New horizons

Management of taxes Personal tax

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Jon Claypole and *Ezra Dulberg* highlight the many challenges in store for the taxation of cryptocurrencies

Key Points

What is the issue?

It is believed that cryptocurrencies are being used as a means to evade taxes, partly due to their portability but also because they are largely untraceable

What does it mean to me?

There is a view that cryptocurrencies are anonymous, but this is not entirely correct. It is possible to trace a specific transaction but the problem HMRC may face is tracing who controls the (virtual) ‘wallets’ that are used to store cryptocurrencies

What can I take away?

It seems likely that HMRC will soon need to apply the best of its brains to analysing the risks and deciding upon a response – which is likely to involve a new tax code to address the issues raised by a digital society.

Cryptocurrency – the future of e-vasion?

If you don’t know what Bitcoins are, you can take comfort from the fact that you are not alone. In the UK, the fourth top ‘*what is...*’ Google search in 2017 was ‘*what is Bitcoin*’ – and it was also the second most searched topic in Google’s ‘news’ section. The UK population is becoming more interested in cryptocurrencies, and as tax advisers, it is important to understand how money, commodities and currencies are evolving today.

Government and Regulatory bodies, such as HMRC, are already responding and adapting to this trend. For example, when it asks taxpayers for a Statement of Worldwide Assets and Liabilities, the form now asks for disclosure of an individual’s Bitcoin ownership under the ‘Cash’ heading (although whether it even constitutes ‘cash’ may be a different question altogether, which we discuss below).

But if you have been following the news lately, you’ll be aware that the value of Bitcoin and other cryptocurrencies can be subject to dramatic changes in fairly short periods. For example, the value of Bitcoin ranged from $16,660 overnight to $13,482 all in the space of a day. In terms of a Statement of Worldwide Assets and Liabilities, unlike with cash, HMRC would be faced with a great deal of uncertainty as to precisely how much of an asset the taxpayer actually has both on the date of the statement and at the point in time the taxpayer may need to realise their Bitcoins to pay the tax liabilities due. This demonstrates one of the practical difficulties of incorporating cryptocurrencies into the current tax framework. As this article will discuss, the tax consequences of dealing with cryptocurrencies need to be considered and ambiguities clarified because it looks as if cryptocurrencies are here to stay.

The authors make no apologies for the lack of any solution in this article. Its intention is to highlight the issues they see and encourage HMRC and the Government to provide clarity as soon as possible.

Tax evasion?

As well as investors, it seems that tax authorities across the world are becoming very interested in cryptocurrencies – but why is that? It is believed that cryptocurrencies are being used as a means to evade taxes, partly due to their portability but also because they are largely untraceable. In January 2017 an international conference held by Interpol, Europol and the Basel Institute on Governance was dedicated to the issue of digital currencies being used for money laundering and tax evasion purposes. They concluded that the two main issues faced by tax authorities were:

a) Individuals involved in cryptocurrency transactions benefit from a degree of anonymity, making it hard to trace who earned what; and
b) There is a lack of understanding by judges, regulators, inspectors and authorities generally, on this expansive topic.

It was agreed at the conference that more information sharing, training and regulation should be introduced internationally. At the same time, clarity and legislation would be welcomed for those compliant taxpayers who are simply following the trend of cryptocurrency trading. Over a year later, there is no evidence of the outputs of that conference and uncertainty continues.

Hiding behind a screen

There is a view that cryptocurrencies are anonymous, but this is not entirely correct. It is possible to trace a specific transaction but the problem HMRC may face is tracing who controls the (virtual) ‘wallets’ that are used to store cryptocurrencies. A ‘wallet’ is a software program which cryptocurrency users must possess allowing them to send and receive cryptocurrencies.

Given the ‘virtual’ nature of a cryptocurrency, HMRC obviously faces an uphill battle tracing and monitoring a taxpayer’s cryptocurrency activity, made harder by the availability of technology which makes it even more difficult to trace the individuals involved by obscuring the trail of the transactions back to the original source.

That said, HMRC is able to gain information from a taxpayer's UK bank account – and the aim of the Common Reporting Standard is to ensure that other jurisdictions obtain similar information from their financial institutions and exchange that information with other jurisdictions on an annual basis. No such arrangements exist (as yet) for cryptocurrencies but tax evaders may experience difficulties when they come to exchanging their Bitcoins for a 'real' rather than a 'virtual' currency as their cryptocurrency will acquire a degree of traceability at the point where they are converted into a fiat currency (e.g. GBP) and transferred into a bank account. Of course the UK tax system of Self Assessment requires disclosure of all income and gains and the vast majority of the public are compliant with their obligations. The current position with cryptocurrencies transactions however makes it extremely difficult for HMRC to identify transactions of those investors unwilling to participate in the tax system. This of course is not a unique problem for HMRC as most if not all tax authorities and Governments could face the same challenges.

