ICAEW
REPRESENTATION 68/22

THE TAXATION OF DEENTRALISED FINANCE INVOLVING THE LENDING AND STAKING OF CRYPTOASSETS - CALL FOR EVIDENCE

Issued 30 August 2022

ICAEW welcomes the opportunity to comment on “The taxation of Decentralised Finance involving the lending and staking of crypto assets - call for evidence” published by HMRC on 5 July 2022, a copy of which is available from this link.

For questions on this response, please contact our Tax Faculty at taxfac@icaew.com quoting REP 68/22.

This response of 30 August 2022 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW’s membership. The Tax Faculty’s work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty’s Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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KEY POINTS

1. We appreciate the work that HMRC has done in recent years to develop its guidance relating to the taxation of crypto assets. This has been based largely on applying first principles established through existing legislation and case law.
2. The problem, however, is that the resulting regime is not workable. The number of transactions carried out in the crypto asset space is significantly more than through more traditional activities. This makes the current regime unworkable if each transaction results in a taxable gain or loss.
3. There is a long-term need for a brand-new regime for crypto assets as a whole to make compliance possible for everyone. This must include making some transactions tax-nothings until value is received in the form of 'real' currency. In the shorter term, the taxation of Decentralised Finance transactions should be reviewed as a priority.
4. Not only does the current regime make it hard to comply, it is also acting as a disincentive for businesses to set up crypto hubs in the UK, which is contrary to the government's aims.
5. Some of the outcomes arising under HMRC's current interpretation of the rules include dry tax charges, as well as gains arising where, when you look at the transaction as a whole, the taxpayer has made a loss.
6. We have set out below the treatment of Decentralised Finance transactions in crypto assets in Estonia. We believe that this treatment produces a fair and proportionate tax outcome and could therefore be adopted in the UK.

ANSWERS TO SPECIFIC QUESTIONS

Question 1

HMRC would like more information about the UK DeFi (Decentralised Finance) lending and staking sector. Please provide any information you hold that is relevant to the questions [in the call for evidence]

7. We do not have sufficient expertise to be able to answer this question.

Question 2

Bearing in mind that UK individuals are subject to the same tax treatment for DeFi lending and staking wherever the platforms they use are located, does the current tax treatment make the UK less attractive to platforms as a place to do business? If so, which jurisdictions are favoured and why?

8. If the tax treatment is dependent on the tax residence position of the individual user rather than where the platform is located, this has a greater impact on whether individuals retain their UK residence, rather than whether platforms relocate outside the UK. Users of crypto exchanges are likely to be more internationally mobile than other individuals and therefore be able to affect their residence position by, for example, limiting the number of days they spend in the UK during the tax year.

Question 3

Approximately what proportion of DeFi lending and staking transactions give rise to disposals for tax purposes under the current rules?

9. We do not have the information needed to answer this question accurately, but we assume that it is a high proportion. We also know there to be significant non-compliance with the existing regime, largely because taxpayers are unaware that their activities are resulting in

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taxable transactions. HMRC's interpretation often leads to counter-intuitive results and HMRC's own research shows that even the most well-informed of taxpayers are unaware of these.

Question 4

Of the transactions giving rise to the disposals, what proportion would fall within the (i) Repo rules and (ii) Stock Lending rules, if crypto assets were treated as securities?

10. We do not have the information needed to answer this question.

Question 5

Do you favour changes to the current rules?

11. We favour change to the current rules as they fail to meet any of our ten tenets (see Appendix I):
    1. There has been no previous consultation on the taxation of crypto assets and we welcome this opportunity to consider changes to the regime.
    2. The statutory rules being applied were not drafted with these transactions in mind and so cannot be targeted at them.
    3. Instead, the current treatment has been developed by applying general tax law and developing HMRC guidance based on first principles. A separate statutory regime is needed to set out the tax treatment in this area and would provide more certainty of treatment both for taxpayers and for HMRC.
    4. The lack of certainty in this area is exacerbated by the distinction made between transactions where beneficial ownership is or is not transferred to the crypto exchange. This can be difficult to determine in some cases and because it is a new area, there is a deficit of case law to draw on.
    5. Making a distinction between types of transactions based on beneficial ownership creates complexity and means that taxpayers are often not aware of the correct treatment of their transactions, or that there is any tax consequence at all.. HMRC's research on this in February 2022 shows that many taxpayers do not appreciate that a normal disposal of crypto assets has tax consequences.
    6. The current regime relies on valuation of the underlying crypto assets and the return gained from lending them. Valuations can be inherently subjective which means that taxpayers' liabilities are not easy to calculate.
    7. As the nature of crypto transactions continues to evolve, the existing tax code will become increasingly out of date and fail to reflect the way these transactions are carried out.
    8. There is currently no facility for the rules applicable to crypto assets to be adapted to match changing practices and circumstances.
    9. The current rules are not fair in all cases as they often result in 'dry tax charges' where taxable gains arise without disposal proceeds being realised from which tax liabilities can be paid.
    10. Although we believe that the main impact of the current rules is to encourage affected individuals to become non-UK resident, they also fail to reflect the current nature of crypto transactions and therefore leave the UK behind the curve compared to other countries.

