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The taxation of Decentralised Finance involving the lending and staking of cryptoassets - call for evidence

Response by the Chartered Institute of Taxation

1 Executive summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, including our Low Incomes Tax Reform Group (LITRG) and extensive volunteer network, in providing our response.

1.2 We think the Government should undertake a complete overhaul of the legislation and guidance concerning cryptoassets and their recognition and treatment by the UK tax system – for both direct and indirect taxation, to ensure no one tax is looked at in isolation with others left behind. Whilst some of our members' clients are engaged in Decentralised Finance (De-Fi) investments and/or have other investments in cryptoassets, many investors will be unrepresented. Aspects of the tax system as it currently applies to cryptoassets can be challenging for advisors, particularly with regard to the amount of research that must be done to determine an individual's tax position and the level of reporting required. We expect that unrepresented taxpayers would find the present system difficult to understand and comply with, which we consider creates a significant risk of non-compliance. It is worth noting that recent HMRC research found that 10% of UK adults said that they hold or have held a cryptoasset, and 16% of UK adults considered it very or somewhat likely that they would acquire cryptocurrencies in the future. This means that a significant and growing proportion of the population have investments in this area, and so the tax system should be well designed to enable often lay and unrepresented taxpayers to understand their tax position and be able to comply with their obligations[1].

1.3 The existing tax law does not cater well, or even practicably, to the unique nature of cryptoassets, largely because of the very large number of transactions that can take place and because so many of them take place without any commercial realisation of the profits arising. There is also the volatility of the asset values, even

[1] According to Kantar research '*Individuals holding cryptoassets: uptake and understanding*', February 2022 commissioned by HMRC. https://www.gov.uk/government/publications/individuals-holding-cryptoassets-uptake-and-understanding

by comparison with volatile conventional assets such as shares. Consequently, simply seeking to treat them analogously with traditional assets such as shares/securities is unlikely to work. Examples of the challenges in this area include:

- Cryptoassets are subject to the same cost pooling rules as shares, but there can hundreds of daily transactions, adding up to thousands (maybe more) annually – keeping track of such transactions as the pooling rules require is almost impossible.
- De-Fi lending and staking are challenging as they require a significant amount of analysis of often numerous transactions. From an investor's perspective, it is commonplace for tax liabilities to arise even where no fiat currency (i.e. cash) has been received, which is perceived as a dry tax charge. Although dry taxes are, to some degree, an inevitable part of the tax system, for them to apply on such a widespread and systematic basis can be challenging for individuals to understand and, in some cases, to pay. Many of the investors will be young and have no savings outside of cryptocurrency to pay tax on gains arising on tokens within the decentralised ecosystem.

1.4 Implementation of any of the three options put forward in this consultation would probably be positive; on balance we would see option 2 as a front runner, but fundamentally we think the government needs to start with a blank piece of paper and draft new legislation and guidance specifically tailored to address cryptoassets and their unique nature i.e. the flexibility in which they can be used, the potential number of transactions involved, their propensity to occur without commercial realisation, and the volatility of asset values. With respect to lending and staking of cryptoassets, we would prefer to see these De-Fi transactions removed from the ambit of CGT altogether, including the reporting requirements, until the assets are sold/exchanged and their value is realised. The CIOT is very keen to continue assisting the government/HMRC by giving our input into the development of this.

1.5 Aside from tax and administration, there is a wider concern that the difficulties around application of tax rules to cryptoassets lies in tandem with lack of sufficient and effective regulation of them. Whilst large corporates who 'mine' and deal in crypto could be considered largely immune from the inherent risks, there is little in the way of consumer protection for the wider public. Life savings can be lost by investing in crypto and the lack of wider education and advice means that investments may often be based on hype and misinformation; it is akin to gambling for some people. Many will be sitting on losses from investments into fraudulent projects but have not sold their tokens (the fees to do so probably exceed the token value) but are not aware of the possibility of negligible value claims, another complicated area. Investments/trading in these assets are subject to little in the way of regulation and providers can liquidate holdings with no notice or recompense, and some of the most vulnerable people in society could be hit hardest by this.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through LITRG, the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

2.5 Our stated objectives for the tax system include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

3 Introduction

3.1 As part of the government's strategy towards the FinTech sector, this consultation focuses specifically on the lending and staking of cryptoassets within De-Fi. The government acknowledges that the existing CGT rules do not fit well with the unique nature of these assets - in particular the current rules/guidance consider that a tax point often arises due to a change in the beneficial ownership of the asset, which is very different from how it is perceived by investors, especially in relation to lending and staking.

4 The UK De-Fi lending and staking sector

4.1 The government's willingness to understand more fully the cryptoasset industry, and that of De-Fi platforms more specifically, is certainly very welcome and, we hope, indicative of a constructive and collaborative approach with CIOT and other professional bodies to resolve the current uncertainties and anomalies.