What are cryptocurrencies?

There is no international consensus on what cryptocurrencies actually are and the variations range from currency to a commodity – and everything in between! For example, Bitcoin is not considered a currency in Finland or Sweden, and nor is it considered legal tender in Malaysia or Indonesia. Indeed, the recent decision in the UK by Lloyds Banking Group to prevent its customers from buying Bitcoin and other cryptocurrencies on their credit cards might raise doubts as to whether Bitcoin will continue to be recognised as a currency in the UK!

Of course there is no requirement for HMRC to take the same stance as the tax authorities of other countries. But it is possible that HMRC may consider these analyses to alter its own definition as its understanding and objectives alter with time. In its own guidance published in 2014, HMRC states that 'Given the evolutionary nature of these cryptocurrencies, HMRC will issue further guidance as appropriate.' This is an indication that HMRC is considering its options!

The limited understanding and consensus on the characteristics and nature of cryptocurrencies also makes taxing such transactions harder and more complex. In its 'Brief 9 (2014): Bitcoin and other cryptocurrencies', HMRC stated that for Corporation Tax purposes 'For the tax treatment of virtual currencies, the general rules on foreign exchange and loan relationships apply.' The authors note Julie Butler and Fred Butler's article published in *Tax Adviser* in February 2018 which discusses this guidance and HMRC’s position on the different taxes involved in cryptocurrency trading and support the views put forward.

But what if cryptocurrencies are not actually currencies? Will different tax rules apply? There is much debate on whether it could be considered a currency, and therefore subject to foreign exchange tax rules, or a commodity. Andrew Bailey, Chief Executive of the Financial Conduct Authority for example, describes Bitcoin as a commodity rather than a currency, and potentially even a form of gambling.

In an article in the *Bank of England Quarterly Bulletin*, Vol. 54, No. 1 (McLeay, Radia, and Thomas (2014), ‘Money creation in the modern economy’), money is described as a series of claims, or ‘IOUs’. When a bank holds an individual’s deposit of money for example, the deposit can be seen as a liability, or an ‘IOU’, for the bank and an asset for the deposit holder. The authors argue that as the nature of digital currencies means that there is no claim on anybody, cryptocurrencies share more characteristics with those of a commodity, or perhaps they even constitute a new form – a digital commodity. Perhaps in due course the taxing authorities will decide that the unique form of cryptocurrencies merits its own set of tax rules, rather than clinging on to existing concepts.

There needs to be clear consensus on what the characteristics of cryptocurrencies are. Until then, tax authorities, and Judges are likely to struggle to establish clear guidelines. Further clarity will also aid taxpayers when completing their Self Assessment tax returns in respect of Bitcoin transactions and reduce the risk of innocently completing tax returns incorrectly.

Are cryptocurrencies a gamble?

There is, of course, no certainty that investing in Bitcoins will make you money. But whether this level of speculation constitutes trading, investing or gambling from a tax perspective is a different matter. In recent months the dramatic rises in the value of Bitcoins have seen many taxpayers enjoy gains which one can see HMRC wanting to tax. However, the *Daily Telegraph* reported on 20 January 2018 that HMRC risks losing millions in revenue as taxpayers look to exploit the possibility that their cryptocurrency trading constitutes a form of gambling – so that gains realised on their disposal would not be chargeable to tax.

Although HMRC are unlikely to accept that cryptocurrency trading always constitutes gambling, it does state in its 2014 guidance that each case will need be looked at on a ‘case-by-case basis taking into account the specific facts.’ It continues by adding that ‘depending on the facts, a transaction may be so highly speculative that it is not taxable or any losses relievable’. This provides a further layer of uncertainty, and potentially a degree of optimism for cryptocurrency investors that any profits are not taxable – but one can be sure that one man’s ‘gambling win’ might yet be another man’s capital gain – and, make enough profits and HMRC might even argue that it is profits from ‘a venture in the nature of a trade’. The counter of course is that if HMRC wants to tax all gains and profits, is it going to allow any losses? This of course is one of the factors why it does not tax gambling wins. The phrase ‘there is no such thing as a poor bookie’ is not without foundation and the Government is unlikely to be willing to allow all cryptocurrency losses just to secure its ability to tax the profits and gains.

