Links in a chain

Large Corporate | OMB | Personal tax



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Tyler Welmans provides a comprehensive overview of the ways in which cryptocurrencies and blockchain technology interact with the tax arrangements of a variety of individuals and businesses

Key Points

What is the issue?

In its simplest form, a blockchain is akin to a database for recording transactions which simultaneously distributes the transaction information to all computers in the network, and contains links to the previous block.

What does it mean to me?

In ten short years blockchain has evolved from a single network (Bitcoin), into the hundreds of networks and many thousands of cryptoassets in circulation today.

What can I take away?

Tax professionals looking to position themselves to serve this new market should begin upskilling now if preparations are not already underway

It’s just over a decade since the arrival of Bitcoin and the cryptocurrency frenzy, and even the most passionate advocates couldn’t have predicted the level of attention this new technology would attract.

Although the progress has been far more chaotic than the history books will likely describe, in ten short years blockchain has evolved from a single network (Bitcoin), into the hundreds of networks and many thousands of cryptoassets in circulation today.

Cryptoassets (including cryptocurrencies), are programmable digital tokens created, stored and transferred using blockchains (a form of distributed ledger held in software on computers globally). The tokens can represent ownership of any underlying asset. Examples range from purely virtual crypto currencies such as Bitcoin, to tokens representing traditional currency (think dollars), gold, units of electricity, equity, financial securities and all manner of rights of ownership (property, cars, software etc).

In 2017 and early 2018, the notional value of all publicly traded cryptoassets in circulation rose above $800bn (£620bn based on the current exchange rate), before crashing dramatically through much of 2018. Today, that value stands at around £100bn – just over half of which is accounted for by Bitcoin – with anywhere between £5bn and £20bn changing hands on a daily basis.

In parallel, new variants of the technology have evolved to offer businesses a chance to get in on the action. The prospect of using shared platforms to track mutual trade documents, or even physical products through a supply chain, is attractive for businesses looking to improve transparency and reduce costs. These newer variants of business blockchain offer faster performance than public blockchain networks, and greater control over access to confidential data. According to Coindesk, over the past five years, more than £20bn has been invested in new ventures, through initial token offerings and traditional venture capital investment.

So, what should the forward-looking tax professional prepare for? We have prepared three case studies: the speculative investor, the tech start-up and the global manufacturing giant. Keep in mind that, in its simplest form, a blockchain is akin to a database for recording transactions which simultaneously distributes the transaction information to all computers in the network, and contains links to the previous block.

Case 1: The speculative crypto-currency investor

Perhaps the most well understood of all blockchain stories is that of the early investor: let’s call her Alice. Alice, who is UK resident and domiciled, spent £1,000 in 2012 to purchase 100 Bitcoins and has seen her investment grow some 40,000%. Alice now needs advice on how to appropriately handle the tax considerations as she plans to sell some of the assets. In this simplified case, the treatment is reasonably clear in most jurisdictions, with capital gains on disposal of cryptocurrency that was purchased usually taxable through existing asset disposal provisions.

Of course, the reality is more complicated. Alice may have executed hundreds of trades, including through margin trading and spread betting, she may have invested in hundreds of tokens, she may have lost some to phishing or hacking. Many of her tokens will have declined in value, and she may even have accumulated other tokens she does not know about (such as ‘Bitcoin Cash’ which was effectively credited to every holder of Bitcoin in August 2017). In the UK, HMRC have recently provided detailed guidance for individuals across a range of disposal scenarios, but it is safe to say specialist guidance will be required by many of the casual investors who have accumulated what may now be sizable crypto-portfolios.

Case 2: The crypto-funded start-up

Our hypothetical start-up, DeFi Ventures Ltd launched in 2016 to develop and proamote decentralised financial services. Amid great hype and with limited experience, they formed a corporate entity in Malta and conducted an Initial Token Offering in 2018. They issued 100 million DeFi tokens and sold them to investors worldwide, in return for the cryptocurrency Ether (ETH); the sale generated $50m in cryptocurrency. The company employs a dispersed group of developers based in six countries, several of whom are paid directly with cryptocurrency. The group opted to liquidate some of the token sale proceeds to cover operating costs, but retained most of the balance in cryptocurrency, which has subsequently dropped to half of its original value.

