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Further Reflections on the Taxation of Crypto-Assets

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SPEED READ

As the world of cryptocurrencies and other digital assets becomes increasingly mainstream, and growing numbers of clients consider investing or trading in that sphere, advisers can no longer play the academic technophobe card, and need to start boning up. Easier said than done though: establishing what a particular crypto-asset actually is, and how it works, can be tricky – establishing how it should be taxed can (in some circumstances) be downright fiendish. Until we have more HMRC guidance and relevant case law to work with, advisers should take a principles based approach in light of the particular factual matrix.

Laura Mullarkey and Richard Sultman (Cleary Gottlieb) address key tax issues relevant to crypto-assets.

This article seeks primarily to address key tax issues relevant to crypto-assets. To give that discussion more context, we commence with a short layman's guide to the technology and terminology.

The technology

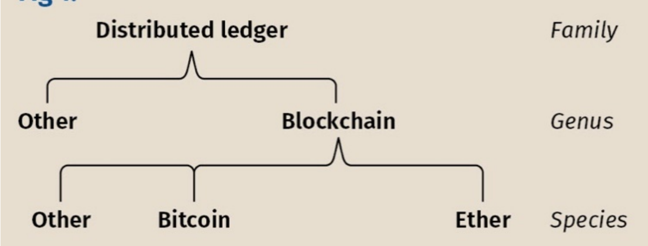
Underpinning the world of crypto-assets is so-called 'distributed ledger technology' (DLT). DLT might sound like jargon (or a sandwich) but is, at its core, just a database which stores certain information. This technology can be used to store most types of data, for many different purposes, but in the case of cryptocurrencies and similar crypto-assets, the information will principally include:

— how many of the particular crypto-coin denomination exist; and

— who holds what.

Blockchain is just one (particularly famous) type of DLT *(see the figure below).*

Fig 1.



The ‘distributed’ element of DLT is that, rather than such a database being held in one official, central repository, the database is distributed throughout a peer-to-peer network. Each version of the database is equally authoritative, and a consensus mechanism is used to ensure that all versions are identical. (Do note, however, that now terms like DLT and blockchain have captured media attention, many organisations claim they are using this technology when, in fact, their databases are not truly ‘distributed’, and may involve a central authority, and only private, permissioned access to the network. Accordingly, you should always check how the technology relevant to any given crypto-asset actually works, as it may influence your analysis of the asset, and transactions in it.)

One issue with peer-to-peer public, permissionless networks is security. As holdings of coins, and transactions in them, are public, what is to stop them being stolen? The solution is cryptography: transactions are encrypted using public and private keys, with the effect that only the intended recipient of a crypto-payment, who holds the correct private key in their e-wallet, is able to access that payment.

So what is an e-wallet? We have read analysis from tax advisers suggesting that an e-wallet should be regarded as akin to a foreign currency bank account, with the consequence that the foreign currency bank account exemption in TCGA 1992 s 252 might be capable of applying to prevent a chargeable gain accruing to an individual holder of a crypto-asset through an e-wallet account. We would urge caution here. Not only does an e-wallet for crypto-assets not contain ‘foreign currency’, it also does not contain the crypto-asset itself, as this only exists on the ledger. Rather, the e-wallet holds the private key which allows the holder to spend that asset. Whether this is a distinction without a difference remains to be tested. Furthermore, it is worth asking what the user of the e-wallet service actually owns: depending on the contract with the e-wallet provider, they might have beneficial ownership of the contents of their e-wallet, or they might just have a credit claim.

The terminology

In a previous article, authors from Eversheds Sutherland (‘Taxing token generation events’, *Tax Journal*, 19 October 2018) offered a tripartite classification of DLT generated crypto-assets:

1. crypto-transaction tokens (e.g. Bitcoin);
2. crypto-fuel tokens (e.g. Ether); and
3. crypto-voucher tokens (which carry rights in relation to underlying assets).

