

It's a digital jungle out there: a crypto tax roadmap

In the first in a new series on crypto, Andy Wood creates a mindmap (of sorts) of some of the crypto-related scenarios an adviser might come across

Of course, the buying and selling of bitcoin, Ether or Dogecoin, are probably the things that most people associate with crypto. Although this might be the most common scenario, it is not the only activity you might have clients calling you up about.

Indeed, over the years, activities have become more and more varied and sophisticated.

BUYING AND SELLING

As alluded to above, this is probably the most common area. There are, of course, quite a few articles and resources around buying and selling tokens. But perhaps fewer around NFTs.

Cryptocurrencies (fungible tokens)

Generally speaking, the buying and selling of cryptoassets will be an investment activity and subject to the capital gains regime. Individuals and trustees will be subject to CGT and companies subject to corporation tax on those gains. In case of the latter, the intangibles rules will not be relevant.

Fungible tokens are subject to the pooling rules as they apply to individuals and companies.

Except for the Treasury Select Committee(!), we have exorcised the possibility that crypto transactions are highly unlikely to be gambling transactions. Further, crypto is not a profit on foreign exchange.

The major exception will be where the buying and selling is part of a trade. Here, the profits would be subject to income tax and NICs. The advent of DeFi has provided ample opportunities for crypto enthusiasts to hunt the best rates on an active and strategic basis. These are often called 'yield farmers'. Does this necessarily mean those using DeFi will be treated as trading? No, it does not. It will be one of many factors.

Non-Fungible Tokens (NFTs)

There is not much to say about NFTS other than the fact that, as they are not fungible, they are not subject to the pooling rules.

Inheritance Tax (IHT)

It is worth noting that the courts have determined that cryptoassets are property for general legal purposes. This means two things:

- Cryptoassets are in one's estate for IHT purposes; and
- They can be the subject matter of a trust.

Bearing in mind how one manages and controls cryptoassets, this gives rise to some key practical points when it comes to estate planning. Striking a balance between security and succession management will be key. Specialist advice should be sought.

INVESTING FOR A RETURN

General

As stated above, we have moved a long way from the early years of crypto where someone could hold (or should that be hodl?) bitcoin and one or two other coins.

The advance of smart contracts, DeFi, etc., have presented the crypto enthusiast with many ways of investing their cryptoassets for a return. Of course, this is not without risk, as we have seen with the meltdown of firms such as Celsius.

Transferring/withdrawing assets

Perhaps one of the more surprising aspects of using DeFi (and CeFi) platforms is the potential tax charge when one transfers one's cryptoassets to the platform.

In cases of DeFi/CeFi lending and DeFi/CeFi staking, from a legal perspective, the investor might be transferring the beneficial interest in the assets to the platform. As such, this would be a disposal for tax purposes.

It is perhaps fair to say that these lending transactions are similar to securities lending which, in certain circumstances, benefits from a 'disregard' in the CGT legislation even where legal and beneficial ownership passes.

The Government has recognised this and, as part of a series of consultations, is suggesting that a similar 'disregard' might apply for analogous crypto transactions.

It should be noted, that transferring assets to platforms such as Coinbase or Binance are less likely to result in a disposal as the terms and conditions suggest there is no passing of beneficial title.

Return on investment

Generally speaking, the investor will be motivated by the promise of a return (in tokens) which might be expressed in terms of a % APY. How are these returns taxed?

The first point to note is that this is not interest. Case law is clear that, in order to be interest, it must be paid in respect of 'money'. Crypto is not money.

Accordingly, the yield received will be subject to the Miscellaneous Income rules.

Again, an exception to this might be where the activities of the investor amount to trading. Where this is the case, then the income will be taxed as trading profits.

Finally, there might be scenarios where the return is a capital, rather than an income return. As such, this will fall with the CGT regime. However, this is perhaps relatively uncommon.

MINING AND SIMILAR ACTIVITIES

General

At its core, crypto-mining is the process of creating new coins, a far cry from the coal mines I remember growing up in a 1980s West Yorkshire pit village.

Mining ensures the validation of cryptocurrency transactions on a blockchain, preventing the dreaded double-spending of digital currency within the network. To maintain the integrity of the distributed ledger, consensus mechanisms play a pivotal role, demanding a certain network consensus for transactions.

