THE VIRTUAL CURRENCY REGULATION REVIEW

Editors
Michael S Sackheim and Nathan A Howell

THE LAWREVIEWS

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This article was first published in November 2018
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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-912228-77-5

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their learned assistance throughout the preparation of this book:

ALLEN & GLEDHILL LLP

AMERELLER

ANDERSON MORI & TOMOTSUNE

ARTHUR COX

BECH-BRUUN

BRANDL & TALOS RECHTSANWÄLTE GMBH

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PREFACE

On 31 October 2008, Satoshi Nakamoto published a white paper describing what he referred to as a system for peer-to-peer payments, using a public decentralised ledger known as a blockchain and cryptography as a source of trust to verify transactions. That paper, released in the dark days of a growing global financial market crisis, laid the foundations for Bitcoin, which would become operational in early 2009. Satoshi has never been identified, but his white paper represented a watershed moment in the evolution of virtual currency. Bitcoin was an obscure asset in 2009, but it is far from obscure today, and there are now many other virtual currencies and related assets. In 2013, a new type of blockchain that came to be known as Ethereum was proposed. Ethereum's native virtual currency, Ether, went live in 2015 and opened up a new phase in the evolution of virtual currency. Ethereum provided a broader platform, or protocol, for the development of all sorts of other virtual currencies and related assets.

Whether Bitcoin, Ether or any other virtual currency will one day be widely and consistently in use remains uncertain. However, the virtual currency revolution has now come far enough and has endured a sufficient number of potentially fatal events that we are confident virtual currency in some form is here to stay. Virtual currencies and the blockchain and other distributed ledger technology on which they are based are real, and are being deployed right now in many markets and for many purposes. The technology has matured beyond hypothetical use cases and beta testing. These technologies are being put in place in the real world, and we as lawyers must now endeavour to understand what that means for our clients.

Virtual currencies are essentially borderless: they exist on global and interconnected computer systems. They are generally decentralised, meaning that the records relating to a virtual currency and transactions therein may be maintained in a number of separate jurisdictions simultaneously. The borderless nature of this technology was the core inspiration for *The Virtual Currency Regulation Review* (*Review*). As practitioners, we cannot afford to focus solely on our own regulatory silos. For example, a US banking lawyer advising clients on matters related to virtual currency must not only have a working understanding of US securities and commodities regulation; he or she must also have a broad view of the regulatory treatment of virtual currency in other major commercial jurisdictions.

Global regulators have taken a range of approaches to responding to virtual currencies. Some regulators have attempted to stamp out the use of virtual currencies out of a fear that virtual currencies such as Bitcoin allow capital to flow freely and without the usual checks that are designed to prevent money laundering and the illicit use of funds. Others have attempted to write specific laws and regulations tailored to virtual currencies. Still others – the United States included – have attempted to apply legacy regulatory structures to virtual

currencies. Those regulatory structures attempt what is essentially 'regulation by analogy'. For example, a virtual currency may be regulated in the same manner as money, or in the same manner as a security or commodity. The editors make one general observation at the outset: there is no consistency across jurisdictions in their approach to regulating virtual currencies. That is, there is currently no widely accepted global regulatory standard. That is what makes a publication such as *The Review* both so interesting and so challenging to assemble.

The lack of global standards has led to a great deal of regulatory arbitrage, as virtual currency innovators shop for jurisdictions with optimally calibrated regulatory structures that provide an acceptable amount of legal certainty. While some market participants are interested in finding the jurisdiction with the lightest touch (or no touch), most of our clients are not attempting to flee from regulation entirely. They appreciate that regulation is necessary to allow virtual currencies to achieve their potential, but they do need regulatory systems with an appropriate balance and a high degree of clarity. The technology underlying virtual currencies is complex enough without adding layers of regulatory complexity into the mix.

It is perhaps ironic that the sources of strength of virtual currencies – decentralisation and the lack of trusted intermediaries necessary to create a shared truth – are the same characteristics that the regulators themselves seem to be displaying. There is no central authority over virtual currencies, either within and across jurisdictions, and each regulator takes an approach that seems appropriate to that regulator based on its own narrow view of the markets and legacy regulations. We believe optimal regulatory structures will emerge and converge over time. Ultimately, the borderless nature of these markets allows market participants to 'vote with their feet', and they will gravitate toward jurisdictions that achieve the right regulatory balance. It is much easier to do this in a virtual business than it would be in a brick and mortar business. Computer servers are relatively easy to relocate. Factories and workers are less so.

The Review is intended to provide a practical, business-focused analysis of recent legal and regulatory changes and developments, and of their effects, and to look forward at expected trends in the area of virtual currencies on a country-by-country basis. It is not intended to be an exhaustive guide to the regulation of virtual currencies globally or in any of the included jurisdictions. Instead, for each jurisdiction, the authors have endeavoured to provide a sufficient overview for the reader to understand the current legal and regulatory environment.

