participants a partnership or trust or an unincorporated body that we treat as a company or simply ‘none of the above’?

Or if the source of income from selling goods is where title passes, for example, which is the US source rule, clearly smart contracts will need to provide an answer to that question, just as ‘dumb’ contracts ought. The absence of a meaningful source rule in Australian tax law will clearly be a nuisance in a blockchain world, just as it is in the current world. We have recently seen some of the problems arising from this failing in Australian law. In TR 2014/7, the ATO grappled with problems arising from putting in place foreign currency hedges to protect the value of an underlying portfolio of (usually offshore) assets. A key issue was whether any gain or loss from a hedging transaction was foreign sourced or Australian sourced. The ATO took the view that the source of a foreign currency gain or loss was ‘where [the] hedging transaction is formed’ and that will ordinarily be ‘where the communication of the acceptance is received’. The source of income from intangible contractual relationships entered into using blockchain technology will no doubt require another 35-page ATO Ruling to tell us whether the source of the income is the seller’s place of business or the buyer’s place of business or where the goods are when they are sold or something else entirely.

In the GST world, advisers have to think about the residence of the supplier and customer, sometimes where the parties are when the supply occurs and sometimes where ‘things’ are ‘done’. Again, there may be some nuances in this space. For example, if the supply occurs when and where a contract is settled, when and where does that happen if the transaction occurs on a blockchain? Is it when the last entity confirms the transaction? Will the blockchain be able to be used to determine/validate whether the counterparty is an ‘Australian consumer’, as the upcoming digital import GST legislative changes require? We have already seen the problem of transactions occurring using Bitcoin being treated as a barter for GST purposes, something which the government has promised to reverse.
In the stamp duty world, advisers used to care about whether instruments are dutiable and, sometimes, whether instruments need to be created, although the reliance on documents is being superseded by imposing duty on underlying transactions. In so far as documents matter, the blockchain world might become a tax-free zone – which suggests that duty will increasingly be imposed on transactions, documented or not.

The ATO and other government agencies might find some uses for blockchain technology for information registers they currently maintain and disseminate (think of ABNs or the Register of Foreign Ownership of Agricultural Land) or for information that must be reported to them (like Payment Summaries or third party reporting of tax-related information which will be greatly expanded from 1 July 2017). Perhaps the ATO will try to insert themselves as a node in systems to facilitate greater and direct data capture. It remains to be seen whether there is any appetite for government to adopt this technology for gathering information or for validating the information reported to them.

Even if there isn’t any enthusiasm to embrace blockchain technology, governments may have reason to fear it. They will certainly need to be concerned about anonymity and the possibility that many chains will simply involve anonymous parties. Reporting and withholding may be thwarted if sizeable transactions can be done anonymously and using digital currencies such as Bitcoin (or any one of the multitude of other crypto-currencies currently vying for public acceptance). On the other hand, many central banks have been considering the issue of digital currencies themselves and the macroeconomic consequences of doing so.

The jury is still out on whether we are merely changing mechanisms – that blockchain is just about how transactions are agreed, implemented and evidenced – or whether we are indeed seeing new types of arrangements and transactions emerging. In other words, is this simply analogous to the start of retail e-commerce in the 1990s, or the appearance of mail order in the mid-1800s? If the world is divided between blockchain enthusiasts and skeptics that is probably because we are still trying to work out what this thing is good for. As new uses emerge, only then will we have a clearer answer to the question whether tax people need to be especially attentive.
These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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