

Cryptocurrency (Lecture B1362 – 14.41 minutes)

Cryptocurrency and the tax treatment of transactions is an area designed to make many tax advisors feel very old and out-of-date due to the complexity of the subject.

What is cryptocurrency?

If I tell you it is a peer-to-peer electronic currency, that makes it sound too simple. Although most people will have heard of Bitcoin, what about Ethereum, Tether, Terra, Cardano, Solano, Avalanche, Polkadot, Dogecoin, Cronos or Tezos (all in the top 50 currencies to buy on crypto.com as at the date of writing)?

To give you a sense of the size of the market, \$24Bn of Bitcoin was traded in the last 24 hours as of today. It is also a very volatile market with the price having fallen by around 50% in the last year.

There has also been the recent publicity about the failure of the FTX platform recently where investors have lost significant amounts of money (maybe as much as \$50bn). Some of those investors will be in the UK.

Tax treatment

However, what we really need to understand is how transactions are treated for tax purposes. There are an increasing number of questions being asked about the tax position and HMRC are also starting to get interested. Recent publicity suggests that they have 20 ongoing criminal investigations into cryptocurrency. It is unclear, however, whether those cases relate to the use of cryptocurrency to facilitate other types of tax evasion and money laundering or whether the investigations relate to the currency itself.

HMRC has recently published its 'Cryptocurrency Manual' although it is light on details in some key areas. It would be helpful if there was more guidance but it is acknowledged that this is a new area so there is bound to be many grey areas.

Trading or capital?

For most individuals, any profit made on trading in cryptocurrency will be capital in nature and so subject to capital gains tax. For anyone with a small holding the gain may be covered by the annual exemption so no tax will be due, assuming no other gains are made in the tax year. Significant gains will be subject to tax at 10% or, more likely, 20%. It is not going to be possible to argue, as some would like to, that any profit is tax-free on the basis it is similar to gambling.

The rules then follow the basic provisions as if they were any other asset. For example, if a client has lost \$1m on the FTX exchange, that would be a capital loss which would be available to set off against current year or future capital gains but cannot be carried back to offset against gains in previous years.

In some cases, HMRC might wish to argue that an individual is trading so the profits are subject to income tax. Whether someone is trading is determined by reference to the 'badges of trade' which is a complex area based on case law. HMRC are always reluctant to accept anyone who is dealing in financial assets, stocks and shares, contracts for difference and now cryptocurrency, is trading unless they are a regulated dealer or they are doing this as an integral part of a larger trade. This is mainly

because HMRC do not want losses generated to be able to be offset against wider income. It will depend on the facts of each case though.

In reality, you would need to be looking at large numbers of transactions, a degree of structure and organisation, and a significant commitment of time to even be close to being able to argue there is a trade.

Individuals will be liable to pay income tax (and possible National Insurance Contributions) on cryptocurrency that they receive from their employer or from certain other types of activities. Again, this is where it is all quite puzzling for the uninitiated.

'Mining' is where tokens are awarded to persons who are verifying additions to blockchain digital ledgers, typically by using computers to solve mathematical problems which generate new tokens. The same applies to 'Staking' where the ability to create new entry into the token register is determined by the size of the original stake. 'Airdrops' are where someone receives an allocation of tokens as part of a marketing or advertising campaign.

Any of these might be a trade (based on the badges of trade referenced above) or it might just be miscellaneous income. Airdrops might not even be taxable income if the person receives them without doing anything in return. Of course, any business which receives cryptocurrency in exchange for provisions of goods or services will be liable to tax on those as the value will be included as part of the trading profits. This may become more relevant in the future but it is not something which we are seeing very often at the moment.

If the profit is going to be taxed as a capital gain, the other point we need to consider is when is there a disposal? A disposal is going to occur when the cryptocurrency is sold for money, exchanged for different types of cryptocurrency, used to pay for goods or services or given away for no consideration. However, because of the strange nature of this new world, there are transactions which are not disposals. Currency can be split out into 'wallets' and moving the same currency from one wallet to another will not be a disposal. Gifts of cryptocurrency to charity would be free from capital gains tax under normal rules as long as none of the anti-avoidance provisions apply.

