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Cryptoassets: UK and US approach transactions in similar manner

The UK's tax authority, HM Revenue and Customs (HMRC), has recently published updated guidance on the tax treatment of cryptoassets. Kate Habershon, Neil McKnight and Nelson Yates II of Morgan, Lewis & Bockius examine the guidance and how it compares to the US's perspective.

HMRC's updated guidance, published in December 2018, explains how UK tax-paying individuals engaging in transactions involving certain cryptoassets are likely to be taxed. The guidance confirms HMRC's view that cryptocurrencies are not equivalent to currency, and gives examples of how certain crypto-specific transactions are likely to be treated by HMRC. In many respects the approach taken to the taxation of cryptoassets by HMRC is similar to that adopted in other jurisdictions, notably by the US Internal Revenue Service (IRS).

This is not the first time HMRC has produced guidance in this area. In 2014, it issued Revenue and Customs Brief 9 (2014), outlining at a high level certain aspects of its position on the capital gains tax, corporation tax, income tax and VAT consequences of certain dealings in Bitcoin and similar cryptocurrencies. Whilst much of this has since been reflected in HMRC's internal guidance manuals, at that time cryptoassets were still relatively new to the mainstream – a fact not lost to HMRC which, at the time, suggested that certain transactions in cryptoassets may be so highly speculative as to be analogous to gambling and so not taxable.

In many respects the new guidance reiterates the position of the 2014 brief: there is no special tax regime for cryptoassets and their tax treatment is determined by reference to general principles.

However, the guidance sets out HMRC's view on how the UK tax code should apply to certain specific cryptoasset transactions.

Whilst the guidance focuses on "exchange tokens" such as Bitcoin and other cryptocurrencies rather than utility tokens or security tokens, the general principles set out may also apply to dealings in other cryptoassets.

As a starting point, HMRC reiterates its view that cryptoassets are not money or currency, which is important when considering how to apply UK tax rules to cryptoasset transactions. For individuals,

HMRC expects that most taxable transactions in cryptoassets will be in the nature of an investment activity, so any gains or profits realised will be chargeable to capital gains tax rather than income tax.

The guidance does, however, set out a number of exceptions to this, such as where individuals mine cryptoassets or receive cryptoassets in exchange for goods or services – in both cases stating that the GBP-equivalent value of the resulting cryptoassets may be subject to income tax. This is consistent with the general principle that transactions must be translated into their sterling value before the resulting tax liability can be calculated.

HMRC states that transactions which are subject to income tax will normally be taxed either as miscellaneous income, or less commonly as trading income. The distinction will depend on the circumstances of the transaction (for example, repeated transactions where there is clear intention to realise a profit are more likely to be trading in nature) and is important because it will determine how taxable profits are calculated and also how losses can be used. This is in many respects similar to how HMRC approaches individuals transacting in shares and securities, where there is often a (rebuttable) presumption that individuals dealing in such assets are not carrying on a trade for UK tax purposes.

Individuals engaging in mining of cryptoassets should pay particular attention to whether they could be treated as carrying on a trade, which will depend on a number of factors including the degree of activity they undertake and their levels of organisation, commerciality and risk taking.

The guidance also confirms HMRC's unsurprising view that individuals who are remunerated for their UK employment in the form of cryptoassets will be subject to income tax (and possibly national insurance) on the GBP-equivalent value of the cryptoassets they receive. This raises questions for employers intending to pay their employees in cryptoassets, who will need to consider whether they need to account for income tax and national insurance under the UK's pay-as-you-earn (PAYE) payroll withholding system. This is likely to be the case if remuneration is in the form of cryptocurrencies that can be readily converted to conventional cash, and employers making such payments will need to remember that HMRC does not (yet) accept payment of tax in the form of cryptoassets and thus should make arrangements to ensure they recover cash directly or indirectly from employees to make good the income tax and national insurance liabilities, e.g. by withholding tokens and selling them on behalf of affected employees.

Perhaps most interestingly the guidance describes HMRC's view on how the UK tax code might apply to individuals engaging in certain crypto-specific transactions such as "airdrops" and "blockchain forks".

HMRC's view is that airdropped cryptoassets received by an individual who does not provide anything in return (e.g. where the cryptoassets are received as part of a marketing promotion), or otherwise than in the course of a business, may not be within the scope of income tax on receipt.

However, gains realised on a future sale or disposal of those cryptoassets would in principle be chargeable to capital gains tax.

Blockchain forks raise interesting tax questions, particularly in the case of a hard fork. HMRC's guidance suggests that such an event may not result in a 'dry' capital gain arising to individuals. Instead, the 'new' cryptoasset emerging after the fork would in principle be treated as an asset derived from the 'old' cryptoasset, although this does raise potentially challenging valuation questions. It is also welcome to see that HMRC is willing to accept negligible value claims where individuals lose their private key and are unable to enjoy their cryptoassets.

The future

HMRC has stated that it will issue guidance in the near future addressing the treatment of cryptoassets for companies and business. It is expected that this will address corporation tax and VAT concerns, and it is hoped that it will also provide further examples of HMRC's approach to certain specific transactions such as initial coin offerings (ICOs), which are gaining traction as a route to corporate fundraising.

It will also be interesting to see whether HMRC's position on the VAT treatment of transactions in cryptoassets and the extent to which they constitute 'economic activity' evolves as cryptoassets become increasingly important in commercial ventures.

What does seem clear is that the value of this guidance will be the extent to which it addresses more challenging questions, such as the interaction between accounting rules, corporation tax and cryptoassets, particularly when cryptoassets are held otherwise than as investments.

The US approach

There are similarities in the approach taken by the US IRS to that of HMRC when approaching transactions in cryptoassets.

The IRS published Notice 2014-21, 2014-16 IRB 938, five years ago on convertible virtual currency transactions, i.e. those virtual currencies that have an equivalent value in or act as a substitute for real currency. In that guidance, the IRS confirmed that certain virtual currencies, known as "convertible virtual currencies", were not to be treated as currency for US federal income tax purposes, which is a view shared by many tax authorities.

Instead, general principles of US taxation of property apply to transactions in these convertible virtual currencies. For example, as in the UK, the payment of salary or wages in Bitcoin would be taxable as ordinary income for the employee, and the employer may also be taxed on any built-in gain or loss, depending on the employer's basis in the Bitcoin.

However, in the light of developments in this area, the IRS guidance is somewhat out of date. It does not, for example, cover all cryptoassets (although HMRC's guidance is also limited to a particular sub-set of cryptoasset) and it does not address cryptospecific transactions such as blockchain forks and – as is also the case with HMRC's guidance – ICOs.

Whilst the IRS is not proposing to issue further comprehensive guidance in the near future, it has indicated that it will issue informal guidance soon. In the meantime, the IRS continues to focus on virtual currency transactions from a compliance perspective, for example, issuing "friendly reminders" to report transactions, issuing subpoenas to a virtual currency exchange, and announcing a "campaign" on virtual currency to target noncompliance.

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