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ICOs in Singapore – Some Tax Considerations

06 FEBRUARY 2018

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CATEGORY:
ARTICLE

With the proliferation of blockchain technology and cryptocurrencies, the Initial Coin Offering (' ICO') has quickly become the preferred method for blockchain players to raise capital. Instead of selling shares to investors like in an Initial Public Offering ('IPO'), the issuing entity in an ICO raises funds by selling new digital tokens to early backers of a blockchain or distributed application project. Singapore has emerged as one of the preferred jurisdictions out of which to conduct ICOs. This is due to a number of factors which include its position as a global financial centre, a conducive start-up ecosystem, and initiatives such as Project Ubin.

The regulatory status of an ICO is now squarely on the agenda of those planning an ICO. Regulators in the United States of America have recently issued a number of cease and desist orders, with Munchee Inc. and to BitConnect being two high profile examples. Not only do these cases serve as a timely reminder, but they are also clearly demonstrate that greater scrutiny is placed on ICOs in general. An issue that is receiving comparatively little attention is the potential tax exposure of the proceeds from a digital token issue. Set out below are some Singapore tax considerations associated with using a Singapore based structure to conduct an ICO.

Key tax considerations for an ICO in Singapore

Taxability of ICO proceeds

The Singapore tax system is semi-territorial in nature. Corporate income tax is payable at the rate of 17% upon:

(i) income accruing in or derived from Singapore; and
(ii) foreign-sourced income to the extent that it is received in Singapore.

The first question which must be asked is whether the proceeds from undertaking an ICO are income. The nature of tokens and cryptocurrencies from a Singapore tax perspective has not been clearly defined and the Inland Revenue Authority of Singapore ('IRAS') has yet to release any guidance. These are not legal tender and they generally do not confer any membership interests in the token-issuing entity. To argue that the purchase of a token as akin to a subscription for membership interests would likely be fatal from a securities law perspective if the contrary is intended.

There is an extremely wide range of functions attaching to different utility tokens in particular. It is common that they confer usage rights in relation to a blockchain platform or distributed application. They are, in many respects, not dissimilar to purchasing tickets to see a movie or a sporting event. In the same way that the promoter of a sporting event would be subject to tax on the proceeds from ticket sales, the same analysis applies to an entity undertaking an ICO. The fact that the revenue associated with using a blockchain or distributed application is received all at once does not change its character as income.

The charge to Singapore tax is set out in Section 10(1) of the *Income Tax Act* (Cap. 134) (' ITA'). Paragraph (a) applies to bring to tax the proceeds of a trade or business which are carried on by a taxpayer. The idea of carrying on a trade or business typically requires a level of repetition and periodicity. This is one of the badges of trade which are the indicia generally used to determine whether an activity amounts to the carrying on of a trade. While the idea of an adventure in the nature of trade was rejected by the Singapore Court of Appeal in *DEF v Comptroller of Income Tax* [1961] 1 MLJ 55, Section 10(1)(g) of the ITA operates as a catch-all provision and applies to tax 'gains or profits of an income nature'. The fact that a token issuer may conduct no activities other than those in relation to an ICO (which is common where an SPV is used as the issuer) therefore does not preclude taxation under Section 10(1) of the ITA.

An issuing entity based in Singapore may argue that the proceeds from an ICO are foreign-sourced income. With this characterisation, the ICO proceeds are not subject to Singapore tax as long as they are not received or deemed to be received in Singapore. The source of income has been famously described as a hard, practical matter of fact and so a careful evaluation of all relevant circumstances is required. The IRAS tends to consider the question of source substantively and look at the place where the decisions leading to the derivation of income are made. This may be compared to other territorial-based jurisdictions such as Hong Kong which arguably place greater weight on the place where contractual formalities take place. A foreign-source argument is more likely to be successful if the developers behind the blockchain technology are based outside Singapore, the ICO is marketed outside of Singapore via participation in industry events and on the internet generally and the participants in the ICO are predominately from outside of Singapore. It is difficult in abstract to say how robust this position is and Singapore tax advisers will likely differ as to the strength of the opinions they will give – or not give – in view of the facts.