4.2 However, we are unable to answer question 1 and provide details of specific platforms and statistics about wider investors and their investments. These are details to which, as a professional body, we do not have full access. Even if we did, another reason why this is a difficult question is that the market and industry as a whole is developing so fast, it would far too difficult to give this sort of data which HMRC/the government could rely on. We would point out that the Kantar research[2] (cited above) gives a good general picture of investors' interaction with De-Fi platforms. The FCA would have a better overview of UK De-Fi platforms and their activity/user base.

[2] Ibid – section 6

5 Existing tax treatment of lending and staking

5.1 The focus in this part of the consultation is on lending and staking. The two concepts are very similar, with lending involving people seeking crypto loans and using a De-Fi platform in the same way as borrowing from a conventional bank. Staking involves locking up cryptoassets for (usually) a short period of time to help keep a blockchain running. In both instances, rewards are received in return for the temporary loaning out of the asset. In order to determine whether there is a disposal for tax purposes, HMRC looks (understandably, in terms of the legal position) at whether beneficial ownership has been transferred – the main criterion when considering whether a disposal for CGT purposes has been made. Apart from the fact that that on this criterion there might be many successive disposals, the lack of clarity over the terms of the contracts entailed by engaging on these platforms (itself perhaps associated with the lack of regulation) is another factor impeding the tax analysis of what has happened. But almost all transactions currently give rise to at least an initial disposal. As with staking, taking out a De-Fi loan and providing collateral is also treated by HMRC as a disposal for CGT purposes.

5.2 The options which the consultation have put forward are:

- Option 1 - Legislate to bring De-Fi lending and staking within the Repo and Stock Lending rules by De-Fining cryptoassets as 'securities'.
- Option 2 - Legislate to create separate rules for De-Fi lending and staking, along the lines of those applicable to repos and stock lending.
- Option 3 - Apply a 'no gain/no loss' treatment to De-Fi loans and staking, deferring the tax liability until the assets are economically disposed of.

5.3 **Question 2. Bearing in mind that UK individuals are subject to the same tax treatment for De-Fi 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?**

5.4 The current reporting requirements, aside from dry tax charges, certainly make UK a less attractive place of residence for investors from a tax reporting perspective (assuming they know about their obligations and strive to be compliant – acknowledging that for many individuals at least one of these conditions will not be met). In the case of UK non-domiciled individuals, there is also a tax discrimination against investment in cryptoassets as compared with traditional assets (which also translates into a substantive tax disadvantage of UK residence). This is because of HMRC's position that the remittance basis is unavailable to interests in cryptocurrencies (HMRC have not yet specifically commented on the availability of the remittance basis in the context of De-Fi arrangements). Recent changes to HMRC's approach to collateral loans (whereby the total value of the collateral asset purchased with untaxed foreign income/capital is deemed to have been remitted) could also have a detrimental effect; this change in approach potentially taxes individuals on the full value of the asset against which loan monies remitted to the UK were borrowed. All these factors have a knock-on effect on the growth of UK platforms, as they might be expected to be a natural choice for UK investors and might be expected to look out for the likely tax treatment of UK investors engaging with them (albeit that they only do so, and perhaps can only be expected to do so given the complexity of the issues, to a limited extent). We also understand that many prospective De-Fi lending protocols find the process of applying to the FCA for a licence onerous. It is difficult to obtain approval.

5.5 Two examples of more-favourable environments for cryptoassets are Germany and Switzerland. If German investors hold cryptoassets for more than a year then no taxes are due on sale, swap, stake, loan or spend;

for less than a year, gains are chargeable to income tax, but only if the value exceeds €600[3]. Switzerland likewise regards cryptoassets as 'private wealth assets' and so are not subject to income or capital gains taxes at all. Neither Switzerland nor Germany has specific laws governing cryptoassets, rather they have merely classified it as a type of asset (i.e. 'private') which is already tax-free to some extent under more general rules

5.6 The tax system in the UK is viewed by many in the De-Fi/crypto space as punitive and we have the impression that some individuals with large gains relocate to places such as Dubai before crystallising gains. There may be a number of compliance issues around this scenario, but it is indicative to some degree of investor perceptions.

Question 3. Approximately what proportion of De-Fi lending and staking transactions give rise to disposals for tax purposes under the current rules?

5.7 We are unable to provide an answer to this. One reason is simply because the number of transactions, which are likely to be considered as disposals for tax purposes, needs to be counted in the hundreds-of-thousands, even millions. The reality is that it is not practicable for the tax treatment to be dependent upon the transfer of beneficial ownership and the number of transactions, as the law does with other assets. This concept simply does not reflect the commercial reality of the nature and operation of cryptoassets.

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 cryptoassets were treated as securities?

