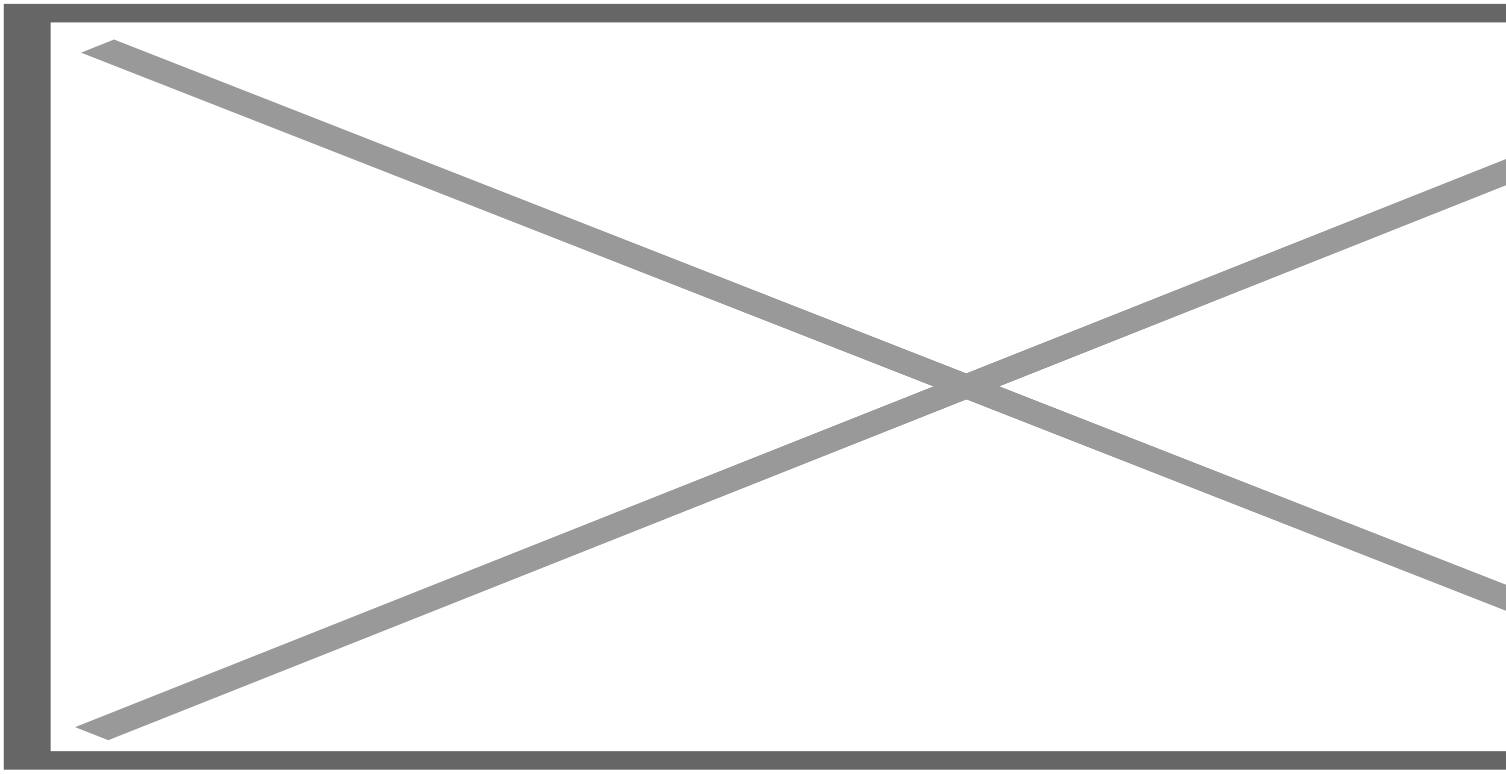
Shedding light on a murky world

Personal tax



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In a world where even investors lack a precise understanding of cryptocurrencies, *Jacquelyn Kimber* attempts to make sense of the taxation of cryptoassets

Key Points

What is the issue?

HMRC’s promised further guidance on the taxation of cryptoassets for businesses and companies, due in ‘early 2019’, has not yet been published.

What does it mean to me?

There may not be a universal definition of what cryptoassets are, but HMRC is clear about what they are not, and that is currency or money.

What can I take away?

HMRC’s position is that for individuals, cryptoassets will generally be an investment asset.

Bitcoin, the first and most well-known cryptoasset, is now just over 10 years old. For many, the world of cryptoassets, with its baffling lexicon and impenetrable acronyms, remains a murky one. Rather worryingly, according to an FCA report, a proper understanding of what precisely cryptocurrencies are appears to be lacking even amongst investors. Whether misunderstood or not, the rapid growth of cryptocurrencies cannot be overlooked, particularly with high profile launches such as Facebook's Libra.

