Taxation Issues for Security Token Offerings

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Introduction

One of the most exciting developments of the Fourth Industrial Revolution presently underway due to the emergence of digital assets is the long overdue prospect that there will be a global redistribution of wealth unlike anything seen before.

The decentralised nature of digital asset ownership, the freedom to trade on decentralised platforms and the transparent nature of blockchain technology means that for the first time in history – centralised forms of authority no longer 'run the global wealth game'.

Some regulators will undoubtedly try to use a sledgehammer to crack the proverbial peanut, and below we will see those countries that have tried to do so.

Other governments will recognise that this is a once in a generation opportunity to access liquidity in relation to sovereign assets in ways never before possible. Corporations likewise will see growth opportunities through unlocking value in underperforming balance sheets.

Given the increasing pace of technological developments (think quantum computing) and continued innovation more people will be able to buy more digital assets – security tokens being chief among these options - from anywhere on the globe than at any time before.

As one who has witnessed the complex mire of global tax regulation and seen the slow pace at which governments have moved towards things like tax harmonization and multi-lateral tax agreements it is quite clear that gaining global consensus on regulating security token offerings (STOs) is going to be just another quagmire which will take years to resolve.

This paper by design is non-technical and it is intended to provide a general coverage of the following:-

1. An overview of STOs;
2. Tax issues to consider for STO issuers;
3. Alternative structuring approaches to STOs;
4. Tax issues to consider for STO participants;
5. A review of the international state of play on STOs;

AN OVERVIEW OF STOs

Similar to an initial coin offering (ICO) an investor is issued with a crypto coin or token representing their investment.

However, unlike an ICO, a security token generally represents an investment contract into the underlying investment asset such as a parcel of real estate or shares or managed funds.

A security token then 'represents' the ownership information of the relevant investment and it is recorded on a blockchain.

Many people are familiar with the fact that when they invest in shares all relevant ownership information is written on a document and issued as a digital certificate. In the case of an STO the process is similar however the relevant ownership information is recorded on a blockchain, and it is issued as a token.

To many observers an STO lies somewhere between an ICO and the more traditional initial public offering (IPO) due to the crossover with both of these methods with respect to investment fundraising.

How is an STO different from an ICO?

While the process is the same, the characteristics of the token vary.

The word security in STO relates to the fact that the token is 'asset-backed' and it has to comply with regulatory governance.

The large majority of ICOs position their coins as a 'utility tokens' that give their users access to the native platform and decentralized applications. The main purpose for the issue of the coin is said to be for 'usage' and not for investment. Hence ICO's generally are able to avoid the legal frameworks that apply to STO's.

An ICO then is easier to organise and has a lower barrier to entry. Compliance costs can be avoided, and generally speaking they can be sold to a wider audience.

STO's are likely to be caught under securities laws as they relate to an 'investment contract'.

This adds to the cost and complexity of complying with relevant regulations and considering what type of investors may be able to participate in the STO.

How is an STO different from an IPO?

The process of raising funds may be similar however as noted above STO's issue their tokens on a blockchain.

IPOs issue their shares on listed stock markets.

IPOs are generally used as the mechanism to take private companies public and to raise funds in the process. An STO however is generally undertaken to gain liquidity in a particular asset. It is usually accredited investors who can partake in an STO.

STOs can be undertaken over any number of assets including, a parcel of land, an artwork, or an investment fund. The STO process is also much more cost effective than an IPO.

While conducting an STOs means the asset owner would still have to pay lawyers and advisors, they have direct market access and don't have to go through a brokerage firm and pay underwriting fees and other costs.

Hence, in the majority of cases they are cheaper and it easier to get market access.

What are the advantages of an STO?

Let us consider this question firstly by reference to an ICO.

From an investor perspective STOs are seen as lower risk as they have to comply with securities laws in the jurisdiction where the STO is being conducted. This generally assists with the goals of transparency and accountability that many investors value.

Also, a security token is backed by a physical asset and hence an investor can more readily ascertain whether or not the token represents fair value.

Utility tokens are somewhat of a mystery in terms of their asset value. Perceptions of future use and benefits is much harder to assess than the actual value of a real-world asset.

Also as compared to a traditional IPO, an STO eliminates the need for a range of intermediary professionals.

It is therefore a far less expensive process. The use of 'smart contracts' reduce the reliance on lawyers and the use of blockchain reduces the need for storage of data on other mediums. This makes the whole process not only cheaper, but faster.

The existence of 'fractional ownership' which is a feature of many STOs, so common in the areas of aircraft ownership, holiday real estate and boat-ownership is also a well understood concept.