Using a foreign- incorporated special purpose vehicle ('SPV') as the token issuing entity may seem like the obvious solution. Because the Singapore system is territorial, little actually turns on the place of incorporation or even tax residency of an entity when considering the taxation of income under Section 10(1) of the ITA. Where a foreign incorporated and tax resident entity is used, but the main functions are performed by a development team in Singapore, the source of the income represented by the token raise needs to be carefully considered in the context of Section 12(1) of the ITA. This provision deems the entirety of the income of a non-resident person from a trade or business carried on partly in Singapore and partly offshore to be entirely Singapore-sourced. It is only that portion of the income which is directly attributable to the operations of the issuing entity carried on outside Singapore which is not caught by this deeming. The operation of this provision makes the question about whether a token-issuing entity is carrying on a trade or business a critical question. An issuing entity which directly employs staff is more likely to be considered to be carrying on a trade or business than one which merely acts a passive governance vehicle and enters into development contracts with related or third-party developers.

Some blockchain projects have used a Singapore company limited by guarantee as the token-issuing entity. This entity is purportedly established as a non-profit vehicle with the corporate objective of promoting the particular blockchain technology and providing a formal governance structure. A company limited by guarantee does not have any shareholders and so it can be seen preferable to a company limited by shares by participants in an ICO. This is because the shareholders of a company limited by shares could more readily access the proceeds of an ICO by requiring the directors to distribute profits or return capital. The ITA provides an exemption for the income derived by charities which are registered or exempt from the requirement to register under the Charities Act (Cap. 37). This exemption is not going to apply to a token-issuing entity established as a company limited by guarantee merely because it is stated as being non-profit.

Section 13U of the ITA could, in theory, be used to apply for an exemption from Singapore income tax where a company limited by guarantee is used. This is a broadly crafted provision which exempts the income of a not-for-profit organisation that has been approved by the Economic Development Board. It is however highly doubtful that approval would be given under this incentive scheme.

Timing of taxation of ICO proceeds

The potential upfront taxation of token proceeds is made worse by a potential timing mismatch. While the entire proceeds from the token issue may potentially be taxable upfront, it is often the case that the actual proceeds from the token raise will be used to fund development and marketing costs over a period which can stretch to a number of years. Most jurisdictions have limitations on a taxpayer's ability to 'carry back' and deduct subsequent expenditure against prior year revenue and Singapore is no exception. Section 37E of the ITA provides that current year unutilised capital allowances and losses can only be carried back for one Year of Assessment ('YA') to be deducted against the assessable income for the immediate preceding YA.

There are limited examples in case law on the ability of a taxpayer to defer the point of derivation of income for the provision of goods and services where payment was made upfront. The general rule is that income is earned when the taxpayer becomes entitled to receive income. The taxpayer must have done all that was required to be done to earn the income. *The Australian High Court decision in Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 is one of a limited number of cases where the point of derivation of income was held to match the time at which pre-paid services were performed. In this case, fees paid upfront for dance lessons were taken to be derived by the dance school as the lessons were provided to students. Notwithstanding that there was no contractual right to a refund from the dance school, the Court found that there was a sufficient contingency that the fees would have to be paid back should the lessons not be provided in due course. Arthur Murray was distinguished in the *Singapore High Court case of ABD Pte Ltd v Comptroller of Income Tax* [2010] SGHC 107 ('ABD') where the Court held that entrance fees to a club were derived when they were levied on the member and not equally over the period of the club membership. This was on the basis that the club's obligation was merely to admit the payer of the entrance fees to membership. The club was therefore entitled to the entrance fees when it approved an application for membership.