5.8 We cannot answer this question because it is not comparing like with like. Cryptoassets are not securities, and by trying to compare them with specific assets and fit them into existing legislation for those assets, in the majority of cases it is not sufficiently clear what the analysis would be, as there are too many supplementary assumptions that would have to be made. The US SEC is looking at whether cryptocurrencies should be classified as securities or commodities from a regulatory perspective. This could impact the tax treatment, certainly in the US, moving forward. The classification will largely be driven by whether there was an ICO (Initial Coin Offering), which would suggest that the token will be a security. The ongoing legal battle between Ripple (XRP) and the SEC should give some further clarity once concluded.

Question 5. Do you favour changes to the current rule?

5.9 Yes, we do. Cryptoassets are a unique type of asset which are not suitably accommodated by existing law. One element of the solution, that seems to us inevitable, is to remove from immediate taxation altogether those transactions which make up lending and staking of cryptoassets. This would provide a highly necessary simplification of the regime, particularly for 'ordinary' (i.e. small scale) investors who will otherwise continue to struggle to understand and comply with their ongoing CGT obligations. There are however a series of questions around potentially charging investors to income tax on the rewards earned, and/or charging CGT on the gains from the assets once commercially realised for fiat currency (or, potentially, other cryptoassets) or perhaps on other occasions. The answer to these questions should be driven (assuming the government wants to keep a high-level neutrality between investing in crypto and traditional assets?) by what rules would create a broadly comparable tax and administrative burden on resident crypto- and traditional investors, bearing in mind the different nature of the two types of assets.

[3] Section 23 Einkommensteuergesetz (German Income Tax Act)

Question 6. Do you consider Option 1 to be a suitable model for De-Fi 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 De-Fi transactions?

5.10 Bringing De-Fi transactions within the repo or stock lending regime would certainly aid simplification by taking CGT and effective beneficial ownership transfer out of the equation and treating these transactions more like pawning or as simple loans.

5.11 The only real downside to this option would be the administration involved in analysing and, where required, reporting the many transactions. Whilst there would be a reduction in the number of transactions treated as a disposal potentially triggering CGT liabilities, we think that the terms of each transaction would still feed computationally into the final tax position, leaving a significant administrative burden in identify and report them – as well as broader issues such as whether the activities are 'trading' for tax purposes.

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?

5.12 This would likely be our preferred option – a completely new set of rules applicable to staking and lending cryptoassets which recognises their unique nature. Indeed, we think it would be preferable to look at a set of rules applying to crypto assets in general. The repo/stock lending rules are probably the closest set of existing rules which would suit the nature of De-Fi transactions, but any new rules should be such as to remove any reporting or computational requirements as well as tax charges from such individual transactions. Once crypto holdings are sold or exchanged then a CGT charge should be crystalised, but individual lending and staking transactions should not be the computational building blocks of the final tax position, in order to achieve simplification in what is an excessively complex area (on a step scale above the general level of complexity in the tax system).

Question 8. Do you consider Option 3 to be a suitable option? What are its pros and cons?

5.13 As with option 2, there is a case to be made for extending this approach to investment in cryptoassets at a more general level, perhaps treating all assets on a given platform as a composite asset. As with option 1, the main advantage of option 3 is that there are no longer systematic 'dry' CGT charges on a scale which is difficult even to compute. However, this option will suffer from the same downside as option 1, in terms of the reporting and computational burden, unless the CGT charge can be calculated by reference largely to the commercial realisation of the profit as a taxpayer would typically recognise it, rather than to amounts generated in the myriad of earlier transactions on which tax had been 'deferred'. The potential disadvantage from a broader policy point of view is then whether cryptoassets then unduly favoured as compared to conventional assets in terms of their tax treatment, bearing in mind that the effective burden of CGT is very much influenced by the scope of the investor's/taxpayer's ability (or otherwise) to defer or limit taxable disposals.

Question 9. Are there alternative approaches to the taxation of De-Fi lending and staking that have been adopted by other jurisdictions that the government could consider? If so, please provide more details and reasons.

5.14 The government could adopt the German or Swiss approach, whereby cryptoassets held as investments generally are outside of the scope of taxes altogether or at least to some degree, but we recognise this is may not be a realistic or fair approach in the context of the UK's tax regime.

Question 10. Besides the options outlined above, are there any further options for change that the government could consider?

5.15 We repeat what we have already outlined in various parts in our response, that is we would urge the government to remove individual De-Fi lending and staking transactions from entering into CGT (and income tax) calculations altogether, in order to ease the tax and administrative which are threatening to undermine compliance, and very burdensome where compliance is attempted. The need is to attempt to define a tax outcome that can be identified and computed from the commercial realisation of the profits (or losses) achieved. In our view, this approach strikes a good balance between fairness and administrative ease for investors along with helping to attract foreign investors into the UK, whilst also not giving an unfair advantage to cryptoasset holders against other investments and not depriving the Exchequer of CGT from commercial realisation of value.

