Money online

Personal tax

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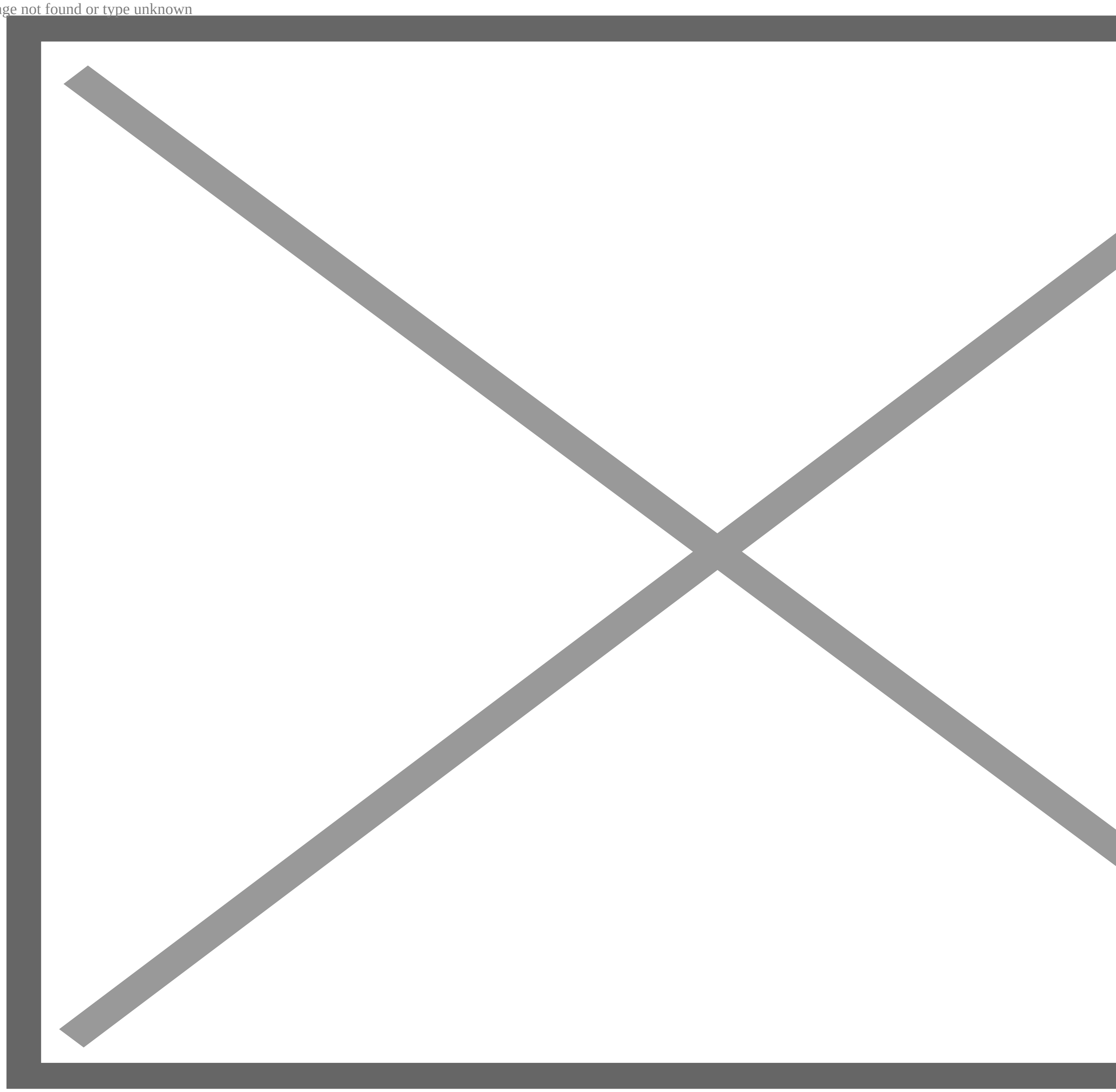

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Julie Butler and *Fred Butler* provide an overview of the taxes that can apply to cryptocurrencies

Key Points

What is the issue?

The increasing activity and value of cryptocurrencies must be embraced and understood by tax advisers from the outset, and compliance reports cannot just be simply ‘processed’ without proper attention to the detail.

What does it mean to me?

The reality is that if cryptocurrency is owned in a personal capacity, the owner must not try to avoid tax. It is essential to make sure that all transactions are disclosed to HMRC, and ‘over’ disclosure is better at this stage than ‘under’ disclosure, with assistance from HMRC being useful.

What can I take away?

Cryptocurrencies can no longer be ignored and will undoubtedly have an impact on all tax advisers and accountants, with questions relating to cryptocurrencies forming part of the standard tax return checklist. Now is the time to build a base of knowledge and improve general awareness, in order to be prepared for the new wave of taxpayers trying to navigate the unfamiliar tax system.