Virtual currency is the broad term that is used in *The Review* to refer to Bitcoin, Ether, tethers and other stable coins, cryptocurrencies, altcoins, ERC20 tokens, digital, virtual and crypto assets, and other digital and virtual tokens and coins, including coins issued in initial coin offerings. The term is intended to provide rough justice to a complex and evolving area of law, and we recognise that in many instances the term virtual currency will not be appropriate. Other related terms, such as cryptocurrencies, digital currencies, digital assets, crypto assets and similar terms, are used throughout as needed. In the law, the words we use matter a great deal, so where necessary the authors of each chapter provide clarity around the terminology used in their jurisdiction, and the legal meaning given to that terminology.

We hope that you find *The Review* useful in your own practices and businesses, and we welcome your questions and feedback. We are still very much in the early days of the virtual currency revolution. No one can truthfully claim to know what the future holds for virtual currencies, but as it does not appear to be a passing fad, we have endeavoured to provide as

much useful information as practicable in *The Review* concerning the regulation of virtual currencies.

The editors would like to extend special thanks to Ivet Bell (New York) and Dan Applebaum (Chicago), both Sidley Austin LLP associates, without whom *The Review*, and particularly the US chapter, would not have come together.

Michael S Sackheim and Nathan A Howell
Sidley Austin LLP
New York and Chicago
October 2018

Chapter 15

ISRAEL

Adrian Daniels, Roy Keidar, Dafna Raz, Eran Lempert and Yuval Shalheveth[1]

I INTRODUCTION TO THE LEGAL AND REGULATORY FRAMEWORK

Earlier this year, the Israel Tax Authority (ITA) issued two circulars, one on the taxation of digital tokens and the second addressing the taxation of utility tokens in initial coin offerings (ICOs). Additionally, in March, the Israel Securities Authority (ISA) released a detailed interim report by the Committee for the Regulation of Public Offerings of Decentralized Cryptocurrency Coins (Report) (with a follow-up report due to come out around October 2018). Moreover, it is expected that before the end of 2018, legislation will come into force that for the first time will see Israeli primary legislation define virtual currencies as financial assets and mandate licensing for related services, as is later discussed in detail.

This chapter addresses the applicability of the existing legal framework in Israel to the use and trade of virtual currencies. It further reviews the significant efforts already made by the Israeli regulators to create new, or to adjust existing, legislation and regulations with regard to virtual currencies in an attempt to keep pace with the bustling global virtual currency market, and especially the booming Israeli one (an estimated US$500 million was raised in Israeli-linked ICOs alone in 2017).

II SECURITIES AND INVESTMENT LAWS

Section 1 of the Israeli Securities Law 1968 (Securities Law) defines securities as:

> *certificates issued in series by a company, a cooperative society or any other corporation conferring a right of membership or participation in them or claim against them, and certificates conferring a right to acquire securities, all of which whether registered or bearer securities, excluding securities issued by the Government or by the Bank of Israel which comply with one of the following:*
> *(1) They do not confer a right of participation or membership in a corporation and are not convertible into, or realisable for, securities conferring such a right;*
> *(2) They are issued under special legislation.*

This definition is broad, and when taken at face value would seemingly include almost all forms of tokens or coins without taking into account the underlying differences therein. However, case law has ruled that the intention of the legislator was clearly not to paint such a broad stoke. The Israeli Supreme Court has further backed this position by quoting

1 Adrian Daniels, Eran Lempert and Yuval Shalheveth are partners, Roy Keidar is special counsel and Dafna Raz is an advocate at Yigal Arnon & Co.

the landmark decision in *US, Howey v. Securities and Exchange Commission*.[2] However, it is important to note that in a 2015 case before the Supreme Court of Israel,[3] the Honourable Elyakim Rubenstein noted as *obiter dictum* that the Israeli definition of securities is inherently different from that in the United States, and stated that 'in any case, it is doubtful whether an analogy should be derived from American law to the Israeli one on this issue'.

The first time the Israeli legislator referred to virtual currencies was in 2016 when the Knesset passed into law the Financial Services Supervision (Regulated Financial Services) 2016 (Financial Services Law). Section 1 of the Financial Services Law provides a list of assets that are defined as financial assets. In this list, both securities and virtual currencies are listed as separate types of assets: therefore, a claim can be made that the implicit intention of the legislator is to exclude virtual currency from the definition of securities.

In its Report, the ISA identifies three subcategories of cryptocurrencies: currency tokens, which are intended to be used as a method of payment; security tokens, which confer a right of ownership, membership or participation; and utility tokens, which confer a right to access or use a service or product.

The determination of whether a token is a security is dependent upon the nature of the transaction. Generally, currency tokens would not be considered a security, as long as they do not confer any other rights, including a right to profits or participation from a company that is the offeror or issuer of the tokens (issuer).

According to the Report, as tokens are the results of a computer program and are often issued in a large quantity, they can easily be considered as issued in a series, and once such tokens are issued by an issuer stipulated in Section 1 of the Securities Law, such tokens meet the first two conditions of a security under the Securities Law.

Therefore, the determining factor in the classification of a token as a security is the rights it grants to those who hold it. According to the Report, the ISA currently views that a token is a *prima facie* security where it confers similar rights to those conferred by traditional securities, including the right to profits or income; a right to receive payments, whether by the distribution of additional tokens or cashing tokens into fiat currency; and ownership or participation rights in enterprises whose purpose is to yield financial profit. As illustrated below, a similar approach is taken by the ISA's international counterparts.