Another good question is what are the allowable expenses that you can deduct from the proceeds when calculating the gain? We are following normal principles here so you can deduct:

- The consideration originally paid for the asset;
- Transaction fees for having the transaction included on the relevant ledgers;
- Advertising for a purchaser or vendor; or
- Professional costs

Paragraph 22150 of the HMRC Cryptocurrency Manual explains that 'exchange fees' paid to perform transactions may or may not be allowable, depending on the exact nature of the fee.

Impact of residency

The final point to note generally is that you need to be careful about the situs rules for disposal of assets. Individuals who are resident in the UK but not domiciled may be able to claim remittance basis on disposals of foreign assets. However, it is the view of HMRC that cryptocurrency is located where the holder is resident. If someone is resident in the UK when they make any profit, that will be subject to UK tax. It is not relevant that they might have bought the cryptocurrency outside the

UK. It is uncertain as to whether you could argue that the server is outside the UK such that assets have a foreign situs, but the guidance suggests that HMRC will not accept that argument.

But how might this apply in practice?

Whilst those are the basic rules, you might be interested to here of a specific case I was asked about by a client as it shows some of the complexity associated with this area.

The initial question was ...

'I have a client who was paid in Flux for some data processing work. Income tax was paid on this. These Flux have gone up in value and are now standing at a profit of £300,000. Our client uses these as a trading asset and is looking to incorporate. Can we holdover the gain on the Flux on incorporation?'

My first question (having acknowledged that I was probably being very stupid) was how did he use the Flux as a trading asset? I had made an assumption that Flux was a cryptoasset of some type!

The first answer we got back was:

'If you hold a certain amount of Flux (currently 10000, 25000 or 100000) in a wallet you can then run a node and link the node to the network, the number of Flux determines the size of the node you can run and the size of the reward. The Flux is effectively locked as collateral whilst your node is running. A node could be a PC or a server. That node will then be awarded some Flux for being part of the network and will be used for running applications'

So, in essence, the Flux tied up in the node enables you to carry out data tasks which are paid with more Flux. You always retain ownership of the original Flux and you can always take it back (or sell it to someone else).

Whilst this clarified to an extent what it is, the next issue was that the answer did not really clarify the tax treatment if the client wanted to incorporate. My conclusion was that there were probably two options, assuming that the Flux is not some kind of trading stock, but I do not think that is the case.

The first is that this Flux is used as something like a licence which enables further work to be done which earns money for the holder. It is portal into a system which then uses your computer power for the purposes of the host business. If it were something like a licence, then I think you could claim holdover relief on incorporation.

However, there is a second alternative which is that this is effectively an investment asset which is generating a return similar to interest. It is a strange one though because whilst the return gained from this is passive (which is similar to interest) it can also be switched off if you do not have the node linked to the network. I suppose I would ask whether, in practice, the 'node' is always linked via the Flux held by the client (and I suppose I cannot see any reason why you would disconnect it given that it involves no real work from what I can see!).

The difficulty is that it is a struggle to see how this could be considered to be a trading activity which is what you would need to be able to prove so that the Flux currency itself is a capital asset being used for the purposes of the trade so that business asset disposal relief and holdover relief become relevant. It is probably the case that any income generated from the arrangement is going to be income but the capital gains position is not as clear.

My ultimate conclusion was that I didn't really know the answer but that there was a risk in transferring these assets on incorporation on the assumption that holdover relief was available. This is particularly true since we know that it is an area that HMRC are looking at.

Conclusion

The tax treatment of cryptocurrency is going to be determined by reference to general principles unless the Government put in place specific legislation to deal with these. The complexity relates to understanding exactly what is going on and what the terminology means. Once you can work that out, the answer may be relatively straightforward or it may be that it is impossible to give a definitive answer because the attitude of HMRC is not clearly expressed. An interesting area but maybe one where it is difficult to give clients certainty in relation to the tax treatment.

Where there is uncertainty, the key is to clearly document the reasoning for treating a transaction in a particular way as this will protect the client from penalties (on the basis that they took reasonable care in trying to work out the tax treatment) in the event that HMRC disagree with the way it has been reported.

Contributed by Ros Martin