Whether a deferral argument is tenable will likely depend on the terms and conditions of the specific ICO in question and the rights attached to the tokens being issued. In a typical ICO, the terms and conditions make it clear that the purchase of tokens is non-refundable. The issuing entity also makes no guarantee for the completion and deployment of the blockchain platform or distributed application. In these circumstances, and in light of the decision in *ABD*, the issuing entity would likely be considered to be entitled to the proceeds from the ICO at the point of receipt.

It is possible that using a Simple Agreement for Future Tokens (' SAFT') arrangement may change this conclusion. This model is popular for issuers based in or distributing to the US. It is characterised as a pre-funded forward contract for the acquisition of a native token which is issued once a new blockchain project goes live. The whitepaper prepared as part of the SAFT project (refer to: saftproject.com/) suggests that at least for US tax purposes the taxing point is the time at which the tokens are issued and not when the SAFT is entered into. There are no specific rules within the ITA which assist in analysing the SAFT either directly or by analogy. The accounting treatment of a transaction is highly relevant – if the SAFT structure results in a deferral of the time at which accounting income is recognised then it may be effective in causing a deferral. This deferral is however likely to be effective until such time as the blockchain project is released and native tokens are issued.

Singapore tax on disposal of tokens

Besides the initial taxability of the proceeds from the ICO, an issuing entity may also be subject to income tax on subsequent realisation gains. This may include the sale of Ethereum and other cryptocurrencies contributed as part of an ICO, together with the portion of the pre-mine which is retained in treasury by the issuing entity.

Singapore does not impose tax on capital gains. The question is therefore whether any sale proceeds realised in this manner are income in nature. The Courts in Singapore apply the 'badges of trade' to assist in making the distinction between income and capital. This indicia includes such factors as the taxpayer's intention at the time of acquiring the asset in question and whether the taxpayer entered into a series of transactions or simply a one-off transaction. Looking at these two factors alone, there is a considerable risk that any gains arising will have the character of income. As the Ethereum contributed as part of an ICO is acquired for the specific purpose of disposal to fund the project of the token-issuing entity, the better view is likely that these assets are held on revenue account.

Where the realisation gains made on the disposal of Ethereum and other contributed cryptocurrencies are taken to be income in nature, the next question is whether this is Singapore or foreign-sourced. This is a difficult question which is a matter of fact and degree. It is difficult to ascribe a source to cryptocurrencies which are by their nature decentralised. The IRAS would therefore likely look at a combination of the disposal formalities such as the exchange on which the tokens or coins are sold and the location of the controlling minds behind the decision to sell. If the mind and management are located in Singapore, there is a strong risk that such gains would be Singapore-sourced income. The use of a Singapore company as a token-issuing vehicle means that it must have at least one resident director to comply with the requirements of the *Companies Act* (Cap. 50). It is very difficult to build a foreign-source argument in these circumstances for any realisation gains.

Goods and Services Tax ('GST') implications of token issuance

Under Section 10(2)(b) of the *Goods and Services Tax Act* (Cap. 117A) ('GSTA'), anything which is not a supply of goods but is done for consideration *(including the granting, assignment or surrender of any right)* is taken to be a supply of services. Utility tokens are not equity or debt securities or other financial instruments at law. The issuance of these tokens to participants in an ICO therefore cannot be an exempt financial supply for GST purposes.

The characterisation of the issuance or sale of cryptocurrencies as a taxable supply of services is specifically confirmed by the IRAS on their website. Where one cryptocurrency is exchanged for another, this is treated as being a barter trade. This means that both parties are taken to have made a taxable supply if they are GST-registered or are required to be GST-registered.