Cryptocurrencies are currently a ‘hot topic’. The increasing activity and value of cryptocurrencies must be embraced and understood by tax advisers from the outset, and compliance reports cannot just be simply ‘processed’ without proper attention to the detail. The entire motive, subject matter and circumstances of realisation have to be examined, with the basic principle of all tax problems being to understand exactly what the facts are.

What is cryptocurrency?

Historically, money has taken various forms; what was once recorded in physical ledgers is now entered electronically on a bank’s books. It could therefore be argued that most money nowadays is already digital.

Similarly, most, if not all, virtual currencies are digital. The European Central Bank (ECB) defines a virtual currency as ‘a digital representation of value, not issued by a central bank, credit intuition or e-money institution, which in some circumstances can be used as an alternative to money’. Essentially, they are a digital currency or asset that can be bought, sold or exchanged.

Cryptocurrencies use encryption technology (cryptography) in its creation in order to ensure the security of transactions but also prevent the creation of additional units. Once purchased, cryptocurrencies are held within a ‘wallet’ which holds the currency but also allows the owner to spend the currency as it contains the private and public keys for decryption.

Although there are a range of cryptocurrencies available with different features and different users, the first, and arguably most prominent, is Bitcoin. Satoshi Nakamoto, the mysterious creator of Bitcoin, first released it in 2009 as open-source software. Bitcoin operates via a peer-to-peer network, independent of any central authority or bank. As it is traded without intermediaries from one person to another, it theoretically makes the transaction much safer. All functions such as issue, transaction processing and verification are managed collectively by this network and recorded in a shared public database called a ‘blockchain’. This is maintained through a system of interactive nodes which contain bitcoin software, with a new Bitcoin being produced when a new block is attached to the chain. A new block can only be added to the chain when the answer to a complex cryptographic algorithm is solved, and participants carrying out this activity are known as ‘Miners’.

Most of the considerations in this article revolve around Bitcoin, given that it forms the focus of most of the tax authorities around the world. The value of Bitcoin has soared in the last 12 months, with a record-breaking rally coming after it split into two separate cryptocurrencies: the new Bitcoin Cash, along with the original Bitcoin.

We, as professionals, must look at all of the possible tax positions that could be related to cryptocurrency including; Corporation Tax (CT), Income Tax (IT), Capital Gains Tax (CGT), Value Added Tax (VAT) and the implications of Inheritance Tax (IHT).

Cryptocurrency trading

Within HM Revenue and Customs Brief 9 (2014): Bitcoin and other cryptocurrencies, it is stated that:

> ‘As with any other activity, whether the treatment of income received from and charges made in connection with, activities involving Bitcoin and other similar cryptocurrencies will be subject to CT, IT or CGT and depends on the activities and the parties involved.‘

To quote Brief 9:

> ‘For businesses which accept payment for goods or services in Bitcoin there is no change to when revenue is recognised or how taxable profits are calculated.
>
> - CT – the profits or losses on exchange movements between currencies are taxable. For the tax treatment of virtual currencies, the general rules on foreign exchange and loan relationships apply. We have not at this stage identified and need to consider bespoke rules. For companies, exchange movements are determined between the company’s functional currency (usually the currency in which the accounts are prepared) and the other currency in question. If there is an exchange rate between Bitcoin and the functional currency then this analysis applies. Therefore no special tax rules for Bitcoin transactions are required. The profits and losses of a company entering into transactions involving Bitcoin would be reflected in accounts and taxable under normal CT rules.
> - IT – the profits and losses of a non-incorporated business on Bitcoin transactions must be reflected in their accounts and will be taxable on normal IT rules.’

Essentially income is taxable when paid as virtual currency but there is no implication that Bitcoin mining should be charged to IT. Given that the normal foreign exchange rules apply for reporting transactions, BIM 39515 suggests that under FRS 102, for example, the business would first translate the foreign currency transactions (i.e. the sales) into, say, sterling using the spot exchange rate (or an average rate for the week or month, if the exchange rate does not fluctuate significantly), and then, at the end of the reporting period, to translate foreign currency monetary items at the exchange rate applicable at that time.

Capital Gains Tax (CGT)

To reference the HMRC brief, ‘if a profit or loss currency contract is not within trading profits or otherwise within the loan relationship rules, it would normally be taxable as a chargeable gain or allowance as a loss for CT and CGT purposes. Gains and losses incurred on bitcoin or other cryptocurrencies are chargeable or allowable for CGT if they accrue to an individual or, for CT on chargeable gains if they accrue to a company’.

With the surge in the value of various cryptocurrencies in the last few years, there has been a vast increase in the value held within virtual wallets. This has brought a new wave of perhaps unknowing people into the tax system. With the variety of cryptocurrency available, there are numerous trades within a virtual wallet without any cash receipts.