The ability to trade security tokens on secondary platforms at any time, brings additional liquidity to the market. This is particularly the case with traditionally illiquid assets, such as fine art and collectibles.

The vast majority of STOs are structured in jurisdictions which support their use and thus are legal compliant.

The market is forecast to grow strongly over the years ahead.

What are the main challenges with STOs?

One of the increasing challenges facing the STO market is the lack of global uniformity with respect to laws concerning their operation as we will see in Section 5 below.

There is likely to be an increasing focus on Know Your Customer (KYC) and Anti Money Laundering (AML) laws to make sure that STOs comply with relevant securities laws.

It is also the case that processes will need to be established to facilitate custodianship, tracking of ownership and exchange approvals.

While the STO process is less expensive than a traditional IPO, there is more work to be done initially as compared to an ICO.

The regulations in certain jurisdictions might also limit who can invest in an STO, which reduces the overall investor pool.

TAX ISSUES TO CONSIDER FOR STO ISSUERS

Many people appreciate that for the owners of valuable assets, the ability to issue security tokens is a great opportunity as it allows the owner to retain majority control of the asset while releasing liquidity to help them do other things.

Let us consider two examples (out of many different options):

Example 1 – An STO for a Government or State-Owned Entity (SOE)

A Government or one of its SOE's may be rich in natural assets, yet unable to access cash from those assets due to an inability to raise credit on global financial markets.

Many developing countries face this problem.

The World Bank and the International Monetary Fund (IMF) typically provide debt solutions to developing countries which are subject to many conditions. The common criticism from many developing nations is that these conditions are onerous and generally make it unattractive to take further debt on.

The result is that often economic growth is stymied for years because of the impasse between the developing country and the IMF.

In the case of a country that owns say, an illiquid natural resource – (e.g., a forest) an STO is an opportunity to release capital by attracting international investors who want to acquire a security token that represents part ownership of the underlying asset.

In the case of a forest there the potential to earn income from 'carbon credit' sales that the forest stores.

This example is one way forward for developing country governments to access liquidity from sovereign assets.

While the tax issues for a government or SOE are minimal (it is unlikely to tax itself!) there are international tax issues to consider including how its international tax agreements operate with respect to the flows of income it pays international investors?

A secondary issue is whether it can or should offer tax incentives to foreign investors for projects it is offering by way of an STO.

In the case of the STO over a natural forest as noted earlier the SOE needs to consider if future income generated from carbon credit sales would be treated as income from real property. Most double tax treaties have a specific clause in them which recognises taxing rights for any income generated from real property.

If such 'carbon credit' income was viewed as income from real property, then presumably the relevant Government's tax office would seek to withhold tax on part of the income stream that the SOE has to pay to its foreign investors.

In the event that carbon credit income is not viewed as income from real property the question which then arises is whether the income would be taxable as being generated from a 'permanent establishment'.

The question arises because depending upon the terms and conditions of the security token issuance the foreign investor may be treated as part owner of the forest itself.

The definition of 'permanent establishment' in many tax treaties includes:-

'a mine, an oil or gas well, a quarry or any other place of extraction of natural resources'

As such being a part owner of a permanent establishment means that the foreign holder of the security token could be directly taxable because they derive income sourced in the country where the forest is located.

This may be somewhat of a disincentive.

Once possibility that a government could consider is to specifically exempt foreign investors from taxation for any gains made in STO's they are involved with.

For some developing countries an STO will be a much more attractive option to gain liquidity than yet another loan from the IMF.

Example 2 – A Private Company Conducting an STO

Many corporate groups have assets on their balance sheet which are not cash generating or the stock market may be undervaluing the company as a whole for reasons beyond its control.

In cases such as these an STO is a strategic option that could be examined.

Not only is the company's Board of Directors best placed to look at the assets of a group which may be undervalued, they are also best placed to assess which assets could be partially 'sold off' but still controlled for use in the business.

Assuming this company is a resident in a jurisdiction which allows STO's (we will have more to say on this below) there are a number of tax issues for the Board to think through including:

1. Does the process of conducting an STO of a particular asset give rise to a capital gain or ordinary business income?
2. How is existing company debt treated?
3. What are the withholding tax obligations the company faces for any non-resident holders of its security tokens?
4. Has the STO for the company created additional reporting obligations by triggering a joint venture or partnership relationship?

These are just some of the tax questions that the Board will have to work through.Let us now examine these questions in a bit more detail.

Does the STO of a particular asset give rise to a capital gain or ordinary business income?