The DeFi team require detailed tax support in relation to appropriate treatment of the proceeds of their token sale (worth $50m of ETH). They also require support in relation to initial and ongoing conversions of cryptocurrency to regular money in order to cover operating costs. Additionally, they require support in relation to staff payments and related tax compliance.

This illustrative case clearly presents some complex scenarios; specialist support is needed to unpick the classification, valuation and treatment of new cryptoassets generated and received during the token sale, as well as in relation to ongoing disposals. Specialist employment tax advice is needed to make sense of appropriate payroll tax handling across several countries.

Case 3: The multinational manufacturer

X-Cars Plc, our third hypothetical case study, is a global electric vehicle manufacturer and has been exploring Distributed Ledger Technology for several years. X-Cars has developed a blockchain platform through which they plan to launch a digital vehicle network that will better connect suppliers, manufacturers and maintenance facilities with vehicles and the customers that own and use them. They intend to launch a service which will use digital tokens to enable a variety of innovative services. X-key tokens will be used to unlock/start vehicles, X-charge tokens will be purchased in advance and spent by owners to pay for electricity at specially designed vehicle charging stations.

Additionally, the company also plans to issue a variety of loyalty style reward-tokens such as maintenance discount vouchers and even cashback on certain purchases to vehicle owners, which may be in the form of either cryptocurrency or other ‘stable’

tokens designed to reflect fixed cash values. The company has a compliance workstream examining a number of different themes of risk and compliance, stretching from GDPR and data security through to accounting and the tax treatment surrounding different tokens. It is extremely cautious about the implications of this new platform. X-Cars is concerned that the introduction of various tokens presents complex compliance questions, and that ongoing tax and other analysis will likely affect the final design of the solution in order to ensure and simplify such compliance.

In perhaps the most complex scenario yet, it is clear that X-Cars is beginning to bump into questions that test the boundaries of existing policy and guidance. They will be among the first organisations to implement a network in which tokens representing a variety of financial and non-financial things which will be created and circulated among a very large consumer base around the world. Should these tokens be considered balance sheet assets, and should they be given valuation and tax consideration? How should vehicle charging transactions be taxed, and at what point? Another fundamental question is that of situs, the location of assets involved in a transaction, and even the location in which a transaction should be deemed to have taken place.

In a decentralised system designed to provide resilience and efficiency by spreading both data and governance across a wide area, rules designed for a centralised world can be hard to apply. Finally, what are the tax implications to vehicle owners receiving/sending/exchanging tokens of different types (cashback, unsolicited discount vouchers, vehicle access keys etc)? There are many challenges to be understood within the tax domain that will involve surveying relevant guidance across many geographies, and building a catalogue of reference case studies.

Momentum

Although our three examples are hypothetical, they are also representative of real activity. There is sufficient momentum in this industry for demand to stretch the availability of skilled advice in relation to crypto-tax treatment, for some years to come. We should also expect continued modernisation of tax law, which can deal appropriately with a changing world. In the meantime, policymakers are working to reduce complexity through improved guidance. Many EU policymakers appear to be aligning on a view that tokens may fall into three broad categories: exchange tokens (used for payments), utility tokens (typically used to enable to access some kind of

product or service) and security tokens (which can be akin to traditional shares, securities, bonds etc). While we should expect this to evolve, such categories are beginning to offer a basis against which different kinds of treatments can be set out and applied.

More than 60% of respondents to a Deloitte survey on blockchain expected to spend upwards of $1m on the technology over the next 12 months. Interestingly, much of this looks set to be spent not on developers, but on compliance. The obstacle most often cited to adoption was not the complexity of implementing the technology, but concern over regulatory issues.

While the initial implementation of blockchain and the regulation surrounding it can be tricky, the technology is set up to deliver the benefits of automation and real-time reporting, an eventual outcome for all global tax administration. Moreover, blockchain ensures the integrity of data so that a complete audit trail is maintained. All of this is delivered to multiple parties even if they are located in different countries, driving down the cost of compliance and ensuring symmetrical reporting.

In short, there is much to be accomplished in the field of compliance, and the applicable tax treatment is a vital piece of the puzzle. Tax professionals looking to position themselves to serve this new market should begin upskilling now if preparations are not already underway.