The charge to GST is very much dependent on the nexus of both parties to a cryptocurrency transaction with Singapore. The supplies made by a foreign-incorporated token-issuing entity will potentially be subject to GST in Singapore if the entity *'belongs'* in Singapore as this term is defined. This will likely be the conclusion if the token-issuing entity has either a business or fixed establishment in Singapore. These are two separate concepts. An entity will be deemed to have a business establishment in Singapore if it carries on business through an agent or a branch in Singapore. Under guidance published by the IRAS, an enterprise is treated as having a business establishment in Singapore if its *'main seat of economic activity'* is in Singapore. An entity would likely be considered to have its 'main seat of economic activity' in Singapore if the key officers of the entity are based in Singapore or meet and make decisions or carry on activities in Singapore. A fixed establishment on the other hand, is defined as an establishment that has both the human and technical resources necessary to provide the services in question on a permanent basis.

Where a token-issuing company is incorporated in Singapore, it will likely be taken to belong in Singapore. Where a foreign-issuing SPV is used, a careful analysis is required to determine whether it may have either a business or fixed establishment in Singapore. The risk of GST applying is likely limited to the supply of tokens to persons who themselves belong in Singapore. The supply of tokens to non-residents who do not have any nexus with Singapore may be a supply of international services which is zero-rated under Section 21(3) of the GSTA.

Taxation implications of promotor pre-mine

It is very common for a share of the *'pre-mine'* of tokens in an ICO to be allocated to the promoters of the ICO and other key personnel as part of their remuneration. An issuing entity will also need to consider if the transfer of pre-mine tokens to promoters and key personnel who are based in Singapore will be subject to GST. It is also necessary to consider the income tax implications which will likely be determined by the location where an employee or contractor is tax resident.

The IRAS guidance on the GST treatment for employee fringe benefits clarifies that an employer is not required to account for output tax on the provision of free services to its employees. The IRAS provides the example of a carpet cleaning company providing free carpet cleaning services to the homes of its employees. The fact that these services are free is of key importance. Under Section 10(2) of the GSTA the concept of a supply excludes anything that is done for no consideration. Where tokens are granted from a pre-mine allocation, arguably the provision of labour by a Singapore-based employee or contractor will be sufficient consideration. The receipt of tokens from a pre-mine allocation is a potentially attractive part of the terms under which an employee or contractor will assist with a blockchain project. The supply of these tokens is thus likely a taxable supply of services by a Singapore-based token issuer to employees and contractors who belong in Singapore for GST purposes.

The income tax analysis applying to the allocation of pre-mine to promoters is straightforward. Gains or profits from employment are taxable under Section 10(1)(b) of the ITA and this will pick up the market value of any tokens granted to an employee. Where a contractor receives a pre-mine allocation, it is likely that this will be taken to be proceeds from carrying on a trade or business which is taxable under Section 10(1)(a). The ITA contains deferral rules for employee share options and share awards, but these rules are not going to apply for a token issuance even where the token is treated as a regulated security token.

It is an open question whether a deferral in vesting is sufficient to push back the time of derivation of a pre-mine allocation for Singapore income tax purposes. There is an argument based on general principles that the income has not been derived until the tokens have vested. Selecting the most appropriate point of derivation is important as it will determine both the value of the tokens at the time that they are derived, and potentially which YA the income falls into. A similar analysis applies to option agreements over pre-mined tokens.

In considering the taxation of promoters, a potential crucial issue is the ownership of a foreign token-issuing entity. Where a promoter is resident in a jurisdiction which has a worldwide basis of taxation it is likely that there will be controlled foreign corporation ('CFC') rules to contend with. If a promotor is taken to own or control a token-issuing entity in another jurisdiction then there is a risk that the entire proceeds of the token raise may be taxable in their hands. This could be the result even though they may have no ability to access the proceeds of the token issue.

Conclusion

Blockchain players wishing to conduct ICOs out of Singapore will need to bear in mind several tax considerations. In addition to obtaining legal advice from a regulatory perspective, an issuer should also seek specialist advice to ensure that its token offering is efficient from a tax perspective. Because this is all so new, token issuers based in Singapore have yet to run through a compliance cycle and have their structures subject to the scrutiny of auditors and the IRAS. Structures which have not been carefully analysed in advance could lead to an unpleasant surprise.

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