Bitcoin trading?

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Julie Butler reviews the taxation implications of bitcoin dealing

Key Points

What is the issue?

The understanding of bitcoin operations together with any hobbies that can earn (and lose) money from a tax viewpoint and how these activities are treated from a tax planning angle together with a compliance on tax returns

What does it mean for me?

The need to review bitcoin activity, and indeed all clients' affairs, on a case-by-case basis and to obtain strong evidence in each instance

What can I take away?

The importance of ongoing 'fact finds' of any changes and developments in clients' tax affairs, together with the need to request information from clients regarding all new activities, paying special attention to grey areas, unusual transactions and to support all claims with evidence

The bitcoin is an innovative payment network and a new kind of money. Bitcoin is a form of digital currency that uses peer to peer technology to operate with no central authority or banks.

'Bitcoin is seen as the world's first decentralised digital currency, otherwise known as a "cryptocurrency". The advent of cryptocurrencies such as bitcoin is a new and evolving area and determining their legal and regulatory status is ongoing. Cryptocurrencies have a unique identity and cannot therefore be directly compared to any other form of investment activity or payment mechanism.' (Revenue and Customs Brief 9 (2014), 'Bitcoin and other cryptocurrencies'.)

Clearly, all tax advisers now need to understand this new method of trading.

Is such activity a hobby or a trade?

There have been a number of recent tribunal cases on the question of whether an activity is deemed to be a hobby or trading, with only the latter falling within the scope of the taxation system.

In *ELJ McMorris* (TC 4204), the taxpayer bought a 50% share in a racehorse in February 2010 and agreed to meet half the costs of training, livery and racing. He then tried to claim the result as a trading loss, offsetting his other taxable income.

The First-tier Tribunal referred to the badges of trade described by Nicolas Browne-Wilkinson in *Marson v Morton* [1986] STC 463. The deal in the *McMorris* case was considered a one-off transaction; Mr McMorris 'clearly derived pleasure' from the project. The tribunal had no hesitation in deciding the taxpayer's activities did not amount to a trade – and, given the informality of the arrangements between the co-owners, ITA 2007 s 66 was not satisfied because the activities were not carried out on a commercial basis. Similar questions are now being asked about bitcoin activity on a case by case basis.

This review of whether an activity is classified as a trade or a hobby ties into the consideration process of the tax position of bitcoin.

Taxation of bitcoin

In HMRC guidance in Revenue and Customs Brief 9, they have specified that bitcoin profits have to be reviewed case by case with simple interpretation. The general guidance is:

- deliberate trading (known as bitcoin mining) – income tax;
- investment – CGT; and
- gambling – tax free but no tax relief on losses.

The business of bitcoin (bitcoin mining)

The guidance continues by stating:

'Corporation tax – the profits or losses on exchange movements between currencies are taxable. For the tax treatment of virtual currencies, the general rules on foreign exchange and loan relationships apply.'

'Income tax – the profits and losses of a non-incorporated business on bitcoin transactions must be reflected in their accounts and will be taxable on normal IT rules.'

'Chargeable gains: corporate tax and capital gains tax – if a profit or loss on a currency contract is not within trading profits or otherwise within the loan relationship rules, it would normally be taxable as a chargeable gain or allowable as a loss for CT or CGT purposes.'

Speculative bitcoin activity

The guidance continues further:

‘Depending on the facts, a transaction may be so highly speculative that it is not taxable, nor any losses recorded relievable. For example, gambling or betting wins are not taxable and gambling losses cannot be offset against other taxable profits.’

Gambling is ordinarily outside the scope of tax and so this ‘tax free’ treatment will follow with bitcoin activity.

In the UK, the guidance given by HMRC is that a trading activity will continue to be assessed on the basis of preparing profit and loss accounts to determine taxable profits; and the value of goods or services bought or sold using virtual currencies must still be accounted for at their market value or the exchange value of the virtual currency converted into UK pound sterling.

This is clear for an existing trader, but an individual holding bitcoin or other virtual currency may not be sure whether their investment or holding is taxable or whether the losses are allowable. If speculating on the coins increasing in value, it may be that this activity is seen as akin to gambling; and if HMRC agree there would be no tax due on wins, but no relief for losses either. If the virtual currency is held with the intention to create long-term wealth, then this is more in the nature of investment and the gain or loss on disposal or sale would be more likely to come into charge to tax as a capital gain. HMRC tell us that whether or not a profit or gain is chargeable, or loss-allowable, will be assessed case by case. Prospective investors should take advice on whether their activities would constitute a trade before they embark on.

Bitcoin and VAT

HMRC guidance clearly advises that the sales of virtual currency will not be subject to VAT. Income received from bitcoin ‘mining’– that is, the service of providing computer power to process transactions and secure the network for a fee – is generally outside the scope of VAT. Miners’ income in respect of other verification services is also exempt from VAT. The exchange of bitcoin for pound sterling, or other currencies, also does not attract VAT and neither does any charge over the value of the bitcoin for arranging or making the transaction. Supplying goods or services in the normal course of business and accepting payment in bitcoin will

mean VAT is still due in the normal way on the value of the supply.

The theme of the taxation treatment of bitcoin is derived from the understanding if the transactions are part of an ongoing trade; the ‘fact find’ of each operation will determine how much tax is charged.

Badges of trade

The *McMorris* case considered the badges of trade. In this regard, although bitcoins are considered a modern phenomenon, the guidance on badges of trade dates from the 1950s.
In June 1955, the Royal Commission on the Taxation of Profits and Income used these judicial decisions to establish what they regarded to be the following main criteria in identifying the badges of trade:

- the subject matter of the realisation;
- the length of the period of ownership;
- the frequency or number of similar transactions by the same person;
- supplementary work on or in connection with the property realised;
- the circumstances that were responsible for the realisation; and
- motive.

The review of the tax treatment of bitcoin case by case will also involve the review of badges of trade.

Trading with a view to realisation of profit

HMRC look closely at the offset of sideways loss relief against other income. *D Patel* (TC 4225) is a case that considers whether a real trade exists. The facts of *Patel* are that he was a social worker, employed full-time by a district council. In 2004, he began a business supplying ingredients and running cookery workshops. Three years later Mr Patel set up another business selling Indian art and photography. Neither business was profit making and the taxpayer claimed sideways relief in respect of the losses against his employment income. HMRC refused on the ground that Mr Patel had not run his businesses on a commercial basis.

The First-tier Tribunal found that the trades had begun as hobbies and never grew beyond that. Although some factors indicated a commercial approach by Mr Patel, such as the creation of professionally designed websites and the taxpayer taking steps to protect his trademark, the tribunal concluded that he had no clear idea of the level of sales, nor was he seriously interested in profits. Mr Patel's aim was to pursue his interests and share his love of Indian culture. The judge decided neither trade was carried on a commercial basis.

Clearly detailed business plans showing the ability of making a profit from the outset would have been useful in support of this case.

Action points

The activity of bitcoin has to be embraced and understood by tax advisers from the outset. Loss claims cannot be just 'processed' by tax advisers. The whole motive, subject matter and circumstances of realisation have to be examined. It is essential that there is evidence to support all claims. Any bitcoin operation has to be looked at on a 'case by case' basis, as do all sideways loss claims, which have to be dealt with on a 'loss by loss' basis. All loss claims must be supported by evidence and business plans.