The crypto revolution

Management of taxes Personal tax

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Gary Ashford considers the various taxati on issues that may arise in the fast evolving world of cryptocurrency

Key Points

What is the issue?

Since the introduction of bitcoin in 2009, there has been a proliferati on of cryptocurrencies. Cryptoassets have grown by roughly 200% in 2021, from just under $800 billion to $2.3 trillion today.

What does it mean for me?

Over the last year or so, a lot of work has been done by the UK and various other governments to determine what is necessary to ‘regulate’ a highly unregulated, and mushrooming, economic ecosystem.

What can I take away?

HMRC has recently embarked on a new nudge campaign to advise some holders that it is aware of their crypto holdings, and that these may be taxable.

Many of those reading this article will have read about crypto and bitcoin, and may well have a strong opinion that this is a ‘fad’. However, I believe that crypto is definitely not a fad, but will in fact form a very important part of the future fabric of our financial universe – although it may look quite different to the unregulated world we see at the moment.

Since the introduction of bitcoin in 2009, there has been a proliferation of cryptocurrencies. At a recent count, there are over 8,000! Sir John Cunliffe, Deputy Governor for Financial Stability at the Bank of England, confirmed on 13 October 2021 that cryptoassets have grown by roughly 200% in 2021, from just under $800 billion to $2.3 trillion today. Five years ago, the market was just $16 billion.

As someone who is doing a lot of work around the digital economy, including crypto assets, this article is drafted to provide a slightly broader perspective on the crypto landscape, whilst also, of course, focusing on some of the various taxation issues which are arising.

Image

THE ORIGINS OF CRYPTOCURRENCY

Bitcoin was created by the elusive (or possibly non-existent) Satoshi Nakamoto, who in October 2008 issued a link to an online paper 'Bitcoin: A Peer to Peer Electronic Cash System'.

The main concept of Bitcoin when introduced was to create electronic money, and extinguish the risk of losing one's capital to financial institutions in distress. This was particularly relevant at the launch, given the backdrop of the Global Financial Crisis of 2007 and 2008.

Nakamoto released the Bitcoin code in January 2009. He did this 'open source', effectively giving the rights to use and distribute the code to anyone for any purpose.

Bitcoin was designed as a digital 'currency' and sits on a distributed ledger technology (DLT) blockchain. This effectively places it outside of the control of trusted third parties, such as banks, and relies on the 'proof of work' by peers in the network ('nodes'). Each time a transaction occurs, the nodes will essentially undertake a number of digital calculations. When complete, the transaction will be approved, by way of cancelling the previous 'blocks' and adding a new block (hence the name 'blockchain').

What is crypto?

Whilst the term 'currency' is often applied, most experts would confidently posit that none of the main currently recognised crypto amounts to a 'currency' or, indeed, digital money. Although it well predates crypto, one of the significant cases on this is Moss v Hancock [1899] 2 QB 111, which provides a definition of money as:

'[T]hat which passes freely from hand to hand throughout the community in final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it to consume it or to apply it to any other person other than in turn to tender it to others in discharge of debts or payment for commodities.'

Crypto assets, as we know them, still have some way to go to pass these tests, and so are not generally regarded as money. However, as many world central banks start to introduce their own digital currencies, I do think we will start to see some cryptos passing the tests of money.

Over the last year or so, a lot of work has been done by the UK and various other governments to determine this point, and what is necessary to 'regulate' a highly unregulated, and mushrooming, economic ecosystem. The UK government has introduced consultations on the regulatory approach to cryptoassets, including in the financial markets. The European Commission's Regulation of Markets in Crypto-assets (MiCA) proposal will soon introduce EU regulations on crypto.

In October 2018, the joint Bank of England, FCA and HM Treasury Crypto Assets Taskforce published a report in which they categorised crypto into securities tokens, exchange tokens and utility tokens, all with somewhat different features and roles. The report concluded that ‘while distributed ledger technology is at an early stage of development, it has the potential to deliver significant benefits in financial services and other sectors in the future’.

Legal status of crypto

If advising on crypto, it is important to understand what it is, and its legal status. The digital economy and the role of intangibles is always complex, particularly when seeking to apply the correct tax analysis. Fortunately, various legal disputes have been addressed in the courts (mainly because bitcoin has significantly increased in value).

The UK Jurisdiction Taskforce has also published a ‘Legal statement on the status of cryptoassets and smart contracts’, which aimed to answer some of the critical legal questions regarding crypto and provide some certainty in its use. It concluded that cryptoassets have all of the indicia of property, and that the novel or distinctive features possessed by cryptoassets, such as intangibility or decentralisation, do not disqualify them from being property.

