Cryptocurrency: could you require a HMRC disclosure?

Antony Greenwood explains how cryptocurrency should be treated for tax purposes.

HMRC released its guidance on how cryptocurrency should be taxed in December 2018 and has now enshrined that guidance in its manuals. However, this will have come too late for many individuals who had received, mined, or exchanged cryptocurrency before the 2017/18 tax year.

We have outlined below how cryptocurrency should be treated for tax purposes, but we are aware of individuals who have already been contacted by HMRC in relation to their cryptocurrency transactions. HMRC has confirmed it has been approaching exchanges for information on their users' activities, and will shortly begin sending 'educational' letters to individuals that have held cryptocurrency.

Furthermore, it has been reported that the Organisation for Economic Co-operation and Development (OECD) is considering adding cryptocurrency exchanges to the list of institutions that must report information under the Common Reporting Standards. With the use of cryptocurrency increasing, this seems a certainty, and is likely to apply from 2022.

We would, therefore, urge any individual that has bought, sold or exchanged cryptocurrency, mined it, or received it in exchange for services, to contact a professional adviser to review their affairs and consider whether a disclosure is required.

Approaching HMRC first is the best way to minimise, or even completely negate, any penalties that may be imposed for filing an incorrect tax return or failing to file at all.

Cryptocurrency received for services (earnings)
Currency received in exchange for services is taxable as income. The method of taxation, however, and the availability of relief for any expenses differs depending on whether you're engaged in employment, or self-employment.

Employment: In the vast majority of cases, cryptocurrency will be considered a readily convertible asset, as markets exist for the cryptocurrency to be sold. Payment in readily convertible assets is taxable when paid to an employee, at the value on that date, and the employer should deduct and pay income tax and National Insurance Contributions (NIC) through the PAYE system.

Employed individuals should, therefore, have had their tax obligations met by their employer, even if they were paid in cryptocurrency. Any employers that have not correctly accounted for their employee's tax obligations, through the PAYE system, may be guilty of an offence, and should get in touch to consider whether a disclosure needs to be made, and the content of that disclosure.

Self-employment: Self-employed individuals, however, will be responsible for declaring and paying their own tax and NIC, and this is done through the Self-Assessment regime. In most cases, the value of the cryptocurrency, for the purpose of tax and NIC, will be the market value when it was received.

To file a tax return, individuals require a Unique Tax Reference number, which can be applied for online. Tax returns are then required to be filed online by 31 January, following the end of the tax year.

For the self-employed, costs incurred wholly and exclusively for the purpose of their trade can be deducted when calculating their taxable income. Employed individuals cannot deduct such expenses (subject to certain exceptions).

It's possible to be considered self-employed by virtue of your cryptocurrency trading activity, but HMRC has confirmed that individuals will only be treated as trading in cryptocurrency in very limited circumstances. The majority of individuals will, therefore, only pay income tax on cryptocurrency if they have received the tokens in exchange for work carried out.

Trading in cryptocurrency
The benefit of 'trading' is that any losses would be considered trading losses. Broadly speaking, such losses can be set against other income to obtain income tax relief for any fall in value of the cryptocurrency, rather than just making a claim for capital loss relief. This would mean recovering 20%/40%/45% of the loss rather than just 10%/20% (rates of tax for income vs capital gains).

The downside, however, is that any profits made from trading in cryptocurrency would then be subject to those higher rates of tax. Any benefit, therefore, may soon be outweighed by tax on profits made in subsequent years.

To make a trading loss claim, you would need to demonstrate you meet the 'badges of trade'. The most relevant ones to cryptocurrency are as follows:

- Engaging in systematic and repeated transactions, with the intention to realise a profit;
- Purchasing 'stock' with borrowed funds, so that you have to sell the asset to repay the loan;
- Selling the asset in such a way that is typical of trading, rather than to raise funds for another reason;
- Buying and selling quickly, as you would expect in a trading business; and
- Purchasing the asset, rather than receiving it as part of an inheritance, or as a gift.

Deciding whether you're trading can be complicated. I strongly recommend getting in contact before making any claim for trading losses in relation to cryptocurrency.

Cryptocurrency purchased, sold or exchanged
The majority of individuals who buy, or otherwise receive, cryptocurrency will be considered to have acquired a capital asset.

Where the cryptocurrency is sold, or exchanged for another asset (including another type of cryptocurrency), and a profit is made, capital gains tax will be due on any gains over and above the Annual Exemption amount for the relevant tax year. If the disposal realises a loss, relief can be claimed against capital gains of the same year, or subsequent years.

Calculation of the gain (or loss) is calculated by reference to the 'pooled' cost of the currency. This is essentially the cost of all of that specific currency, divided by the amount of that currency. For example, if you purchased two Bitcoin for £100 each, and then later purchased another four Bitcoin for £200 each, the total cost of your Bitcoin would be £1,000.

This total cost is then split amongst the six Bitcoin, and so if you sold one Bitcoin, the cost of that Bitcoin for capital gains tax purposes would be £166.66.

There are special 'bed and breakfasting' rules that apply where cryptocurrency is purchased within 30 days of selling cryptocurrency of the same type. Essentially, those tokens acquired within 30 days are treated as having already been disposed of (earliest disposal first).

Negligible value claim
Where the value of cryptocurrency has fallen to such an extent that it's of 'negligible value', it's possible to make a negligible value claim. This generally occurs where the asset is worthless, or of such a low value it cannot be sold, usually because no-one will buy it. The claim allows you to treat the asset as being disposed of, and then reacquired at the current value.

Negligible value claims, or relief for capital losses made, can be set against subsequent capital gains. This treatment applies even where the cryptocurrency was received for services. The base cost in that instance would be the value of the cryptocurrency when it was received.

Problems with calculating capital gains
Some individuals will complete a high volume of transactions every day, often utilising special software for the purpose. Given the pooling and bed and breakfasting rules outlined above, accurately calculating taxable gains in these circumstances may be impossible for any individual.

There are, however, programs available that will calculate all gains by reference to HMRC's guidance, simply by allowing them access to your data. Such programs can now be used to correct past filings, or file disclosures for years where no tax returns have been filed.

As noted above, HMRC has already started targeting users of cryptocurrency, and we would urge anyone who has made a profit from cryptocurrency to speak to a member of our team to determine whether you have tax liabilities that need to be disclosed, before HMRC come knocking.

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