Although it may seem that tokens conferring a purely functional right are a security under the Securities Law, as they include a future claim against the issuer, the ISA reiterates that an investment in the acquisition of a product or service, whether future or current, may not be considered an investment in a security under the Securities Law, and that tokens purchased for consumer-related purposes will not necessarily be classified as securities. Moreover, the mere transferability of a token does not contribute to its qualification as a security.

The ISA further elaborates on the issue of hybrid tokens, which represent utility tokens purchased due to the potential increase in the tokens' value and in order to enjoy any profits it may yield. In such instances, the token's utility may not disqualify it as a security, and any classification will likely be based upon the individual circumstances in each ICO and the legislative purposes of the Securities Law.

2 *US Howey v. Securities and Exchange Commission*, 66 S. Ct 1100 (1947).

3 Appeal of Administrative Petition 7313/14 *Israel Scurity Authority v. Kvutzat Kedem Chizuk V'Chidush Mivnim Ltd*.

Nevertheless, the ISA proposes the following considerations when determining whether a utility token qualifies as a security token: the purpose for which the purchasers of the token acquired it; the level of the token's functionality during the offering, meaning to what degree can token purchasers use it for the purpose for which it was created; and representations and warranties made by the issuer, including a promise to yield profits and create or work towards creating a secondary market for the trade of such tokens.

Any change in the nature of a service or product the right to which is conferred in a token caused by a coin offering, meaning the transition from a product or service into an intangible and tradable property, should also be considered when making any such determination.

The Report also recommends applying more lenient regulatory frameworks to ICOs that are more accommodating for early-stage companies, some of which have already been approved under the existing laws and regulations in different contexts and which may be more suitable for ICOs. The Report made the following recommendations to facilitate the process of adjusting regulations and encourage regulated ICOs:

a creating a track of certain exemptions from registration requirements, similar to the United States Securities and Exchange Commissions' Regulation A+;

b applying Israeli crowdfunding regulations to ICOs, including a limitation of the offering amount to 6 million shekels a year, and exempting non-Israeli investors from the limitation on the amount each individual investor may invest;

c creating a regulatory sandbox for early stage FinTech companies;

d creating a dual listing arrangement similar to that in place under the Securities Law, which shall allow certain exemptions to companies that issue their tokens in other specific jurisdictions approved by the ISA, and allow ICOs in Israel to follow the respective foreign regulation requirements; and

e creating special reporting requirements that are more suitable to the specifics of ICOs, such as information about the development team, software protocol, cybersecurity measures, etc.

The Report was distributed for public comment and consideration, as further discussed in Section X. It should only be treated the initial position of the ISA, which would be consolidated in the near future.

III BANKING AND MONEY TRANSMISSION

The Israeli institutional banking sector, led by the Bank of Israel and similar to other banks around the world, has been more cautious in its approach towards virtual currencies. This has led to some difficulties, as can be seen in 2017 ruling of the Tel-Aviv District Court in *Bits of Gold Ltd v. Bank Leumi LeIsrael Ltd* (*Bits of Gold*). Bits of Gold Ltd (Bits of Gold), an Israeli cryptocurrency exchange platform, filed a motion in June 2015 against Bank Leumi LeIsrael Ltd (Bank) following the Bank's decision to block all activities in Bits of Gold's bank account linked to the trade of Bitcoin and other virtual currencies after almost two years of operations. The Bank based its decision on a joint press release by the Bank of Israel, the Capital Market, Insurance and Saving Authority in the Minsitry of Finance, the ITA, the ISA, and the Israel Money Laundering and Terror Financing Prohibition Authority regarding the potential risks inherent in virtual currencies.[4] The Bank argued that the regulators had

4 http://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/19-02-2014-BitCoin.aspx.

not given any guidance on how to mitigate such risks and ensure banks' compliance with the applicable laws, and therefore it was prudent to take a conservative approach by limiting all activities in Bits of Gold's account related to the trade of virtual currencies.

The Court ruled that the main question was whether banks are right in refusing to offer banking services to customers involved in the trade of virtual currencies. Before making its decision, the Court invited the Supervisor of the Banks to provide its position on the matter. The Supervisor informed the Court that it considered transactions related to the trade of virtual currencies as high-risk activities both for banks and banks' clients. However, the fact that these are high-risk transactions does not mean they should be prohibited altogether, rather that each bank should be allowed discretion in determining its policy and to ensure that the necessary risk management protections are in place.[5] The Court determined that under these circumstances, where the regulator has warned about the risks involved in connection with virtual currencies but failed to provide clear guidelines and rules for the Bank to follow, the Bank's decision was within the range of reasonable responses. Therefore, the motion was dismissed.[6]

It should be noted that *Bits of Gold* is currently pending an appeal before the Israeli Supreme Court. Moreover, since the *Bits of Gold* ruling, no further guidelines have been issued on how or whether institutional banks should permit transactions and activities in accounts that are related to virtual currencies, or transmittals of fiat in exchange for virtual currencies. It seems that banks would be happy to receive virtual currencies, but in the absence of regulatory guidelines, they need an approval stamp from the regulator to provide a legal shield before they do so. Progress may not involve the regulation of virtual currencies as currency, but rather as a financial asset, as previously expressed by the Bank of Israel Deputy Governor,[7] and normalising businesses related to virtual currencies by regulating and licensing them. Such processes, which are discussed below, are likely to make banks consider such businesses as being more mainstream and less risky, thus allowing banks to relax their policies in respect of the virtual currency sector.