The answer to this question largely depends on the tax law of the particular jurisdiction the company is a resident in.

Singapore for example does not have a capital gain tax.

Therefore, if a Singapore company held an asset on capital account – a piece of land and it issued security tokens over 49% of that land – then the company would make a capital gain.

Under Singapore's tax laws that capital gain would not be subject to tax.

In Australia on the other hand capital gains are subject to tax. Therefore, a company issuing security tokens which effectively conveys 49% of the interest in the land to security token holders would pay corporate tax on any proceeds received.

The general answer to this question to this question involves an examination of the domestic tax laws ot the jurisdiction in which the company conducting the STO resides in.

How is any existing company debt treated?

Generally speaking, interest on loans for tax purposes is tied to the use of the money.

Hence if a Company borrowed to buy a pool of assets over time and the debt facility increased as and when those assets were acquired – care has to be taken should an STO be contemplated.

It is not a case of simply conducting the STO and then spending the money elsewhere in the business.

A careful review of the loan position of the company has to be undertaken to determine whether some of the STO proceeds must be repaid to the original bank that financed the company's purchase of the asset.

Let's consider the case where a company borrowed $10M to buy an asset which now is worth $50M on the open market.

The company does not want to sell the asset as it needs the asset to continue to run its business.

It also does not want to do a 'sale and leaseback' transaction as this may cause it issues with respect to debt covenants and or other financial reporting obligations.

To access say $20M of liquidity the company could do an STO for say 40% of the asset.

Effectively this would keep 60% of the asset owned by the company. It would allow the company to use this capital within its business. Assuming a corporate tax rate of 25% it is likely the company would pay tax on the following:

- Cost of asset $10M
- Portion of the asset sold 40%
- Cost base relating to the portion sold $4M
- Proceeds from the sale of the STO are $20M
- Profit on the STO would be $16M
- Tax on the profit at 25% would be $4M.
- We will assume a tax provision is set up for this amount.
- Now for good order as the company expected to have $16M net of tax – it should also repay the bank that financed the asset purchase.
- As 40% of the asset was sold the amount to repay the bank would $4M.
- This is because $4M represents 40% of the cost of the asset which was fully financed by the loan.
- This will ensure that the remaining interest cost is ta deductable to the company. Hence the freed up liquidity for the company to use in this example is $12m.
- Not only does this provide the company with significant working capital it reduces its existing debt and ensures the company does not have to borrow to embark on its next growth initiative.

This will ensure that the remaining interest cost is deductible to the company.

Hence the freed-up liquidity for company use in the above example is $12M.

Not only does this provide the company with significant working capital it reduces its existing debt and ensures the company does not have to borrow to embark on its next growth initiative.

In my view more companies will come to appreciate the additional flexibility that conducting an STO provides them.

What are the withholding tax obligations the company faces for any non-resident holders of its security tokens?

Let us first examine what withholding taxes are.

In general, the term 'a withholding tax' is any form of deduction prior to a distribution of income which is levied at the point of payment, and which is treated as an advance payment of income tax.

Most of us are aware of such taxes being withheld from payments relating to dividends, interest, royalties and or salary and wages.

Many domestic taxation systems around the world require the payer of these sorts of payments to withhold tax so that the government receives its tax payment before the payment is made to the recipient.

In terms of payments made to foreign investors, withholding taxes are usually a final tax because it is unlikely that non-residents of a particular country will comply with the tax filing requirements of the country from which the payment was made.

Thus, the withholding tax is the last chance for the government to access tax payments before monies are remitted overseas.

One of the questions that first has to be considered when the topic of withholding taxes arises is what type of income is being paid to a non-resident.

If the STO contemplated by the company produces 'asset ownership' but does not produce any income yield from the STO - then no withholding tax is likely to be due and payable.

Foreign holders of the STO presumably may (depending upon the terms of the STO) be free to sell them to another foreign purchaser on the secondary market.

In this case no withholding tax would likely apply to the foreign holder of the STO as this transaction occurs outside the country of issue.

If we assume that the STO produces a cashflow yield which is satisfied by the company making a regular payment of interest or rental income, then many domestic withholding tax regimes would require the paying company to withhold some form of tax.

However, if the payment is not a dividend, an interest payment or a royalty payment then most domestic tax regimes around the world would not impose upon the company the obligation to withhold tax on income flowing to the non-resident token holder.

An STO over an expensive manufacturing plant (that does not give the STO holder any right to the income stream produced by the plant) may only provide the right for the STO to share in any value improvement in the manufacturing plant.

This would be unlikely to be caught by a withholding tax regime.