Subsequently, there have been capital gains realised within these virtual wallets, with the new wave of lay taxpayers being unaware of both their reporting requirements and tax liabilities that have arisen without any extraction of funds having taken place.

Furthermore, an issue may arise when the buying and selling of cryptocurrency, subject to capital gains tax, becomes a trade and thus is subject to income tax. As the hallmarks of the 'badges of trade' become more and more apparent, the unaware taxpayer could be walking further into a very unfamiliar world and soon be subject to income tax. Perhaps the unaware taxpayer could take steps now to mitigate this by incorporating their activities.

As alluded to above, if instead of making sales for Bitcoins in the course of a trade, the business disposed of an investment asset for Bitcoins, and the transactions were subject to CGT rather than income tax, it would be carrying out a barter transaction. The consideration for CGT purposes would therefore be the sterling equivalent of the Bitcoins at the date of disposal.

Notably, shares, foreign currency and Bitcoin alike are 'fungible'. This means the purchases can be pooled into a Section 104 holding and then each individual share or Bitcoin in the holding can be treated as if acquired at the same average cost.

CGT must be considered when the activities are conducted in a personal capacity, and the person involved does not regularly trade with a view to the realisation of profit. Even in a situation where gains are below the tax-free allowance, if you dispose of chargeable assets with an overall worth of more than four times the annual CGT allowance, this must still be declared on the tax return.

CG78310 provides guidance regarding investments as opposed to the trading of cryptocurrencies.

Corporation tax

In addition to the information set out above, the guidance given by HMRC is that a trading activity will continue to be assessed on the basis of preparing profit and loss accounts to determine taxable profits and the value of goods or services bought or sold using virtual currencies must still be accounted for at their market value or the exchange value of the virtual currency converted into UK pound sterling.

Brief 9 states activities include 'the buying and selling of Bitcoin and providing exchange facilities for parties to trade bitcoin with recognised currencies'. Bitcoin can be held as an investment or to pay for goods or services, and HMRC have noted that 'In the UK, there are already a number of outlets, including pubs, restaurants and internet retailers that accept payment by Bitcoin'.

With the reducing level of CT and the lack of clarity in respect of Bitcoin and other cryptocurrency coming from HMRC, it raises the question as to whether the cryptocurrency 'buyer and seller' should hedge their bets and put their activity in a company. The issue that then arises focuses on getting the inflated virtual wallet into the company.

Gambling

Gambling is ordinarily outside the scope of tax and so is ‘tax free’. Despite the high level of risk associated with Bitcoin activity, it is not deemed to be gambling. Gambling could be defined as an activity which does not involve buying or selling anything, rather it is just putting down a bet and hoping to make a gain from it. However, if something is bought and sold, no matter how ethereal, high-risk or speculative it may be, it is an asset and therefore cannot be classed as gambling. As such, Bitcoin activities are taxable, unlike gambling, as per the above guidance, the corollary of which, of course, is that the losses would be available for offset against other taxable profits.

Bitcoin Miners and VAT

Special users, known as ‘Miners’, gather together blocks of transactions and compete to verify them. In return for this service, a miner that successfully verifies a block of transactions receives both reward of newly created Bitcoins and any transaction fee(s) offered by the parties to the transaction(s) in question. There are thus several elements to consider when it comes to VAT.

Bitcoin received by miners for their mining activities generally falls outside the scope of VAT on the basis that the link between the services provided and consideration received is insufficiently direct.

As such, the activities do not amount to an economic activity for VAT purposes. Charges made by miners and others for performing specific Bitcoin transactions will also be exempt from VAT under Item 1, Sch 9, Gp 5 VATA.

However, in the case of Hedqvist, the Court of Justice of the European Union (CJEU) ruled that transactions that consist of the exchange of traditional currency for Bitcoin (and vice versa) constitute supplies of services for consideration for VAT purposes, even where the taxable person derives their profit from the spread (i.e. the difference between the purchase and selling price) rather than commission.

Case by case

Looking at all matters on a ‘case by case’ basis and taking into account specific facts and circumstances (per Brief 9) is the only way forward with regards to the taxation of cryptocurrencies. Professionals must identify the specific facts first and then establish the tax treatment, the disclosure requirements and the way forward for the unaware taxpayer.

Compliance

The reality is that if cryptocurrency is owned in a personal capacity, the owner must not try to avoid tax. It is essential to make sure that all transactions are disclosed to HMRC, and ‘over’ disclosure is better at this stage than ‘under’ disclosure, with assistance from HMRC being useful.

A lot has happened since 2014 and there is no doubt that more guidance will be presented to assist both taxpayers and tax advisers alike. Cryptocurrencies can no longer be ignored and will undoubtedly have an impact on all tax advisers and accountants, with questions relating to cryptocurrencies forming part of the standard tax return checklist.

Now is the time to build a base of knowledge and improve general awareness, in order to be prepared for the new wave of taxpayers trying to navigate the unfamiliar tax system.