IV ANTI-MONEY LAUNDERING

In October 2018, the provisions of the Financial Services Law are due to come into force, which will regulate businesses engaging in the custody, conversion, transmission and management of financial assets (whose definition includes virtual currencies). Supplemental regulations are also due to come into force, including the draft of the Prohibition on Money Laundering (The Providers of Financial Assets Services and Credit Providers Services' Requirements regarding Identification, Reporting, and Record-Keeping for the Prevention of Money Laundering and the Financing of Terrorism) Order, 2018 (Draft Order), which addresses the identification, reporting and documentation duties of regulated financial service providers, including virtual currencies service providers. The Draft Order, if approved in its current form, is expected to

5 Originated Motion (District Court, Tel Aviv) 1992-06-15 *Bits of Gold Ltd v. Bank Leumi LeIsrael Ltd*, paragraph 37.

6 Ibid., paragraph 39.

7 Remarks by Bank of Israel Deputy Governor Dr Nadine Baudot-Trajtenberg at the Knesset Finance Committee meeting on activity and use of virtual currencies. 8 January 2018: http://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/8-1-18-DeputyGove.aspx.

come into force before the end of 2018 and is likely to provide a comprehensive answer to the problem of identifying holders of virtual currencies, a major concern of law enforcement agencies.

The Draft Order proposes that each licensed virtual currency financial services provider must identify and document some unique identifiers that have not been collected or documented so far, in addition to standard information, namely, the addresses (public key) of the virtual wallets involved in transactions and the IP addresses used by clients. Additional special reporting will be required for crypto-specific transactions that the regulator identifies as suspicious, such as:

a the use of anonymous virtual currencies (such as Monero, Zcash, Zcoin and Verge);
b trade through 'mixer' platforms (which through a series of random actions, make the source of the transaction untraceable);
c use of anonymous IP addresses;
d transfers from dark market platforms; and
e use of IP addresses that are inconsistent with the relevant geographic region.

These regulations are unprecedented both in scope and technical detail. If enacted, Israel will have taken the regulation of virtual currencies a big step forward. Even if legislation is delayed, the Draft Order may provide a blueprint that other regulators are likely to adopt.

In the context of the more conservative institutional banking sector, in *Bits of Gold*, the Bank argued that since it had no guidelines to refer to and could not rely on Bits of Gold's voluntary actions to suffice in order to comply with the applicable laws and reduce the risks involved, they had to take the necessary measures related to Bits of Gold's business as an exchange for virtual currencies. The enactment of the Financial Services Law and, potentially, of the progressive Draft Order, may provide Bits of Gold and similar businesses with a path into the mainstream financial system. It is likely that, as virtual currency businesses become regulated, licensed service providers compliant with the legal requirements, particularly with respect to advanced know your customer (KYC) procedures, they are more likely to be recognised as legitimate businesses by the Israeli banks as well.

V REGULATION OF EXCHANGES

Section 45(a) of the Securities Law states that 'no person may open or manage a securities trading system except under a license given to him according to this Section (in this law – 'Stock Exchange License')'.

Section 44EE of the Securities Law defines a securities trading system as 'a multilateral system with which trading in securities is conducted, by bringing together buy orders and sell orders of securities and facilitating transactions between buyers and sellers of securities, acting without discretion, according to pre-determined rules'.

As noted above, the definition of securities under the Securities Law casts a wide net, and this may lead to most virtual currencies falling under the definition of securities. Should the definition of securities be applied to virtual currencies, then any trading exchange on which virtual coins are bought, sold or traded would in turn require a stock exchange licence under the Securities Law, and would be regulated as such. However, unrelated to virtual currencies, the ISA previously provided foreign stock exchanges with exemptions from receiving a stock exchange licence so long as the exchange meets the following criteria:

a trading in Israel is limited to qualified investors trading only for themselves (provided they are not individuals);

b exchanges cannot market to any investors who do not fall under category (a) after they have been identified as such, and they cannot engage in any public marketing activity, including advertising in the media;

c services offered to Israeli investors will not include securities traded on a stock exchange in Israel or derivatives of these securities, apart from the securities of dual Israeli corporations traded in Israel and abroad;

d an exchange's activity in Israel will constitute only a small portion of the overall activity of the exchange, and all of the financial instruments offered to investors in Israel are to be supervised by one of the bodies supervising the exchange. Additionally, the exchange cannot gear any activity towards Israeli investors; and

e all orders originating in Israel will be matched, cleared and settled on exchange systems outside Israel, while transactions between customers located in Israel will not be netted in Israel.