Also given the structure of most double tax treaties it is not immediately clear if the STO holder could be caught by the 'general profits' article.

I think the key point here is to recognise that any company undertaking an STO where foreigners are likely to participate has to consider its withholding tax obligations carefully.

Has the STO for the company created additional reporting obligations by triggering a partnership relationship?

One of the unintended consequences of dealing with an STO include the tax reporting obligations which then exist, or which may come to exist after the STO.

Some STO's are clearly more 'partnership' in nature that 'joint venture'.

While much will depend on the wording of the STO documentation any element of sharing the profit from an asset after the costs of its management have been attended to is far more likely to constitute a common law partnership than a joint venture.

The significance of the precise relationship that a company has with its security token community cannot really be understated.

This is for at least 3 reasons:

- Firstly, there is the question of how liabilities are protected in the STO documentation for anyone participating in the STO as an investor, domestic or international.
- Secondly there is the question as to whether the company has to file an additional partnership tax return for itself and its security token holders where they jointly own a particular asset that was formerly 100% owned by the company. This can add quite a lot to the compliance obligations of the company.
- Thirdly there is the question as to how the company manages and tracks changes in the security token holders as they are bought and sold on the secondary market.

It is highly likely that the taxation office of the relevant jurisdiction where the company resides would expect the company to have KYC and AML on the initial security token holders and the new ones as they change.

If the company is unable to monitor the jurisdiction in which its security token holders reside then it is most unlikely to be able to comply with the withholding tax laws of a particular county.

The domestic tax regime in which the company finds itself will have an impact on the annual reporting required in respect of partnerships of which it is a partner.

The key point in relation to this question though is that the Board of Directors of the company need to be aware of the additional tax and reporting obligations that the STO will impose upon them.

ALTERNATIVE STRUCTURING IDEAS

As we will see further below a number of countries specifically prohibit STOs from being carried out in their jurisdiction.

In other jurisdictions the governments are yet to develop their positions on STOs.

For these reasons alternative approaches may be required in order for a company to conduct an STO.

While the applicability of an alternative option is highly dependent on the legal regime of the country of incorporation and or the residence of the directors, the strategy below could be considered further as an alternate pathway.

Many potential investors in STOs will generally require a jurisdiction to legally permit the STO to occur before they participate.

Let us assume that Company A below resides in a jurisdiction that does not have laws permitting STOs.

The management of the company nonetheless wishes to undertake an STO.

Let's consider the following diagrams:

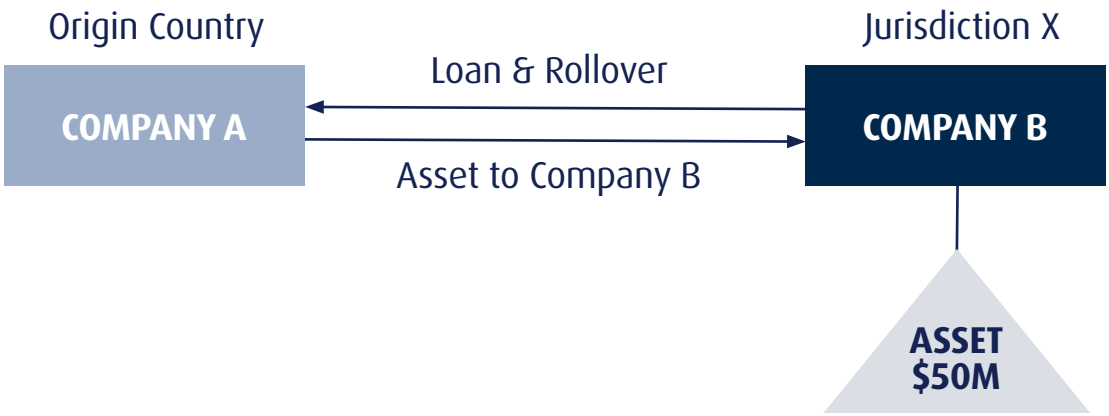
Initial Position

The initial position is that Company A owns an asset worth $50M.

Management of the company conducts a review of relevant jurisdictions and determines that Jurisdiction X would be the ideal location to conduct their STO.

To embark on its plan of releasing liquidity locked up in the relevant asset, Company A conducts a rollover of the Asset to Company B (which it controls).