The recent proprietary injunction cases of *Robertson v Persons Unknown* (unreported) and *AA v Persons Unknown* [2019] EWHC 3556 in part sought to determine the nature of crypto, and whether the relevant legal rules for such injunctions could apply on the basis of whether crypto amounted to property. Applying the relevant historic case law, particularly National Provincial Bank v Ainsworth [1965] AC 1175, it was deemed to be the case that crypto (in the form of bitcoin) amounts to property, on the basis that it holds the characteristics of property in being definable, identifiable by third parties, capable in its nature of assumption by third parties, and has some degree of permanence or stability.

Taxation

And so to the taxation of crypto. This article mainly focuses on the role of exchange tokens and utility tokens, but in reference to the UK employment related securities rules, securities tokens are also in point.

HMRC issued its Cryptoassets Manual on the tax treatment of cryptoassets (see bit.ly/3cGQ5v3), and I have had the pleasure of assisting HMRC in this as part of my representative role for the CIOT. The Manual replaces less comprehensive HMRC guidance published in 2014.

As with everything digital, guidance will need to be updated on a regular basis due to ongoing and quick moving developments. In particular, decentralised finance (DeFi) will need to be incorporated, and most likely cross referenced with HMRC’s other guidance manuals, in particular the Corporate Finance Manual.

Taking into account the complexity around intangibles, the writer feels that before applying any calculati ons around crypto, an understanding of the facts is particularly important. The ‘substance over form doctrine’ may well be important, and care should be taken to determine whether there is any associated contract. This is particularly important for utility tokens, such as non-fungible tokens.

Personal taxation

Currently, most tax advisers will be seeing individuals who are holding or disposing of crypto portfolios. The legal interpretation of crypto as property is extremely useful, particularly in the area of bitcoin (and many other cryptos, such as Ethereum) held for investment purposes, on the basis that the crypto amounts to a store of value.

The main tax head is capital gains tax, which many will already recognise charges by way of Taxation of Chargeable Gains 1992 s 21 ‘all forms of property … whether situated in the United Kingdom or not’, which ‘shall be treated as assets for the purposes of this Act’.

If within the sphere of capital gains tax, one also has to look at the computati onal mechanics. This may bring you to the share pooling rules, depending on the factual circumstances of the relevant crypto.

Section 104(3)(ii) extends the share pooling rules relating to company shares and securities to ‘any other assets where they are of a nature to be dealt in without identifying the particular assets disposed of or acquired’. The effect of this is that if a client is holding one or more types of crypto for investment purposes, the pooling approach will be required. Each type of token will need its own pool, and acquisition and disposal activity for each will need to be matched to the same day rule, the 30 day rule and the ‘section 104 pool’.

Often confusing is the concept that moving from one crypto to another will most likely (but not always) amount to a disposal and acquisiti on for capital gains tax purposes. Part of the challenge presented by crypto is the way it will sit within an individual DLT [blockchain].

Tax advisers will also be faced with a dictionary of many new terms, such as mining, staking, airdrops, forks and soft forks. I do not have enough space to consider the taxation implications of such matters, but the key is to fully understand the facts. HMRC’s guidance is particularly helpful on many of these matters.

Income tax

As mentioned above, many will have read in the press about references to ‘mining’ and ‘miners.’ Due to the way in which bitcoin (and other similar coins or tokens) was originally constructed, the Proof of Work (PoW) mechanism is necessary for the creation of new crypto (via the cancellation of old and creation of new blocks). Digital ‘work’ therefore needs to be done as part of maintaining the ecosystem.

This again can cause confusion, on many sides. Tax advisers and tax authorities will often pick up on the word ‘work’ and start to think about trading and income tax. However, it is always important to remember that this is a phrase of those within the ecosystem, and doesn’t automatically lead to ‘work’ in the more traditional sense.

That said, an analysis of the facts or a review of contractual obligations is important to determine whether work is being undertaken in the more traditional framework, as there may be a trading issue. It is worth always remembering the badges of trade as set out in the 1955 report by the Royal Commission on the Taxation of Profits and Income: profit seeking motive; the number of transactions; the nature of the asset; changes to the asset; the nature of sale; the application of finance, and so on.

It is also important to better understand some of the ways the crypto ecosystem and wider digital economy operates. For example, in an ‘airdrop’ an individual may receive a free allocation of crypto, perhaps as part of a digital marketing campaign. There could be circumstances in which airdrops are taxable, again dependent on historic principles.