Additionally, in 2017 the Securities Law was amended to include Section 49A, which prohibits the offering of security trading services with respect to a security trading system unless such system is managed by an exchange licensed in Israel. We note that Section 49B allows for the Chair of the ISA to allow such an offering if the exchange is outside Israel and the Chair deems it in the best interest of public investors in Israel.

It should be noted that in January 2018, the ISA published a proposed amendment to the Tel Aviv Stock Exchange (TASE) Articles, according to which:

a a company whose main business is the investment, holding or mining of virtual currencies shall not be included in the TASE indices; and

b securities of a company whose main business is the investment, holding or mining of virtual currencies shall not be listed for trade on TASE, and securities of any company whose main business is the investment, holding or mining of virtual currencies shall be delisted from trade unless the company's equity exceeds 100 million shekels and audited or reviewed financial statements for a 36-month period have been prepared with respect to the company's activity.

Looking forward, we note that the Knesset is currently deliberating on a new bill that is intended to regulate the payment industry. Under the draft proposal of the law, a provider of payment services will be required to abide by certain regulatory restrictions. The current draft of the law does not define a provider of payment services; however, from the explanatory notes to the draft it seems likely that an exchange would fall under any definition and therefore would be subject to the provisions of the law.

VI REGULATION OF ISSUERS AND SPONSORS

As noted above, Israeli law does not provide specific guidelines for the classification of various virtual currencies, and therefore it is hard at this point to say what regulation applies to issuers as such. However, in a 2017 speech on the topic of ICOs, the then-Chair of the ISA, Professor Shmuel Hauser, stated that:

> *As for the ICOs, the story is different. Among others, we have to take into account the fact that ICOs have properties resembling stocks, and that the offering and selling of these currencies may look like traditional IPOs.*

With respect to sponsors, there is a growing industry in Israel of companies promoting and sponsoring ICOs. According to the Report, virtual currencies are not regulated under the Regulation of Investment Advice, Investment Marketing and Portfolio Management Law-1995 (Investment Advice Law) and its regulations, with the exception of derivatives of virtual currencies and structured products based on changes in exchange rates.

VII CRIMINAL AND CIVIL FRAUD AND ENFORCEMENT

To date, we have not seen any criminal or other enforcement proceedings in the context of issuance or trade of virtual currencies. However, in July 2018, following an audit conducted by the ITA in Bits of Gold's offices, in an attempt to monitor its most significant clients rather than the company itself, an unprecedented agreement was reached between Bits of Gold and the ITA, according to which Bits of Gold shall report to the ITA on any transactions executed on its exchange that exceed US$50,000. This agreement is expected to be the first in a series of actions taken by the ITA to enforce tax compliance, and potentially anti-money laundering (AML) compliance, by holders and dealers of virtual currencies.

VIII TAX

The ITA was probably the legislator quickest to respond to the new global and local cryptographic reality. While no apparent tax legislation, by way of amendments to the Income Tax Ordinance (Ordinance)[8] or the Value Added Tax Law (the VAT Law),[9] is currently anticipated, in 2018 the ITA published two relevant circulars:

a in January, a circular titled Taxation of Decentralised Payment Systems Activities (referred to as 'Virtual Currencies'), laying out the ITA's position regarding the tax consequences of the sale of decentralised currencies; and

b in March, a circular titled ICO – the Issuance of 'Digital tokens' for the Provision of Services and/or Products under Development (utility tokens) (7/2018 Circular), contemplating the tax consequences of ICOs and their consequent sale in accordance with the Ordinance and the VAT Laws.

The ITA categorises virtual currencies into three types of virtual currencies, accepting the division that is becoming increasingly acceptable among regulators worldwide: decentralised currencies, utility tokens and security tokens. It should be noted that the ITA has yet to publish its position regarding security tokens.

i Tax aspects of virtual currencies

Income tax

Virtual currencies (both decentralised currencies and utility tokens) do not qualify as currency under Israeli tax law, but rather constitute assets under the Ordinance. Therefore, the sale of a virtual currency is taxable by law. For as long as the virtual currency constitutes a capital asset for its holder (and not a business), then income derived from such sale is taxable at a capital gains tax rate. If, however, the seller's virtual currency activity amounts to a business (in

8 Income Tax Ordinance – 1961.

9 Value Added Tax Law – 1975.

accordance with the tests set by Israeli courts for classifying sources of income), then income derived from such sale shall be taxable as income derived from a business, meaning a marginal tax rate for an individual and a corporate tax rate for companies. It should be noted that income derived from mining activities shall be classified as income derived from a business.

Transactions that include the sale of a virtual currency in exchange for a different virtual currency shall be treated as barter transactions and taxed according to the value of the exchanged assets at the date of the transactions.

Value added tax (VAT)

For the purposes of value added tax (VAT), a decentralised currency does not qualify as currency, but as a financial asset, following a similar rationale to that of the Financial Services Law in this context. Utility tokens however, qualify as negotiable instruments under the VAT Law.