Step 1: Rollover of asset to Company B in jurisdiction X



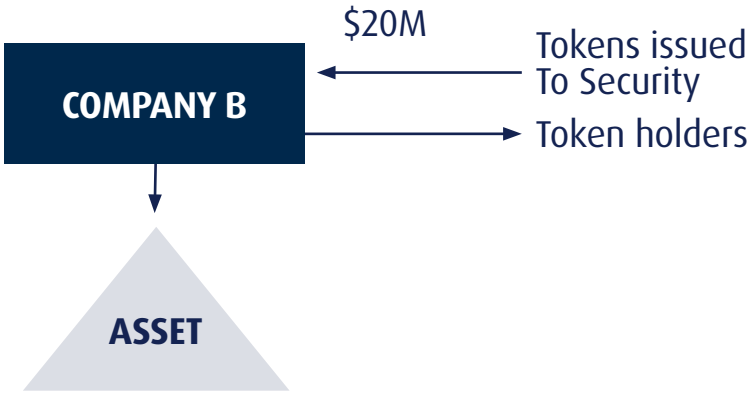
The above diagram indicates that Company A has moved the asset to a related company, Company B. Company B is specifically established to receive the Asset and conduct the STO.

Company B accepts a loan obligation on its books for $50M.

Let us assume that Company B now wishes to release $20M of liquidity 'locked up' in the asset.

Step 2: Company B conducts an STO for 40%

Company B conducts the STO for 40% of the Asset worth $50M and releases $20M of liquidity.



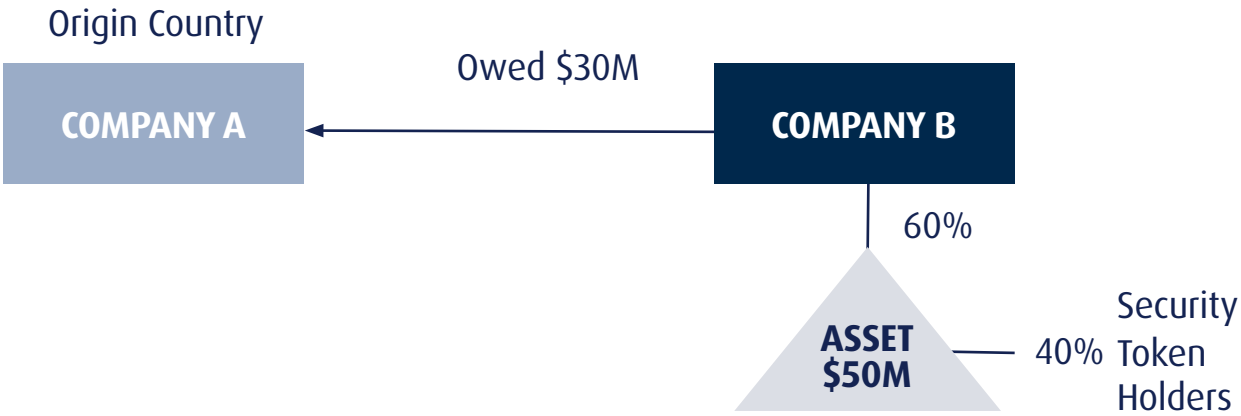
Security token holders pay $20M to Company B for their interests in the Asset.

Step 3: Company B pays repays $20M of the loan facility to Company A

The liquidity sought by Company A to grow its business is returned to it by way of loan repayment, while it still retains the majority control of the asset (through its control of Company B), and it can continue to use the Asset in its business.

In the below diagram we see that the objectives of Company A, unable to be achieved in its home jurisdiction were able to be met in jurisdiction X.

Step 4: Ending Position



This idea above is just one way those keen to undertake an STO can proceed if the laws in their own jurisdiction are not supportive of the strategy.

These ideas will continue to be facilitated by the transformation of technology and the new mindset of forward-thinking advisors working in digital asset markets.

TAX ISSUES TO CONSIDER FOR STO PARTICIPANTS

While there are a number of tax issues to consider for a participant in an STO, the main issues are:

- How is the cost of the STO treated in the jurisdiction where the person is tax resident?
- How is gain or loss on the sale of the security token likely to be treated in the jurisdiction where the person is tax resident?
- Does the tax treatment in acquiring a security token – mirror that of acquiring the asset itself, for example, if one buys a security token over a building – will the tax treatment be the same as if one bought a share of the building?
- How are foreign currency exchange gains (realised or unrealised) with respect to a foreign issued security token treated for tax purposes?

Let us now look at some of these questions in more detail.

How is the cost of the STO treated?

In a previous paper I noted (https://csttax.com/en-sg/blog/international-taxation-of-digital-asset-transactions/) the wide range of responses as to how governments around the world treated virtual currencies.

There is likely to be a continued variation as to how STO's are treated for tax purposes between countries around the world.