In regulatory spheres, the following classifications are more common:

1. security tokens (i.e. tokens that are akin to shares or bonds): these are discussed at length in the aforementioned article, but are actually relatively unusual in the crypto-world;
2. asset tokens (representing rights to any other type of asset, e.g. gold);
3. utility tokens (representing rights to future services from a platform); and
4. payment tokens: these can be subdivided into:
    a) platform tokens which ‘fuel’ a platform, e.g. Ether; and
    b) cryptocurrencies intended as a general medium of exchange, e.g. Bitcoin.

These classifications might help to frame initial inquiries, but there is currently much overlap and inconsistency in the labels given to particular crypto-assets. For example, the US Securities and Exchange Commission (SEC) has been known to categorise assets as security tokens that other regulators would classify as payment tokens, and hybrids of any of the categories are also possible. That means that, at present, there is no substitute for establishing exactly how the crypto-asset you are considering actually functions, and how it is held by your client.

Direct tax issues

Turning to the tax analysis, the preliminary focus will be establishing which regime your client falls within, as regards their holding of crypto-assets. The existing HMRC guidance is contained in *Revenue & Customs Brief 9/2014*, HMRC's *Capital Gains Manual* at CG12100 and VAT Finance Manual at VATFIN2330, although updated guidance is expected by early 2019 (according to the Cryptoassets Taskforce's final report, published on 29 October by HM Treasury, the FCA and Bank of England). The current guidance technically only applies to 'Bitcoin and similar cryptocurrencies' (and only expressly considers blockchain technology, as opposed to other types of DLT). However, the principle therein – which amounts to working out what the taxpayer is actually doing with the cryptocurrency and taxing them on that basis – seems capable of extension to all crypto-assets.

Therefore, an individual owner (assuming that their e-wallet arrangement gives them ownership of the asset) should be subject to the income tax regime if trading in crypto-assets, and to the capital gains regime if investing. (HMRC also acknowledges in its guidance that an individual may be gambling, but we do not consider this possibility further here.)

So far, so straightforward – or is it? Calculation of the capital gain on a disposal should be simple where the asset was both acquired and sold for sterling, but the position is complicated where purchase or sale (or both) was in exchange for another cryptocurrency (and bear in mind that such transactions are particularly common in the crypto-sphere, where people regularly switch crypto in hope of better returns). At CG12100, HMRC confirms that its guidance on non-sterling currency barter transactions (CG78310) is applicable to exchanges of cryptocurrencies. That is a helpful starting point, confirming that the acquisition cost of the asset is the sterling equivalent of the consideration given on the acquisition date, and the consideration on disposal is the sterling value of the consideration actually given. However, it ignores the fact that, unlike for foreign currencies, no official daily spot rates are published for crypto; and offers no suggestions as to how 'sterling value' should be ascertained without such reference points. This is important as price volatility is extremely high for crypto-assets, and can vary significantly from exchange to exchange on the same day. Of course, you could file form CG34 with HMRC to have your valuation checked, but it is hard to see that it is better placed to find an authoritative answer (and the process itself may take months).

Moreover, how is a crypto-asset to be identified for capital gains purposes? If you built up a portfolio of 100 Bitcoin gradually over 10 years, for example, and you now sell 20, which 20 are they? The answer may significantly impact how much base cost you have in the disposed of assets. HMRC states (at CG12100) that 'where the nature of the cryptocurrency means they are dealt in without identifying the particular unit of currency being sold', then share pooling rules should be applied, in accordance with TCGA 1992 s 104(3)(ii). In order to understand whether the cryptocurrency is dealt in 'without identifying the particular unit', you need to understand the technology. And what if the technology would, theoretically, allow you to identify the particular unit of currency, but in practice no one keeps records of it, or your e-wallet provider does not give you access to this information?

For UK corporate holders of crypto-assets, the relevant regime may vary depending on what the assets actually are (as well as how they are held). If the assets in question are 'Bitcoin [or] similar cryptocurrencies', *Brief 9/2014* suggests that, for this purpose only, they should be treated as analogous to foreign currency and therefore dealt with under the foreign exchange gains and losses rules in the loan relationships code (CTA 2009 Part 5). This means that the crypto-asset would be treated as a money debt owed to the corporate holder (CTA 2009 s 483(2)), and exchange gains and losses thereon regarded as arising from its loan relationships and related transactions (s 328). Where the holder is trading, rather than investing, credits and debits would be calculated under the loan relationships regime, but then brought into account under the trading income head of charge in CTA 2009 Part 3 (ss 296 and 297).