The ITA is of the opinion that the sale of a virtual currency that does not amount to a business activity shall not be liable for VAT. If, however, a seller's virtual currency activity amounts to a business activity (in accordance with the tests set by Israeli courts for such classification), then for the purposes of the VAT Law, such seller shall qualify as a financial institution, and shall be liable to pay profit tax and wage tax at a rate of 17 per cent, all in accordance with the VAT Law. Additionally, any person whose business is mining and selling decentralised currencies shall be classified as a dealer under the VAT Law, shall be liable to pay VAT for the entire consideration received for the sale of the currency and shall be entitled to deduct input tax accordingly.

Payment by a virtual currency constitutes consideration in kind. Therefore, the price of a transaction by a dealer whose consideration is to paid in a virtual currency shall be determined according to the market value or, if such value cannot be determined, then cost plus customary profit.

ii Tax aspects of utility tokens

Issuers of utility tokens

A company shall qualify as an issuer of utility tokens only when it has an obligation to provide a future product or service in exchange for a utility token. It should be noted that the development of a trading platform that provides users with a certain unique added value shall be considered as a future obligation of the issuer, but a feature allowing for anonymous trading will not be considered as such added value.

According to the 7/2018 Circular, consideration received in exchange for issuance of utility tokens shall qualify as income in advance or deferred income; therefore, on the day of issuance, the issuer will not have any taxable income. The deferred income shall become taxable in instalments, together with the provision of services, products, or both. The value of other decentralised currencies received in consideration for the issuance shall be the average trade value on the day of issuance, which shall be the average between the average trade rate of two or more leading trading platforms (such as Bitcoinaverage.com, CoinMarketApp, Bloxtax).

However, upon the occurrence of either of the following – consideration received was intended for the development of a service or product (or both), and such development failed; or the issuer is undergoing, for example, liquidation or bankruptcy – and the issuer has transferred to another entity its obligations towards the utility token holders, or has sold its

activity without the transfer of monies received in consideration for the issuance, including receipt of other decentralised currencies, then any remaining income that is advance or deferred income shall become immediately taxable.

An issuer who has reserved utility tokens issued in connection with an ICO for later issuance shall be liable to pay tax for the entire consideration amount received in exchange for the tokens on the date of sale of such utility tokens. The cost of issuance to the issuer shall be zero. Such consideration shall qualify as income derived from a business.

An issuer providing a platform that enables certain transactions and whose commission is payable in a virtual currency shall be liable to pay tax for such commission on the date of the transaction. The income amount shall be determined based on the values of the utility tokens actually received at such time.

A company may resolve, for different reasons, that the entity actually issuing the tokens and executing an ICO shall be a wholly owned subsidiary registered outside of Israel. In such cases, if the subsidiary transfers all obligations and consideration in connection with the issuance of the tokens to the Israeli entity after the issuance (back-to-back), then it shall be considered as the issuer, and the principles set forth in the 7/2018 Circular shall apply following the transfer of the consideration from the subsidiary to the Israeli issuer.

Issuing utility tokens to employees

When issuing utility tokens to employees, the employees' income from the issuance of such utility tokens shall become due upon the earlier of either the date the right conferred by the token is exercised or the date of the sale of such token by the employee. However, the issuer may elect for the tax event to occur on the date of issuance, in which case the issuer must provide a notice to the ITA with respect to its election 60 days prior to the date of issuance. Regardless of whether the tax event occurs on the date of issuance or exercise, the issuer shall credit such employees with the value of the utility tokens on the day of issuance minus any amount paid for the issuance by the employee, if any, as income received from labour. The issuer can deduct the expense in an amount equal to the value of the utility tokens.

Issuers of utility tokens: VAT aspects

For VAT purposes, a transaction could qualify as an asset sale or as a provision of services transaction.

Generally, if the issuance of utility tokens confers a right to a future service, VAT shall become due on the date consideration for the issuance of the tokens is received.[10] However, if the issuer meets certain requirements, including exceeding a certain turnover threshold, or where the payment of the consideration is made in a decentralised currency and not in cash, then the issuer's VAT shall become due on the date of the provision of said future services. If an issuance of utility tokens confers a right relating to the sale of future assets, VAT shall become due upon the delivery of the asset. However, if the issuer meets certain requirements, including not exceeding a certain turnover threshold, VAT shall become due upon the receipt of the consideration for the issuance of tokens.

When VAT is payable on a cash basis, the identity of the purchaser of the tokens might change between the date of issuance and the date on which the right conferred on the token

10 Section 24 of the VAT Law.

is exercised, such that the rate of VAT due might change. In such instances, on the date of the consummation of the transaction, the original invoice should be cancelled and a new invoice, reflecting the VAT rate applicable to the holder of the token at such time, should be issued.

***Encouragement of Capital Investments Law*[11] aspects**

An issuer of utility tokens should examine whether it qualifies for the benefits relating to tax due dates as set forth in the Encouragement of Capital Investments Law (Investment Law).

There remains some ambiguity in terms of Israeli tax law in connection with security tokens, and potential additional types of tokens, such as hybrid tokens (e.g., security tokens that may also be a means of payment as a decentralised currency).