HMRC first put forward their view on the taxation of cryptoassets in March 2014 when it published Brief 9 (2014): Bitcoin and other currencies. Then, just before Christmas 2018, they issued a policy paper on the taxation of individuals investing in cryptoassets. The paper states that it 'sets out HMRC's view – based on the law as it stands at the date of publication – about how individuals who have cryptoassets are taxed'. One would therefore expect taxpayers to be able to rely on the views expressed in the policy paper (subject to the usual tax avoidance caveat), although HMRC state that their views 'may evolve further, as the sector continues to develop'.

The principal focus of HMRC's 2018 policy paper is the holding of cryptoassets by individuals. At the time of writing, the promised further guidance on the taxation of cryptoassets for businesses and companies in 'early 2019' has not been published.

What are cryptoassets?

There is no single agreed definition of cryptoassets, but it is perhaps useful to set out the definition adopted by the Cryptoassets Taskforce (CATF), consisting jointly of the FCA, HM Treasury and the Bank of England:

> 'Cryptoassets are digital representations of value that can be transferred, stored or traded electronically which use some type of distributed ledger technology.'

Distribution ledger technology (DLT) is defined as:

> 'a type of technology that enables the sharing and updating of records in a distributed and decentralised way. The applications of DLT go beyond cryptoassets as the databases can store a range of data such as ownership of existing financial assets (e.g. shares), tangible assets (e.g. wine, houses, gold), or digital assets (e.g. Bitcoin).'

HMRC's policy paper echoes this description and sets out three different types of cryptoassets: exchange tokens, utility tokens and security tokens. Exchange tokens, such as Bitcoin, are the specific focus of the policy paper. HMRC note that a different tax treatment may need to be adopted for utility tokens (something that allows the holder access to particular goods or services) and security tokens (something that provides the holder with a particular interest in a business).

There may not be a universal definition of what cryptoassets are, but HMRC are clear what they are not, and that is currency or money. That is an interesting conclusion, given that history demonstrates the wide range of commodities which have been used as money, such as gold, shells and even feathers. The existence of currency does not require a central bank (think of peppercorns) or have to be legal tender (you can't buy a newspaper with a whisky bottle full of pennies). So if tokens of exchange were money in the past, why not cryptoasset exchange tokens now? The US Internal Revenue Service has also stated that cryptoassets are not money.

Leaving aside that theoretical point, how should cryptoassets be treated for tax purposes? HMRC's position is that for individuals, cryptoassets will generally be an investment asset.

Trading v investment

Whether or not a trade is being carried on is a question of fact. Six ‘badges of trade’ were originally identified by The Royal Commission on the Taxation of Profits and Income in 1955, and subsequent decisions of the courts have increased this to nine (see *Marson v Morton* [1986] STC 463).

In practice, there is unlikely to be a single deciding factor and a court would give the appropriate weighting to each test. In *Wisdom v Chamberlain* [1969] All ER 332, the taxpayer, comedian Norman Wisdom, bought and sold silver bullion as a hedge against an anticipated devaluation of sterling in two transactions. The Court of Appeal focused on the following factors:

- income producing (not);
- pride of possession (none);
- frequency of transactions (two);
- intention to make a profit (yes); and
- financing (borrowing).

It was held that Mr Wisdom’s two transactions were trading in nature. Looking at a typical cryptocurrency acquisition, the asset is similarly not income producing, carries no pride of possession, and purchasers are typically looking for a profit. There are, of course, other elements to the badges of trade which point the other way, but based on the *Wisdom* case in particular, cryptocurrency transactions have more than a mild flavour of trading.

So how does HMRC’s view match up to this? HMRC states: ‘In the vast majority of cases, individuals hold cryptoassets as a personal investment, usually for capital appreciation in its value or to make particular purchases.’

So did Mr Wisdom; but that did not seem to count for much in 1969. The document continues:

> ‘Only in exceptional circumstances would HMRC expect individuals to buy and sell cryptoassets with such frequency, level of organisation and sophistication that the activity amounts to a financial trade in itself.’

This may be true, but Mr Wisdom only undertook two transactions; nevertheless the judge held that these were ‘entered into on a short-term basis for the purpose of making a profit out of the purchase and sale of a commodity, and if that is not an adventure in the nature of trade I do not really know what is’. At best, we can therefore say that the position is a little less black and white than HMRC presents. And, of course, if profits are not taxable as trading income, losses are similarly not eligible for relief against other income of the current or previous tax year.

Income streams

An individual’s transactions in cryptoassets may not amount to a trade, but income tax cannot be ignored altogether. At the simplest end of the scale, investors may simply buy digital currency and use it in exchange for goods or services, or hold it in a digital wallet in the hope of selling it at a profit at some future date. At the other, ‘mining’ currencies such as Bitcoin by solving complex computational problems enabling blocks of transactions to be chained together earns rewards through transaction fees and newly created Bitcoins.