One of the threshold issues for an investor to consider, subject to their tax residence, is whether or not the cost of the STO will be on income account or capital account.

Investors carrying on a trade or business

If the investor participating in an STO carries on a business of trading in digital securities, then it is likely the 'cost' of an STO will be treated on income account.

That is – the STO will form part of their trading portfolio and be treated much in the same way as trading stock would be.

An interesting question arises for a trader who may be active in trading non digital assets such as stocks, bonds and derivates – but who partakes in one STO – is whether the relevant tax office could argue that those business activities extend to the single STO participation. It will likely depend on the facts of the particular case.

However – generally speaking for those who trade in digital assets – the cost of participating in an STO would be likely viewed as purchasing trading stock and thus be on income account.

Non-Trading Investors

For those investors who invest for long term capital gains and who do not trade digital assets it is likely that the asset would be covered by the tax laws relating to the taxation of capital gains.

How is gain or loss on the sale of the security token likely to be

Investors carrying on a trade or business

Consistent with the above - an investor who carries on a business of trading is likely have any gains which result from sale of an STO taxed under the general income tax laws of the country in which they reside.

Similarly, it can be expected that a loss on the sale of a security token would be deductible against income of their digital asset trading business.

Many countries trading stock rules, provide that increases in value of trading stock can be taxed so one side issue to consider is how to 'mark to market' any STO the investor participates in.

Private markets for the transfer of STO's is one way of valuing changes in security token values. However, in cases where there are no liquid markets there will be other valuation issues.

Non - Trading Investors

It is likely that for those investors not carrying on a trade or business – any capital gains made on the sale of a security token would be taxable under the capital gains tax regime of the country in which they reside.

Does the tax treatment in acquiring a security token – mirror that of acquiring the asset itself?

Another interesting question which comes into play when considering the tax treatment of security tokens is whether, for tax purposes, an acquisition of the token equates that which would have applied to an acquisition of the asset backed by the token.

This has some tax significance.

Consider an asset back token over a block of apartments currently producing rental inomce.

Under the STO, the investor may be offered 'contractual rights to part of the income of the residential apartments on the block of land plus some of that capital gain in the event that the block of apartments is sold at a future point in time'.

It may be that the STO does not convey the legal interest in the land itself.

This raises the tax question as to whether there is a tax difference between an investor who buys a parcel of land with apartments being rented on it versus an investor who buys an STO that has its value tied to the income and gains which flow from the block of apartments.

The key point to appreciate here is that one cannot automatically assume that 'equal tax treatment' flows between that of being an STO owner as compared to a landowner.

There is a difference in likely outcomes for tax purposes and that needs thought through by your tax professionals.

How are foreign currency exchange gains realised or unrealised gains

As many investors will invest in STO's, outside their country of residence, an ancillary, though important question is how are exchange gains and losses made on an STO treated?

Investors carrying on a trade or business

If the investor participating in an STO carries on a business of trading in digital securities, then it is likely that foreign exchange gains made on the realization of an STO that is sold will be treated on income account.

This is consistent with how other income would be taxed from trading activities.

Non-Trading Investors

For those investors who invest for capital gains purposes and who do not trade digital assets then in some cases the tax systems of some countries, like Australia, would tax foreign gains and losses under the capital gains tax regime.

THE INTERNATIONAL STATE OF PLAY ON STOS

There is no generally accepted approach to STO's and the rules across the globe vary widely.

Below is a sample of the legislative approach in some of the key jurisdictions that have issued legislation on the subject or are about to.

British Virgin Islands

On 13 July 2020, the Financial Services Commission of the British Virgin Islands (the "BVI") issued a long overdue guidance on the regulation of virtual assets in the BVI (the "Guidance").

The Guidance confirms the treatment of digital assets and digital asset-related activities, enabling digital assets to be issued, held, and traded with more certainty to their treatment under BVI law. Certain types of digital asset-related activity could constitute regulated investment business, which must be duly licensed in the BVI to be carried out.

Where a digital asset product or service provides an enduring benefit beyond being a medium of exchange, it is likely captured under the BVI Securities and Investment Business Act (2013 Revision).

This would likely mean that many STO's could not be undertaken in the BVI unless the entity conducting the STO has the relevant licence.

France

In December 2017, a Blockchain Order was passed which allows for the delivery of securities against payment (settlement) for unlisted financial instruments, thus allowing for the introduction of security token technology.

In March 2020, the Autorite des Marches Financiers (AMF) of France released a legal paper dedicated to security tokens. In this document, the AMF has acknowledged security tokens as their traditional counterpart and has declared the need for all the right licenses for financial services providers operating in the industry, including the need for on MTF (Multilateral Trading Facility) license for secondary exchanges.