However, as set forth above, the Israeli tax regulator has provided a significant amount of clarity in terms of taxation of virtual currencies in circulars, and it is expected to continue to pursue this path to keep up with future developments in the rapidly changing world of virtual currencies.

IX OTHER ISSUES

i Market makers

Israeli companies and ventures wishing to pursue an ICO and offer their tokens mainly to investors outside of Israel tend to engage with entities providing consulting and marketing services. These entities, referred to as market makers, play a key role that is similar, to some extent, to that of underwriters in the institutional capital market, but without regulation of their practices and liabilities. Market makers have become some of the most dominant players in the virtual currency markets, second only to trading platforms. Their dominance can be attributed to their ability to connect globally ventures looking to raise funds in an ICO and investors; their expertise in a market with very few real experts; and their borderless operations, which allow flexibility in avoiding the many geographical and legal obstacles Israeli ventures face.

The first issue with market makers relates to the model of compensation. Market makers are often compensated by issuers for services they provide in connection with an ICO by the issuance of tokens, thus making them significant token holders. As these market makers often wish to quickly 'cash the cheque', they are likely to turn to the secondary market and sell their tokens soon after an ICO. Such sale would likely result in serious fluctuations in the value of the tokens and affect other token holders. Although the terms of engagement of a market maker often include a no-sale term, it seems that regulation of market makers should address this issue while maintaining the balance between conflicting parties.

The second issue is related to the market makers' work with crypto syndicates. Such syndicates are often formed around a financial interest to invest in tokens in order to later sell them in the secondary market. Like market makers, it is irrelevant to such syndicates whether these tokens are utility or security tokens, as they serve as investment vehicles. Market makers are essential, as companies rely on them to reach those syndicates and sell significant amounts of tokens to international investors. This, unsurprisingly, comes at a cost as well. First, as the syndicates have a stronger negotiating power, and the companies are not involved in the negotiation between the market makers and the syndicates, companies

11 Encouragement of Capital Investments Law 1959.

have very little influence on the sale price of the token, which may be lower than planned. Additionally, for compliance purposes, each such group typically has a lead investor who is an accredited investor or is based in a jurisdiction that allows such investment, and only that lead investor goes through a KYC procedure while the rest of the investors in the group remain anonymous. This may create exposure for issuers both from an AML perspective and securities law, as their tokens may be indirectly sold to persons in jurisdictions where such sale is forbidden under applicable law or that may purchase the tokens for illegal purposes.

Another issue related to the dependency of companies in the process of an ICO on such market makers is, again, a result of the essential role that market makers have in ICOs and the fact that their interests conflict with those of the issuer. The common practice that has evolved around ICOs is that companies wishing to sell their tokens publish a white paper that sets out representations that are relevant to the sale of tokens. These are contractually binding, and if they are later found to be inaccurate or misleading, the issuer may be liable towards the purchasers of the tokens. However, as discussed above, market makers, like underwriters, are often involved in the drafting of white papers and are the ones marketing the sale of tokens to investors. Unlike underwriters, there are currently no criteria set by law that market makers are required to meet: they are not registered or licensed, and moreover they carry no liability by law towards either issuers or investors. Furthermore, market makers gain increased profits by increasing sales, so they clearly have an interest in selling as much as they can. In addition, unlike issuers, if market makers make any inaccurate or misleading representations, they will not be held accountable later on: the issuer will. Therefore, if companies fail to negotiate limitations on the representations made by market makers on behalf of an issuer, they may be subject to significant exposure. It should be noted that while market makers are essential to the continued growth and development of ICOs as a legitimate mechanism for fundraising, their practices should be subject to the attention of the regulators in order to ensure a balance between their interests and those of the stakeholders – companies and investors alike – that they engage with.

X LOOKING AHEAD

As previously discussed, while not all aspects of the use and trade of virtual currencies are currently addressed by the Israeli financial regulators, a fair share is. A significant amount of ambiguity exists with respect to the applicability of existing laws to the use of virtual currencies and their trade. Nevertheless, the Israeli regulators have proven to be alert to technological developments and their implications to the current financial system, and are setting avant garde regulation and standards to others at best, or catch up with other regulators at worst.

In addition to the suggestions and predictions we have outlined throughout this chapter, below are some suggestions that have been made by professionals involved in the ISA consultation process around the Report, some of which are anticipated to be part of future Israeli regulation.

i Criteria for utility tokens

The test under which purchasers decide to acquire tokens should not be a subjective test; rather, it should be an examination of the overall circumstances of the sale of such tokens, and whether the issuer has actively tried to prevent a representation that the tokens are a valid means of investment.

The level of a token's functionality during an offering should be assessed to establish whether it is expected to reach functionality within a reasonable period of time following the issuance (this concept is already recognised in the 7/2018 Circular.

A utility token must represent a right to a service or product provided by the project, but not necessarily by the same entity that issued the token.