In HMRC’s view:

> ‘If the mining activity does not amount to a trade, the pound sterling value (at the time of receipt) of any cryptoassets awarded for successful mining will be taxable as income (miscellaneous income) with any appropriate expenses reducing the amount chargeable.
>
> ‘The Other taxable income 2018 (HS 325) self assessment helpsheet has more information about miscellaneous income.
>
> ‘If the individual keeps the awarded assets, they may have to pay capital gains tax when they later dispose of them.’

Assuming that HMRC’s position on the absence of a trade is correct, then it makes sense that the sweep up charge on other income applies in default (ITTOIA 2005 s 637). Transaction fee receipts will similarly be subject to tax as miscellaneous income.

Bitcoin and interest

As cryptocurrencies become increasingly mainstream, various platforms are emerging to enable investors to exploit their cryptocurrency assets in other ways, such as placing them on deposit accounts to earn additional Bitcoins, for example. HMRC’s policy paper is silent on how such ‘interest’ should be regarded for tax purposes. Interest is generally defined in monetary terms, being a sum due or payable for the use of money lent, but if cryptocurrencies are not money, that definition will not do.

The better view is that ‘interest’ earned in the form of additional Bitcoins should be regarded in a similar manner to returns for mining and charged to tax as miscellaneous income. Apart from the potential applications of savings rates and the savings allowance, the practical implications may be minimal.

Chargeable gains

Given HMRC’s view that cryptocurrencies represent an investment asset in the majority of cases, the principal tax consideration for investors will be the treatment of chargeable gains and losses. HMRC state that:

> ‘Cryptoassets are digital and therefore intangible, but count as a “chargeable asset” for capital gains tax if they’re both:
>
> - capable of being owned; and
> - have a value that can be realised.’

HMRC take the view (as do the IRS in the US) that the bundle of rights represented by cryptocurrencies are capable of ownership and therefore represent property. ‘Asset’ has a particular definition for capital gains tax purposes, and broadly means all forms of property including incorporeal property and currency other than sterling (TCGA 1992 s 21). Rights over property separate from the property itself (such as a lease) are assets, but rights which cannot be enforced in the UK, such as image rights, are not. Therein lies the potential difficulty with cryptocurrencies: what are the rights to which the holder is entitled and how could they be enforced? It would be a bold taxpayer who took the view that cryptocurrency is not an asset within TCGA 1992 s 21 and any gains are therefore not chargeable gains, but the argument is perhaps not entirely without merit.

Taking the HMRC view, a disposal or deemed disposal of cryptocurrency will crystallise a taxable capital gain or allowable capital loss in the usual way. Bitcoin and other digital currencies are a fungible asset, so the pooling rules of TCGA 1992 s 104(3)(2) apply, along with the ‘matching’ rules in ss 105 to 106A.

Situs

Situs is relevant to the determination of both capital gains tax and inheritance tax, primarily for those who are not domiciled in the UK, but could also be relevant for determining taxing rights under a double tax treaty. Whilst each has its own particular situs rules, there is a good deal of common ground and the differences in approach are outside the scope of this article.

Intangible assets such as shares have a situs, and only one situs (*R v Williams* [1942] AC 541). The difficulty is determining situs where there is no single determining factor which points to a stronger connection with one jurisdiction than another, as is the case with Bitcoin. The computer code behind Bitcoin and other digital currencies are stored on servers around the world; it is not possible to pinpoint a single situs from the multitude of possibilities. The most straightforward (but not necessarily correct) approach may be to treat cryptocurrencies as located in the jurisdiction where the holder is located. That approach has the benefit of simplicity, but has obvious drawbacks such as providing an opportunity for a remittance base user to choose where to make a disposal. Until further guidance is published by HMRC or (even more remotely) a case is heard before the tribunal, disclosure will be key.

Inheritance tax

If Bitcoin and other cryptocurrencies represent ‘property’ which is capable of being owned, it follows that it can also be gifted and inherited. Individuals who are domiciled (or deemed domiciled) in the UK are within the scope of inheritance tax in respect of all assets, irrespective of where they are located; however, this is not the case for non-domiciliaries, who are subject to UK inheritance tax only on UK situs assets. Again, determining situs will be crucial.

Conclusion

Although some of the conclusions reached in HMRC’s policy papers are open to question, their views are generally favourable to taxpayers and offer some certainty (assuming the policy paper can be relied on) on how transactions in cryptocurrencies will be treated for income and capital gains tax purposes. There remain some large gaps in HMRC’s current analysis, however, particularly in relation to situs, and despite an apparent reluctance to consider bespoke legislation covering cryptocurrency, this is one area where more specific rules will be required.