One of the controversial tax aspects of crypto at present is HMRC's guidance on the location (or situs) of cryptoassets for tax purposes (see CRYPT022600 at bit.ly/3l0MCvK). For tax advisers with clients claiming the non-domicile remittance basis, this is a real challenge. HMRC's view is that the location of the cryptoasset will be determined by the residency of the beneficial owner (and thus will be in the UK where the owner is UK resident). This is essentially on the basis that the private keys (a security element necessary for users to access their cryptocurrency) are under the user's control wherever they are.

The writer has seen varying alternative analyses of this. Again, the important thing will be to fully understand all the facts. For example, if the UK resident has no access to or knowledge of the private keys, then the situs might well be different. However, an obvious challenge is how can one know 'what is in the head of another'! This is a challenge we will see more and more in the digital world. We may well need to have new rules for such matters.

Employment taxes

As the crypto market develops, some businesses will seek to pay their employees in crypto or even incentivise them with crypto. Depending on how the business or company is structured, there could well be employment related securities issues (ITEPA 2003 Chapter 7), and possibly PAYE and NIC implications, if the crypto amounts to a readily convertible asset. Whether or not there is an employment related securities point, simple payment of employees in crypto will simply trigger PAYE and NIC liabilities, as general earnings (ITEPA 2003 s 7).

Tax evasion

There has been much publicity surrounding the risk of crypto in terms of money laundering and the role it can play in tax evasion. While some non-compliance will be because holders of crypto not have been aware that certain crypto transactions are taxable, there will also be elements of tax evasion. Tax advisers must undertake the necessary precautions to identify this, and fully comply with the anti-money laundering obligations, and good ethical practice, in terms of their relationship with HMRC.

We are starting to see many digital businesses offering crypto tax calculations. It is important to be aware of the changes introduced to the UK anti-money laundering rules by virtue of the Money Laundering and Terrorist Financing (Amendment)

Regulations 2019, which broadened the rules to those providing ‘material aid, or assistance or advice, in connection with the tax affairs of other persons, whether provided directly or through a third party’.

If there is an element of deliberate behaviour and the risk of an HMRC criminal investigation, it may be appropriate to advise the client to avail themselves of the protective benefits of the Contractual Disclosure Facility (Code of Practice 9).

HMRC has been increasingly concerned about the tax lost on cryptocurrency, and very keen to counter the risk of non-compliance. Tax advisers will be aware that HMRC has recently embarked on a new nudge campaign to advise some holders that it is aware of their crypto holdings, and that these holdings may be taxable.

HMRC has been using its bulk data information powers (FA 2011 Schedule 23) to secure personal information from a number of the crypto exchanges.

Corporate transactions

Crypto is also an increasing part of the corporate landscape, and it is always important to remember that the corporation tax rules contain various provisions which might apply.

Corporation tax incorporates corporate capital gains, but there are also special rules for loan relationships, intangible assets and derivatives, many of them introduced in 2002, well before crypto. As well as considering the legal and contractual substance to any crypto transactions or holdings, take into account the relevant accounting treatment. For example, how crypto is treated on the company balance sheet may well have a significant impact on the resulting tax position.

VAT

The substance and form of any crypto transactions is just as important for VAT purposes. Some non-fungible tokens, for example, will amount to utility tokens and amount to a provision or future of services, or possibly even trigger the VAT vouchers rules. It will be important to understand exactly what is being offered or provided, often set out in an associated contract or digital terms and conditions in a smart contract.

Decentralised finance

Decentralised finance (or DeFi) is growing very quickly. In the statement by Sir John Cunliffe referenced above, he said that in terms of value it was less than $10 billion at the start of 2020 and nearly $100 billion in September 2021. Currently around half of the DeFi market involves the offering and provision of debt, often where the holders of crypto offer some of their portfolio as collateral. One can see many new financial instruments being created, and we will need rules to fully account for these.

The majority of this market remains unregulated, so it does carry some risk to the health of the wider financial economy. I would expect the DeFi market to become very regulated quite soon.

Particularly in the case of corporation tax, DeFi debt or derivative type arrangements may well trigger some of the corporate tax provisions mentioned above.

In conclusion

We should anticipate significant change to the way financial services are provided in the next decade. Crypto is a part of this, and the term will likely develop, or even be replaced by another in the years ahead.

However, we are already seeing central banks looking to introduce their own digital currencies. This is clearly an indication that they see crypto, in some shape or form, remaining and growing in the years ahead.

Finally, I couldn’t end this article without mentioning the environmental impacts of cryptocurrency. According to the Cambridge Bitcoin Electricity Consumption Index, the energy used is now equivalent to the annual carbon footprint of Argentina. If crypto is to become an integral part of our digital world, then the only answer is for clean technologies. I already see many blockchain companies moving from Proof of Work mining to greener Proof of Stake approaches, and also can see a desire of those in the crypto world to find wider clean solutions.