The AMF has expressed its regulatory concerns for decentralized security token exchanges as part of its legal analysis.

Gibraltar

In 2018, Gibraltar introduced its Digital Ledger Technology (DLT) Regulatory Framework after extensive engagement with the crypto industry.

Under the framework, exchanges must register with the Gibraltar Financial Services Commission and demonstrate that they are meeting the "principles" of the DLT framework which include a strong focus on the detection and disclosure of money laundering and terrorist financing.

In September 2020, Gibraltar updated its DLT framework regulations to better align with FATF recommendations, considering the higher risk factors associated with some digital assets.

The Gibraltar government hasn't actually passed any specific laws but the nation's Minister of Digital and Financial Services, Albert Isola, stated in May 2020 that security tokens are legal and welcome in the country. Security tokens are required to follow the same regulations and laws as traditional securities in Gibraltar.

All crypto assets and tokens will be seen as security tokens unless otherwise demonstrated to the regulators that it is a utility token.

Liechtenstein

Legislators passed the Blockchain Act in July 2019, defining security tokens and ICOs into a framework designed to foster innovation in the country. The bill introduces the Token Container Model which is designed to allow for the tokenization of any asset or right.

The model provides legal certainty for pre-existing rights that are tokenized as well as for the information stored on blockchain-based systems.

Liechtenstein amended its civil law to allow the token world to have priority over the physical world for the cases where tokens exist for rights and assets.

The legislators took a broad approach and referred to the blockchain as transaction systems based on trusted technologies as a way to describe blockchain systems such as Ethereum but also covers distributed ledger technology and potential other use cases.

The Liechtenstein government hopes that this use of more abstract terminology will enable them to future-proof and keep the law valid for the next generations of technology and to allow for the flexible interpretation within a light-touch regulatory framework.

Luxembourg

The legislators of Luxembourg passed the Blockchain Bill in November 2020 to create a legal framework for the dealing of securities through new secure electronic registration technologies.

The Blockchain Bill introduced a new Article 18a into the Law on Securities. The Article regulates holding of securities accounts and registration issues within or through secure electronic registration devices.

Article 18a does not explicitly mention the blockchain technologies; nevertheless, blockchain is specifically referenced in the explanatory commentary provided to the Blockchain Bill by its drafters.

Malaysia

In January 2019, the Securities Commission Malaysia (SC) issued an order that sets out the characteristics of "digital currency" and "digital tokens" that are prescribed as being securities for the purposes of Malaysia's securities law.

The SC's consultation paper outlines a new framework that ultimately comes with a lot of compliance requirements, including limits to how much can be raised and quarterly reporting requirements.

The concept of the ICO has been completely regulated into security tokens. While the underlying technology presents an innovation that the SC wants to allow in its borders its primary focus is on ensuring that nothing can operate outside of its control.

Monaco

Monaco adopted legislation for security tokens and ICOs in June 2020.

The model enables Monaco-based issuers to use security token offerings akin to traditional securities offerings. This means qualified investors only but the possibility for a global audience to reach Monaco-based assets.

The new framework also offered a model for ICOs for Monaco-based entities.

Singapore

The Monetary Authority of Singapore (MAS) has set up a sandbox with companies to operate security token exchanges and platforms. After working with the market participants, the MAS released a guidance paper for Digital Token Offerings in May 2020.

The guidance paper defines security tokens as traditional securities based on Singapore law, and therefore must follow all similar regulations and requirements to comply.

The guidance paper also clarifies the various operator types in the market, such as exchanges and financial advisors, and reinforces the need for the approval by the MAS and the pre-requisite licensing that's needed to perform such activities.

By providing multiple examples the MAS has covered many aspects of issuing a security token thus ensuring clarity for the industry.

The MAS has also made cryptocurrency exchange operators, as well as ICO advisors, be required to get licensed, creating room for ICOs to operate in Singapore if they aren't considered securities.

There are strict regulations around the market infrastructure which is aimed at curbing the behaviour of bad actors.

Switzerland

In 2018, FINMA released guidelines for ICOs which outlined and confines Security Tokens to the same treatment as their traditional counterpart. In September 2020, Swiss legislators passed a law that also allowed for blockchain-based registry support for securities.

Security Token issuers must follow the same financial framework that currently exists in Switzerland. This includes any financial service providers needing to get licensed to conduct their activities.

Meanwhile, issuers can use a blockchain-based registry technology to support tracking their ownership.