Generally speaking, the person who gets to add the new transaction to the blockchain will receive a reward – usually in the form of tokens.

Hobby or trade?

Distinguishing between a hobby and a trade is seminal. Case law showcases instances when a hobby transitions into a trade, particularly in the context of claiming trading losses.

One notable case involving a certain Mr. Patel, where his ventures never grew beyond his passions, as evidenced by his 'mixed' approach to business.

From a practical perspective, one might consider a spectrum. At one end might be a computer enthusiast, originally drawn to the anarchic/libertarian nature of cryptocurrency. Initially, they got into mining without any dreams of making a profit. However, our miner might have managed to turn a profit even after factoring in equipment upgrades and rising energy bills.

At the other end of the spectrum, a commercial, strategic approach might involve rented office space, specialised mining rigs, cooling systems, and possibly staff or contractors. The activities might be conducted through a company. In such a scenario, the activities would be treated as a trade.

Tax treatment

The profits from non-trade mining will fall within the scope of miscellaneous income.

Unfortunately, there is limited statutory guidance in terms of how one computes profits for these purposes.

However, case law indicates that we should use the same rules for miscellaneous income profits as for trading profits.

There are some kind points of distinction. The hobbyist will not be able to avail themselves of capital allowances, unlike their trading counterpart.

In addition, if a loss arises, the hobbyist will have much less scope for utilising losses when compared with the trader where, if they are a sole trader, they will potentially have highly flexible sideways loss provisions to play with.

If mining activities qualify as a trade, the profits are taxable as trading profits. The exact treatment depends on the taxpayer's profile.

Capital allowances come into play here, allowing traders to claim allowances on capital items like computer equipment used in mining operations.

Further, as noted above, the trader is likely to benefit from more flexible offset of losses (although this depends on whether the taxpayer is an individual or company)

NFT creators and dealers

An NFT creator might be analogous to an artist. As such, the key distinction in how they conduct their activities will be whether they are a hobbyist, or a professional artist. Either way, they will likely sell their wares through online platforms such as Opensea, LooksRare or smaller versions.

A hobbyist will find that their profits, calculated in much the same way as a trade, will be subject to the Miscellaneous Income regime.

Where the activities are more deliberate and organised, then they may constitute a trade.

Of course, the trading profits will be subject to income tax and NICs. Some NFT projects can be sizeable operations, including multiple artists, marketing, influencers and substantial capital outlay.

One of the key aspects of being seen as a professional, trading NFT creator will be the ability to claim capital allowances on capital expenditure – including on, say, laptops and tablets.

An NFT dealer is perhaps analogous to an art dealer. In other words, does their activity amount to little more than a collector of NFTs, or are they a trader or dealer?

A collector, buying and selling NFTs, will be subject to the CGT regime as outlined above. However, a dealer in NFTs will be operating a trade and subject to income tax and NICs.

The VAT position on NFTs is also interesting. When a UK-based trader sells NFTs, VAT considerations come into play. Generally, B2C services provided by a UK supplier fall under UK VAT rules.

However, unique rules apply to 'electronic services', like NFT sales, where the service is automated and online. The place of supply is where the customer belongs.

NFT sellers might face challenges in establishing customer status and location due to the digital nature of the transactions.

A recent Spanish ruling classifies NFT sales as electronically supplied services subject to Spanish VAT if the place of supply is in Spain.

However, interestingly, a response from HMRC regarding one of our clients suggests that (for VAT purposes) NFTs are considered financial securities, not goods or services, falling outside the scope of UK VAT. If this is the case, then there is no need of course to consider the place of supply.

P2E gaming and the metaverse

P2E games are like regular video games, but instead of just earning points or rewards, you can earn cryptoassets that can often be exchanged into fiat currency. For parents who are used to buying their kids Roblox Robux for birthdays, it's a chance to make a return on that cash!

It is my view that the majority of rewards earned in a P2E game are likely to be taxable as Miscellaneous Income. One exception might be where the P2E game involved 'lottery' style elements. Such features might provide a non-taxable prize.

In addition, in game characters or items might be structured as NFTs. The player might acquire or develop such NFTs. It is likely that the sale of these items would be subject to CGT.

Exceptionally, I have seen people approach playing P2E games on a commercial basis and, as such, the receipt of crypto being subject to tax as trading income.