Some other elements of proposals for change which could be considered include:

The rewards received as part of lending/staking. These are currently subject to income tax, but potentially CGT as well depending on how it is received. Given the volatility of the value of cryptoassets and typically, the lack of commercial realisation of interim profits, it seems to us that the return on investment is more in the nature of a capital return than is the case with income flows from conventional assets. Taxing the income element is not administratively problematic but computing it as distinct from the capital element would be under options 1 and potentially 2: on the other hand, computing capital gains under current rules is highly problematic. Hence our preference for special rules to compute an overall capital return.

General crypto exemption. As alluded to in question 9 above, the government could consider introducing CGT and/or income tax exemptions to cryptoassets generally; this need not be a blanket exemption but rather based on a minimum length of investment and/or amount invested, along German lines. However, in a UK context this would lack even high-level comparability with the treatment of traditional assets.

Situs. Due consideration should be given to the source and situs of cryptoassets – both regards to what the law is as it stands (HMRC's present guidance is restricted to commenting on the situs of exchange tokens such as cryptocurrencies and numerous practitioners consider that HMRC's guidance is incorrect) and with regards to what the law should be (HMRC's present position based on tax residence means that UK resident, non-UK domiciled individuals are always ineligible for the remittance basis, whereas the remittance basis is typically available in relation to other types of asset classes). Therefore, the tax system, as it stands, seems to discriminate against non-UK domiciled individuals investing in cryptoassets compared to other asset classes. That said, digital assets are intrinsically different to shares and property in the sense that they sit on a blockchain, which is accessible to all investors, no matter where in the world they are located. The tax rules around domicile are geographically based and as such, may not be appropriate to blockchain assets such as NFTs and cryptocurrency. It is very difficult to assess meaningfully the true location of many of these assets. Crypto goes beyond national boundaries and is viewed by those in the space as a 'one world' alternative to fiat currency. It may be necessary to look for a solution which imposes a comparable tax and administrative burden overall rather than to seek to apply traditional concepts to a crypto world.

Tax rates. A further possibility would be to apply different tax rates to crypto profits, again so that the overall burden is comparable. What level these should be set at would depend on the other rules and in particular on the 'natural' frequency of disposals under the regime proposed, and the practical ability (or otherwise) of the taxpayer to control or defer these as compared with the position for conventional assets.

Deemed disposals (see next question).

Question 11. How could the government be confident that any proposed rules would not discriminate in favour of users of De-Fi services?

5.16 In the context of option 2, it may be reasonable to defer any taxation till the point of commercial realisation (acknowledging this would need to be properly defined), given;

- the volatility of the asset values and therefore tentative nature of any gains,
- that one cannot (as yet anyway) readily 'live off' cryptoassets without conversion into fiat currency, and
- when cryptoassets are staked or loaned, the taxpayer significantly loses control over the direction of investment, so it is reasonable to apply the sort of capital gains 'wrapper' that applies to, say, authorised unit trusts in the traditional investment space, and only look to treat as a disposal the withdrawal of investment from the structure. A comparison with a conventional share portfolio (where one does tax gains even if proceeds are reinvested in other shares) would not be apt because of this lack of investor control.

However, if (as we think should be happen), broader consideration should be given to the treatment of crytoassets generally (as many of the issues identified are not confined to staking or lending), the question arises as to whether there would need to be occasions of deemed disposals to prevent investors from deferring taxable disposals indefinitely, leading to a discernibly lower overall level of taxation than on traditional assets. There would be difficult issues of getting 'rough justice' overall between crypto and traditional assets given that different rules would apply to each. However, it is worth noting that even in the scenario of annual deemed disposals (which would perhaps be a very severe regime for some taxpayers bearing in mind the volatility issue) it is likely that very many investors would escape tax and reporting requirements altogether due to the Annual Exempt Amount and related reporting rules. This would also remove the discredit to the tax system that would occur if widespread non-compliance (which seems a real practical risk) takes hold as the market grows and develops further.

We are hesitant (on grounds of the preferred simplicity and neutrality of the whole tax system) to propose a distinct and separate regime for cryptoassets, but such a choice seems the only way of achieving a treatment that is practicable and will neither undermine compliance nor discriminate in practice against crypto and impede its development. However, if a regime is designed in order to impose a broadly equivalent level of tax burden and a reasonable administrative one, it may in the long term offer the possibility of the new rules becoming, in some respects, a model for reform of the system applying to conventional assets.

6 Acknowledgement of submission

6.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

6.2 We would like to engage with the government/HMRC further on this matter including holding meetings with those concerned.

The Chartered Institute of Taxation

31 August 2022