The United Arab Emirates (UAE)

The UAE has been exploring crypto and security token legislation when it launched a crypto asset consultation paper in October 2019.

In July 2021, it was reported that the DIFC would start consultation on a crypto asset framework in the third quarter of 2021.

As to security tokens, it is expected that they will be regulated in accordance with existing regulation with additional requirements to tackle technological risks specific to DLT and blockchain.

While DIFC regulation is business friendly, it is not expected that the framework will allow security tokens issued on DIFC-based platforms to be traded on permissionless applications such as Uniswap or other DEXs.

The United Kingdom

In January 2019, the United Kingdom's Financial Conduct Authority (FCA) released a 50-page consultation paper called 'Guidance on Crypto Assets'.

The FCA distinguishes between three types of tokens; exchange, utility, and security.

Security tokens are seen as investment instruments as outlined by the Regulated Activities Order (RAO) and also defined by Markets in Financial Instruments Regulation.

The FCA is promoting blockchain and DLT innovation within the region but limiting what capacity utility tokens can take form by truly needing to differentiate from an investment instrument.

The USA

In the US, the Securities and Exchange Commission (SEC) in the US is perhaps the most vocal on the issue of how a security token is defined, and whether or not certain utility tokens are, in fact, security tokens that should be regulated.

The USA has not successfully passed any legislation that defines security tokens or any other crypto-asset regulation. The country's various regulations have simply policed their respective jurisdictions within the current confines of the law. However, numerous attempts at bills regarding security tokens and cryptocurrencies have been introduced to Congress but have not passed.

This includes: The Managed Stablecoins are Securities Act 2019 HR 5197, the 116th Congress (2019-2020): Token Taxonomy Act of 2019 and over 30 other related bills so far.

As the industry continues to grow, it is expected that clarity for defining security tokens and crypto-assets will come from legislators or regulators.

We will shortly see how the number of pieces of proposed legislation (often taking different approaches) work their way through the US legislative process.

Countries Prohibiting STO's

Apart from a number forward thinking countries many countries have banned STO's (and cryptocurrency trading in general),

A prime example of that is China which has actually made STOs by private issuers illegal.

Recently the country issued a statement banning all forms of digital assets.

It seems the approach on security tokens is the same as their approach on other assets which is to have complete control over all security token activity in the country.

Other countries that have banned STO's and digital assets also include:

- Algeria
- Bangladesh
- Bolivia
- India
- Lebanon
- Morocco
- Namibia
- Nepal
- Pakistan
- South Korea
- Vietnam

Conclusion

This article has provided an overview of the growing area of STO's, how they work, a number of key tax issues and what many governments are doing in the area.

It is clear that the vast majority of governments are struggling to cope with the general laws including tax laws, around STO's and their place in the regulatory landscape of their economies.

My hope is that in the field of taxation the OECD and other international bodies will begin their work in earnest to give digital asset participants, whether an STO issuer or an STO investor confidence and certainty.

The digital asset world has the potential to continue bringing positive change to the lives of hundreds of millions of people who seek to invest their funds and build their financial future.

No country no matter how large or small can ignore the fundamental change that is underway with respect to the growth and ubiquity of digital assets.

The STO train has well and truly left the station in the digital asset world.

It will be an exciting journey and one that should be embraced by all.

About the Author

John Marcarian

John is an Australian Chartered Accountant with over 25 years of experience. Having founded CST Tax Advisors in 1992, John has in-depth knowledge of international tax matters for both businesses and globally mobile expats.

In 2004 John established the Singapore Office of CST. CST now has offices in a number of cities around the world.

Recognised Thought Leader

John has had a number of articles published in the Tax Specialist, a publication of the Institute of Chartered Accountants of Australia, and the Tax Yearbook, a publication of the International Tax Planning Association.

Most recently, John has published two books; 'Expatland', which is aimed at assisting potential global expats plan their move and 'The CST Way' a professional services book for Global Accounting Firms.

John is a sought-after speaker on tax and business matters and regularly presents to business groups around the world.

Recognised Tax Specialist in Digital Assets

John has a deep understanding of digital assets and the Fourth Industrial Revolution presently underway around the world in the area of blockchain and digital assets.

A recognised tax specialist in digital assets, John has a qualification from the MIT Sloan School of Management in BlockChain Technologies.

He has contributed tax expertise to a specialist US publication on international tax and digital assets.

He works regularly with companies issuing tokens and other forms of digital assets. This unique blend of skills gives John a practical day to day knowledge of the business challenges faced by entrepreneurs in the digital asset market.

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