It is my view that the source of these income rewards will follow the same basis as set out in the section on 'Return on Investment'.

PAYMENTS IN CRYPTO

Buying goods and services

Whether one is buying and selling goods or services in cash or crypto, the consequences will largely be the same.

If one is a trader, then the market value of the crypto will be brought into account at the time of receipt or payment. VAT will be due in the same way and, for example, if the payment is to acquire an interest in land (but not virtual land!), SDLT will apply in the same manner.

One should note that the use of crypto as payment, however, will also result in a separate disposal. So, a gain or loss might arise whenever crypto is exchanged for goods and services.

Employees

Again, employees paid in crypto will be subject to tax in the same manner. The value of the crypto received in payment for their service will be taxable.

PAYE will be relevant where the crypto is a Readily Convertible Asset. A crypto listed on a genuine exchange will likely be an RCA – so bitcoin, Ethereum, bitcoin, etc., will also be subject to PAYE.

Again, on payment, the employer will be treated as making a disposal for tax purposes so there might be a gain or loss on payment.

It is worth noting that it is unlikely that cryptoassets will be securities for the purposes of the employment related securities. So, this might be helpful in designing token incentive schemes.

SITUS AND SOURCE

Situs

The situs of assets for CGT and IHT is a detailed topic in itself on which I have written a number of articles.

Situs is particularly important for UK resident non-doms who are taxable on the remittance basis.

The position regarding centralised exchanges is perhaps straightforward. Although HMRC do not seem to note the difference between centralised and decentralised ownership, the former involves the investor having no proprietary right in the crypto. Instead, they have a right of action against the platform. The situs of such a right is well-established and is where that right of action can be enforced. So, if they exchange is on a rock in the middle of the Caribbean, then that is the situs of the asset.

The position for decentralised tokens is much more up in the air. HMRC's view is that the situs follows the status of the beneficial owner of the assets under the statutory residence test. However, this does not seem to have any basis in law and there are obvious deficiencies – including the fact this could only be the case for individuals.

A better suggestion might be that situs follows the common law residence status of the holder of the assets. As such, the same approach could be applied for individuals, companies and trustees.

Finally, there is a lot of support for the so-called private key approach. Broadly, this is on the basis that one needs to control the private key connected to the cryptoassets to transact. As such, it should be the location of the private key at the time of the transaction.

Source

I have discussed the source of income produced by cryptoassets in a recent article to be published in Taxation magazine.

TYPE OF INCOME

Return on investment

Assuming that the return is not part of the trade, then the source is likely to follow the situs of the assets as it is unlikely any service is being provided. This is at odds with HMRC's Manuals.

Mining and similar activities

Where the relevant mining 'work' is done – regardless of whether trading or hobby.

P2E / metaverse rewards

My view is that the position will follow 'return on investment' above.

COMPLIANCE

General

Crypto has a reputation for 'non-compliance' rather than compliance. There are perhaps a few things worth pointing out.

Getting it right

One of the common errors is that many investors still do not appreciate that exchanging one token for another is a disposal.

As well as potentially missing transactions, this also creates another problematic by-product. That is that even a moderate level of transactions might end up with thousands of lines of compliance data.

Fortunately, there is now some excellent software out there with some of it specifically built for UK tax purposes – so that it incorporates things like bed and breakfasting rules, etc..

From April 2024, there will be specific boxes on the tax return for reporting crypto activity.

HMRC powers

HMRC will have its usual powers and penalties and a taxpayer will be subject to the usual HMRC sanctions.

However, one thing that has caught my eye is HMRC's use of data notices under Schedule 23 of Finance Act 2011. It is clear that HMRC has approached third party exchanges like Coinbase for details about UK taxpayers with specific profiles. This should be a salutary warning to anyone who still believes that cryptoassets are 'off grid'.

Wrapping up

No, this isn't about Wrapped Ether (WETH). It's just a wrap up. You've made it to the end.

The above represents a quick romp through some of the areas that I see coming up that involve the ever-evolving world of crypto.

If invited back, I will look at some of these areas in a bit more detail!

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Andy is the author of Cryptocurrencies and other digital assets: Tax Law and Practice, published by Claritax Books (see <https://tinyurl.com/2p5rwuka>). Readers of HMRC EIP magazine can take advantage of a 20% discount by quoting code EIP23