Additionally, the ISA should publish a set of cases regarding the use of different tokens, including how they were analysed by the ISA and why were they categorised as utility tokens, security tokens or other tokens.

ii ICOs as a form of crowdfunding

The following adjustments to the crowdfunding regulations with respect to ICOs should be made:

a the limitation on the total amount that the issuer may raise within a 12-month period should be removed;

b the limitation on the amount that may be invested each time by an individual purchaser should be raised to 20,000 shekels, and the total amount an individual purchaser may invest in a 12-month period should be raised to 40,000 shekels; and

c regulations shall apply only to residents of Israel, and a statement by an offeree with respect to its place of residence shall suffice, with no further action being needed on the part of the issuer.

iii Licensing of trading and clearing platforms

Carrying out activities such as the sale or purchase of virtual currencies that do not include an element of option, a future sale or purchase or derivatives (spot transactions) should not lead to being considered a trading platform, and such activities would be subject to the Financial Services Law and not the Securities Law. A platform that enables transactions between users without any clearing of monies or virtual currencies should not be considered an exchange or a clearing house, and should not be required to be licensed as such.

iv Applicability of the Investment Advice Law

Virtual currencies are not regulated under the Investment Advice Law. Regulators should address this issue, and allow for the licensing of advisers who can provide supervised services to the public with respect to virtual currencies, which shall be subject to a duty of care and fiduciary duties.

v Trading platforms in Israel

Israeli regulators should adopt a fast track to allow the licensing of trading platforms and enable them to operate in Israel. Such regulation should not be limited to utility tokens, but should allow for the trading of security tokens as well.

vi Regulation the holding of virtual currencies in trust

The Financial Services Law exempts certain service providers from licensing obligations; therefore, the holding of electronic wallets by such exempt service providers should be addressed by the regulators in order to allow such service providers, who are subject to AML obligations, to provide trust services for virtual currencies.

Appendix 1

ABOUT THE AUTHORS

ADRIAN DANIELS

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Adrian Daniels' practice involves a wide variety of corporate transactions, including mergers and acquisitions, public and private financings and complex finance transactions.

Adrian has extensive expertise in US securities laws, has represented issuers in public and follow-on offerings in the United States, and advises Israeli companies on ongoing SEC and NASDAQ matters.

Adrian also has extensive experience in day-to-day corporate matters, providing young companies with legal advice on a full range of routine and complex corporate and commercial issues.

Adrian co-heads the firm's cryptocurrency practice, and lectures and writes extensively on issues related to the field.

Adrian is also active in managing the firm's pro bono practice.

Adrian received his law degree from Leeds University in 1991 and an MA in Middle Eastern studies from London University in 1992. He is a Wolfson Scholar of Lincoln's Inn.

Adrian was admitted to the Bar of England and Wales in 1993 and to the Israel Bar in 1997.

ROY KEIDAR

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Roy Keidar specialises in international law, security, cyber and emerging technologies.

Roy served as the legal adviser in the Israeli National Security Council in the Prime Minister's office, handling various legal issues in the field of international law, national security, counterterrorism, terror financing and administrative law. Prior to that, Roy served as an officer in the International Law Department in the Israel Defence Forces.

Roy's practice involves legal counsel to clients in the field of blockchain, cryptocurrencies and legal aspects related to the issuance of cryptocurrencies, also known as initial coin offerings or token generating events.

Roy frequently contributes to various legal issues, including 3D printing, cyber, autonomous vehicles, artificial intelligence, blockchain, virtual and augmented reality, drones and the internet of things. He also teaches at the IDC Herzliya and regularly lectures in these domains.

He holds an LLB (1998) and an LLM (2001) from Hebrew University, Jerusalem; and a masters in public administration, Harvard University, Cambridge, Massachusetts (2008).

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Dafna represents Israeli and foreign clients in a wide range of complex transactions, including mergers and acquisitions, venture capital and private equity financing, corporate governance and general counselling to companies, including startups. Dafna counsels companies as part of the firm's blockchain and cryptocurrency practice.

Dafna graduated from the Hebrew University of Jerusalem in 2010 with a BA in international relations, adding an MA in international law and institutions from the international relations department of the Hebrew University of Jerusalem in 2012. She received her LLB from Tel Aviv University in 2014.

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Dr Eran Lempert is the co-head of the tax department at Yigal Arnon & Co, and specialises in taxation, international taxation and tax litigation. Eran has extensive experience in representing and advising multinationals and high-net-worth individuals on a wide range of domestic and cross-border tax matters, including the taxation of trusts and estates, merger and acquisition transactions and real estate investments.

YUVAL SHALHEVETH

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Yuval focuses on commercial, banking and real estate law, representing clients in a broad variety of matters including real estate, commercial, banking and financing transactions as well as in telecommunication and PFI projects and tenders.

Yuval represents banks on various matters. Among other things, Yuval consults on matters relating to ISDA agreements and derivatives; assists on regulatory matters; assisted banks with the implementation of Basel II and the review of the legal requirements thereof; represents an Israeli bank in proceedings with various Lehman Brothers companies; and represented the controlling shareholders of one of Israel's largest banks in the acquisition of said bank. Yuval represented Neema Technologies in its precedential collaboration and services agreement with the Marshall Islands government in order to issue one of the world's first legal cryptocurrency tenders, the SOV. This was the first time that a country issued a crypto coin.

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ISBN 978-1-912228-77-5