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The taxation of decentralised finance (DeFi) involving the lending and staking of cryptoassets

Response by the Chartered Institute of Taxation and Association of Taxation Technicians

1 Executive summary

1.1 The Chartered Institute of Taxation (CIOT) and Association of Taxation Technicians (ATT) are pleased to have the opportunity to respond to the HM Revenue and Customs consultation document ('the consultation') on the *taxation of decentralised finance (DeFi) involving the lending and staking of cryptoassets*, issued on the 27 April 2023.[1]

1.2 The 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, as well as our Low Incomes Tax Reform Group (LITRG) and extensive volunteer network, in providing our response.

1.3 The ATT is a charity and the leading professional body for those providing UK tax compliance services. Our primary charitable objective is to promote education and the study of tax administration and practice. One of our key aims is to provide an appropriate qualification for individuals who undertake tax compliance work. Drawing on our members' practical experience and knowledge, we contribute to consultations on the development of the UK tax system and seek to ensure that, for the general public, it is workable and as fair as possible.

1.4 The CIOT and ATT welcome these proposals, which reflect the reality of a number of DeFi transactions and only bring capital gains tax (CGT) into effect once the value of an asset is realised. Not only will these proposals remove the potential for 'dry' tax charges in a number of situations, they will ease the burden of reporting those transactions, thus simplifying the regime. (Given the volume of transactions which it is possible to create via automated trading protocols, dealing with the sheer numbers of transactions can be a serious practical issue, even for investors with relatively modest portfolios.) However, we still consider there is a need for a wider, bespoke set of rules for cryptoassets.

[1] https://www.gov.uk/government/consultations/the-taxation-of-decentralised-finance-involving-the-lending-and-staking-of-cryptoassets

1.5 As a separate issue, we are also concerned about the challenges of highlighting potential tax consequences to unrepresented investors.

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 primary charitable objective of the ATT is to promote education and the study of tax administration and practice. We place a strong emphasis on the practicalities of the tax system. Our work in this area draws heavily on the experience of our members who assist thousands of businesses and individuals to comply with their taxation obligations.

2.3 The CIOT's and ATT'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.

2.4 The CIOT and ATT 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.

2.5 CIOT members and Fellows have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA' and 'CTA(Fellow)' respectively, to represent the leading tax qualification. ATT members and Fellows use the practising title of 'Taxation Technician' or 'Taxation Technician (Fellow)' and the designatory letters 'ATT' and 'ATT (Fellow)' respectively.

3 Introduction

3.1 In response to the first consultation on DeFi lending and staking, the CIOT expressed a preference for there to be a complete overhaul of the tax rules regarding cryptoassets generally. We gave a detailed response outlining some of the options undertaken in other jurisdictions and how a tailored set of rules would lead to a simpler, clearer and more efficient regime. With respect to lending and staking in particular, we recommended that transactions within DeFi should be outside the scope of CGT until the cryptoassets are genuinely disposed of and their value realised ie when exchanged with fiat currencies, or for other non-crypto goods and services. We were concerned too, that having transactions with DeFi subject to CGT (even as no-gain/no-loss) could cause huge difficulties amongst taxpayers and their agents in identifying and reporting any gains.

3.2 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.

3.3 We will not be answering the questions within this latest consultation document directly, rather we will give our thoughts to these proposals in light of these objectives.

4 Economic disposal of the assets

4.1 The crucial change with these proposals is that CGT will be disregarded when the asset is disposed of as part of lending or staking (or exchanged for a token representing the right to return) and where there is a right to withdraw at least the same quantity of the same type of tokens. In these cases, we consider that the owner has not truly disposed of the asset. Whilst disposal of beneficial ownership is usually the acid test for disposals throughout tax law, this does not sit well with the unique characteristic of cryptoassets nor the reality as far as a cryptoasset investor is concerned. By confining a CGT charge to when cryptoassets (including liquidity tokens) are disposed of in return for consideration of fiat currency or a cash equivalent value of goods/services, these changes are bringing the CGT rules more in line with the true ownership position.