Question 6

- ***Do you consider Option 1 to be a suitable model for DeFi lending and staking transactions? What are the pros and cons?***

- ***If appropriate, should the Repo, the Stock Lending or both regimes be expanded to apply to DeFi transactions?***

12. The advantage of adopting option 1 is that it would require minimal change to the tax rules as it would merely involve including crypto assets within the definition of securities.
13. However, while there would be benefits to taxpayers from applying an existing regime to crypto assets, we do not believe that crypto assets are similar to securities and so this feels a little like a sticking plaster solution to a bigger problem.
14. Securities are defined at s263AA (8) TCGA 1992 as:
    - (a) shares in a company wherever resident,
    - (b) loan stock or other securities of—
        - (i) the government of the United Kingdom,
        - (ii) a local authority in the United Kingdom,
        - (iii) another public authority in the United Kingdom,
        - (iv) a company resident in the United Kingdom or other body resident in the United Kingdom, or
    - (c) shares, loan stock, stock or other securities issued by—
        - (i) a government, local authority or other public authority of a territory outside the United Kingdom, or
        - (ii) another body of persons not resident in the United Kingdom.
15. In summary, securities are interests in companies or instruments issued by government bodies in the UK or elsewhere which can be tracked publicly. By contrast, crypto assets are assets of value that do not provide any interest in a company and have not been issued by a government body.
16. In addition, treating crypto assets as securities for purposes other than DeFi transactions could have unforeseen consequences and so should be avoided.
17. While option 1 would address scenarios where DeFi transactions mirror stock lending and sale and repurchase (repo) arrangements, it is possible that in the future other forms of transactions are entered into which do not neatly mirror these arrangements. Further amendments may then be required to reflect these transactions in the tax code. It appears to us that a broader brush approach is required where crypto assets are more broadly taxed on the basis of the economic reality of the arrangements.

Question 7

- ***Do you consider Option 2 to be a suitable option? What are its pros and cons?***
- ***Should the new rules be modelled on the Repo rules or the Stock Lending rules, or would both sets of rules be needed to cater for different contractual arrangements?***

18. The advantage of option 2 over option 1 is that a separate definition of crypto assets could be inserted into UK tax law which could then pave the way for a more comprehensive, brand-new code relating to such assets.
19. However, the problem with Option 2 is that it would treat the whole of any return derived by the lender from DeFi activities as income akin to interest. We understand that part of the return arising from such transactions could be capital in nature (ie the rise in value of the crypto assets during the time that they were lent to the exchange). We are keen to ensure that this part of the return is not taxed as income and indeed is not taxed as capital either until the crypto asset is ultimately disposed of.

Question 8

Do you consider Option 3 to be a suitable option? What are its pros and cons?

20. Option 3 (no gain/no loss treatment) has some appeal because it is a well-trodden path within TCGA and so is likely to be easily understood by tax advisers and well-informed taxpayers.
21. However, one of the issues that often arises with no gain/no loss treatments is that they need to be elected into or they require the tracking of base costs so that an overall gain or loss can be calculated when there is an overall disposal of the asset concerned. We recommend that both of these outcomes are avoided. Instead, if the regime were to treat DeFi transactions as not involving taxable disposals (ie treating them as tax nothings for CGT purposes) until the ultimate disposal of the assets for 'real' currency, this would solve the problem that the current regime produces and would be a workable first step towards a more comprehensive crypto asset tax regime.

Question 9

Are there alternative approaches to the taxation of DeFi lending and staking that have been adopted by other jurisdictions that the government could consider? If so, please provide more details and reasons.

22. We have performed some research into the taxation of crypto asset lending in Estonia (this is a good example because Estonia has embraced the digital world probably more than any other European country). See here for a summary prepared by the Estonian tax authority.
23. In Estonia, where an individual lends or stakes cryptocurrency, this is not considered to be a taxable event, whether or not the value of the currency has changed between the date of acquisition and the date of lending. Similarly, if the same amount of cryptocurrency is returned by the borrower in the same form as originally lent, this not a taxable event either, whether or not the value of the cryptocurrency changed during the period of lending. However, if the value is returned in cash rather than cryptocurrency and the amount returned in euros exceeds the acquisition price of the cryptocurrency granted for the loan, it is treated as a profitable disposal of cryptocurrency. The moment of taxation is the moment of repayment of the loan. We recommend that a similar outcome is treated as a capital gain or loss in the UK.
24. If the lender receives some additional form of return for the lending of the cryptocurrency this is treated as interest and taxed as income.
25. We believe that this capital/income split reflects the economic reality of the arrangements and that it should be adopted as the tax treatment in the UK also.

Question 10

Besides the options outlined above, are there any further options for change that the government could consider?

26. In the longer term, we encourage HMRC to carry out a wholesale review of the tax treatment of crypto assets, with a view to introducing a more comprehensive regime that covers all known transaction types in this space and meets the ten tenets.
27. We are conscious of the increasing volume of tax law (for example the introduction of the multinational top up tax next year, which will add another 100+ pages to the tax code) but we believe that the unique nature of this area deserves its own rules.
28. While we appreciate the impact that HMRC's guidance has had in helping to clarify HMRC's views on the tax treatment of crypto assets, we believe that the general tax code is not fit for

purpose in determining the correct treatment of these assets in all situations and so further legislation is required to clarify this.

29. In our opinion DeFi is not the only crypto taxation area where there are issues. To make the UK a centre for digital assets a general review of the tax law should be undertaken. This would include:

    a) Source and situs (the current HMRC view of situs makes the UK very unattractive to non-UK domiciled individuals).

    b) The situations where:

        i. crypto assets of one class (eg Bitcoin) are exchanged for assets in a different class (eg Ethereum)

        ii. a crypto wallet is assigned to another person (eg an individual's personal company)

Question 11

How could the government be confident that any proposed rules would not discriminate in favour of users of DeFi services?

30. We are not sure what concerns you have here that would lead to the conclusion that the proposed rules would discriminate in favour of users of DeFi services. If you could elaborate, we can consider whether we share this concern.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).