This leaves open the question as to which crypto-assets would not be considered 'similar cryptocurrencies' and, in such a case, what their tax treatment should be. One would need to analyse the asset from first principles in order to establish whether it might fall within a particular regime (e.g. the derivative contract rules in CTA 2009 Part 7, or the intangibles rules in CTA 2009 Part 8); or whether, in the absence of the application of such rules, it might fall into the capital gains regime (assuming, of course, that it amounts to an asset that is capable of being owned in the first place).

Indirect tax issues

The application of VAT and stamp taxes to the world of crypto-assets has been addressed before by this journal, in the aforementioned article, and in 'Initial coin offerings and VAT' (Etienne Wong), *Tax Journal*, 15 March 2018). Rather than retreading established ground, therefore, we simply raise two issues not previously covered. The first is that, although *Hedqvist* (Case C-264/14) confirmed that supplies of Bitcoin exchange services were VAT exempt, there may yet be scope for disagreement as to what is covered by this exemption. The German tax authority recently published guidance distinguishing between exempt Bitcoin exchange services, where the service provider acts as intermediary for buyers and sellers, and VATable 'technical infrastructure' services, which simply 'enable' the exchange (German Federal Ministry of Finance (BMF) letter, 27 February 2018). It will be interesting to see how this unfolds.

Another area of uncertainty is whether the provision of e-wallet services is VATable. This may not matter while most such services are provided for no or minimal fees, but who knows if that may change in future.

Conclusions, and more questions

So, even on the basics, there are meaty issues for advisors to get their teeth into, which require a firm grip of the technology underpinning the assets and the activities of the client. In the absence of clear rules and guidance on many of these issues, practitioners should take a principles based approach.

This approach does not, of course, necessarily make reaching an answer easy, and that can be seen from the questions we pose below. We could probably dedicate an entire article to each of them, but, for now, answers on a postcard?

Is a purely cash-settled cryptocurrency future a 'relevant contract' for the purpose of CTA 2009 Part 7? This may depend on whether it can be treated as a currency future, as these are the only purely cash-settled futures which qualify as 'futures' for 'relevant contract' purposes (CTA 2009 s 581(3) and (4)).

Is investment in a crypto-asset by a non-resident through their UK investment manager an 'investment transaction', such that the non-resident may benefit from the investment manager exemption from creating a UK permanent establishment? Depending on the facts, various existing categories may be relevant; e.g. where the transaction results in a fund becoming party to a loan relationship, or is a transaction in securities, a 'relevant contract' or a unit in a collective investment scheme. However, we believe that this is an area where we are likely to receive official guidance or even legislation, as the government appears keen to support the UK's emerging position as a leading jurisdiction for tech businesses.

And, finally, what are the tax consequences of certain initial coin offerings (ICOs) having used the 'simple agreement for future tokens' (SAFT) mechanism, rather than issuing tokens immediately to participants? (SAFTs were designed to simplify the US securities law analysis for ICOs, and they operate by giving participants who sign up the right to tokens in the future, if and when the relevant platform is established.) Where a participant sells on its interest in the SAFT at a profit before tokens are issued, it would seem obvious that this should be a taxable event (with the SAFT perhaps being analysed as a future under the derivatives code or a capital asset, depending on the circumstances). However, if the participant holds onto the SAFT until tokens are issued, is it still correct to look at the SAFT as an asset in its own right, that has been disposed of, or should the transaction be analysed as an advance payment for a single asset (the token) that was received at a later date? And if the latter, where payment was made in Bitcoin, on what date should the sterling value of the Bitcoin be calculated (to establish base cost in the token)? The date of payment or the date of receipt of the token?

Action points

- Spend time getting to grips with distributed ledger technology.
- Don't assume all crypto-assets are the same.
- Apply a principles based approach to analysis, using HMRC guidance and case law where useful but recognising that there are currently many unanswered questions.

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