Etienne Wong (E. Wong (2016), *Taxation of Virtual Currencies*, Lexis PSL), Tax Counsel, has argued that ‘earlier investors who did not have large portfolios of similar investments in the technology world were more likely to be able to successfully claim’ that they are ‘gamblers’. Clearly given the volatility of the market – and the Lloyds Banking Group attitude – it is plausible to envisage that there may be cryptocurrencies in which the markets are so random and volatile that profits might indeed constitute gambling.

All in all, the difficulties in determining the tax treatment might prove near insurmountable for HMRC without some defining legislation. Although the one we hear most about is Bitcoins, in reality there are hundreds of different cryptocurrencies in circulation with more being created each month. HMRC are likely to encounter a resourcing issue if it is to fully risk assess and consider the merits of each claim made by a taxpayer on a case-by-case basis. In effect, if HMRC are to look at each transaction on a ‘case by case’ basis, to determine whether the taxpayer’s investments in Bitcoin constitute trading – liable to income tax or Corporation Tax – or investments – liable to Capital Gains Tax – or gambling – neither chargeable nor deductible – may require staffing resources beyond HMRC’s wildest dreams or pockets to fund this. This resource challenge is not new for HMRC hence why Self Assessment and the discovery provisions are generally successful but the issue of cryptocurrency adds another layer of pressure to its resources. Ultimately it seems likely that at some point HMRC is going to have to make a decision regarding the nature and tax treatment of Bitcoin, and the Government legislate accordingly.

Conclusion: is new legislation required?

So what does the future of tax legislation and/or clearer guidance from HMRC as to its interpretation for cryptocurrencies hold? To the authors, doing nothing is not an option for the Government and HMRC.

Tax legislation historically has adapted itself to changes in technology. It was not that long ago that the (then Schedule E) expenses legislation referred to the costs of the maintenance of a horse – for those postmen who were required by the terms of their employment to keep a horse to deliver mail to their more remote customers! Benefit-in-kind rules were updated when mobile phones were introduced and HMRC continuously explores options to make tax ‘digital’. The questions then remains on whether current legislation is sufficient to encompass cryptocurrencies or whether amendments are required given their unique features.

For example, HMRC’s guidance, ‘Money laundering supervision for high value dealers’, states that ‘A high value dealer under Money Laundering Regulations is any business or sole trader that accepts or makes high value cash payments of €10,000 or more (or equivalent in any currency) in exchange for goods.’ If cryptocurrencies do not constitute a ‘currency’, it is not certain that a dealer accepting money in cryptocurrencies would fall within this legislation so the temptation for HMRC might be to define them as a currency – but with what taxation consequences?

It is clear that the UK Parliament have recognised the ambiguities and are trying to introduce new legislation to tackle them. In a parliamentary written Q&A session, answered on 3 November 2017, it was said that following discussions at a EU-level, ‘The UK government is currently negotiating amendments to the 4th Anti- Money Laundering Directive that will bring virtual currency exchange platforms and custodian wallet providers into Anti-Money Laundering and Counter-Terrorist Financing regulation.’

Among the many other considerations, for example, you have the question of, if a chargeable gain is made, where that gain is situated – which impacts upon its treatment. The gain could be deemed to be located where the trader was physically located when realising that gain or it could be located wherever the blockchain is located. Alternatively, the gain could be situated wherever the ‘wallet’ is located or wherever the ‘cloud’ storing the transactional data is based. All of these questions take taxation into territory that has not even been considered before. At the risk of attempting to gaze into a crystal ball, one can easily imagine that legislation for cryptocurrencies might have to commence by defining a ‘wallet’ or defining an ‘IT Cloud’ and defining where those are situated before even beginning to consider how a cryptocurrency is defined and taxed.

Cryptocurrencies are unique in many ways. As their use becomes more widespread, the tax implications become more relevant and crucial. If push comes to shove, HMRC could try and use existing legislation and its current guidance to guide itself through this maze – but all the indications are that existing legislation will not prove fit for purpose. In the circumstances, it seems likely that HMRC will soon need to apply the best of its brains to analysing the risks and deciding upon a response – which is likely to involve a new tax code to address the issues raised by a digital society.

The authors apologise to HMRC for not having put any solutions forward to what they perceive as the urgent and important issues it needs to address. They do however wait with interest to see how it responds and adapts.