4.2 If the decision is taken to introduce these changes, HMRC will need to provide detailed guidance within their manuals on the principles of the measures and how these will apply to DeFi transactions in practice. The current proposals do not cover all possible lending/staking arrangements (for example contracts in which the taxpayer does not get back the equivalent of what was lent) and therefore it will also need to be clear in the guidance which transactions are out of scheme. For example, what would happen should the smart contract convert the asset prior to being transferred to the pool, will the eye still be on the beneficial ownership or be on the legal ownership?

5 Reporting and administration

5.1 In our response to the first DeFi consultation, the main reason why we were opposed to options 1 and 3 (treating DeFi lending and staking akin to repo and stock lending, and imposing no-gain/no-loss treatment respectively) was that whilst each of those would remove dry CGT charges, there would still be considerable reporting burdens. DeFi transactions can be quantified in the thousands, so keeping track of all those for reporting purposes would be a huge workload on taxpayers and cost upon their agents. Option 2, taking DeFi transactions out of CGT altogether, not only removes the dry tax charges, but will save taxpayers and their agents a huge amount of work as well as providing greater simplicity and certainty. The modified version of option 2 presented here, will help to reduce the volume of reportable transactions, although how much of an improvement this brings will depend on the ability of software to parse these new rules.

5.2 On balance, we welcome the uptake of option 2, subject to concerns about how taxpayers (and specialist cryptoasset tax calculators) will be able to effectively implement the new measures.

6 Rewards received from lending and staking

6.1 In the initial DeFi consultation, we had expressed a preference for these rewards to be taxed as capital rather than income due to the transactional and volatile nature of the underlying asset. However, we also acknowledged the difficulty of calculating the tax for capital rewards, given the lack of any distinct rules by which these calculations could be made. Our underlying concern was the uncertainty about whether the rewards were indeed capital or income, and the lack of bespoke guidance on these payments.

6.2 We therefore welcome the proposal that the classification and tax basis of the rewards will be definitive, and welcome the certainty which has been provided, if not the decision to deem it as income. By categorising the income as 'miscellaneous' this may help to facilitate the reporting of this income by keeping it separate from any other investment income. From 2024/25, CGT pages on SA100 and SA900s will have a separate section for cryptoasset disposals and we would hope that eventually a similar tailored section will be available within the main body of these tax returns for crypto earnings. In the meantime, having to place DeFi rewards into the miscellaneous box will hopefully focus investors' minds toward correctly reporting these receipts.

6.3 Notwithstanding this, we would echo our original preference for rewards to be taxed as capital, rather than income. As well as the potential impact of a higher rate of tax on the investor and consequential distortions in the market, these rewards are often automatically reinvested using auto compounding protocols and are not realised until the cryptoasset is returned and the lending/staking agreement has come to an end. In that instance, the total capital value of their investment would have grown and, as such, CGT should be the primary tax with respect to these rewards. As we have mentioned several times, these are not conventional assets like unit trusts with a recognised resultant dividend/interest income returns and the Government should avoid the temptation to equate crypto investment as such. Taxing the total value realised (ie principal and rewards) as capital once removed from DeFi would also remove the need for investors and their advisers to separately identify the capital and revenue monies realised. We understand from member feedback that in many transactions the taxpayer is receiving a bundle of tokens in return for staking which represents both reward and principle and that meaningful separation between the two is difficult.

6.4 Another potential issue with treating rewards as miscellaneous income is the international element. If other countries treat rewards as capital, then there could be a conflict between the double tax treaty articles. This may be something which could be fed into the situs issue (see 7.2 below) and act as a further impetus for clarity on that matter; perhaps a statutory provision would override a treaty position, or alternatively maybe crypto could be classified as a separate asset within the UK treaties.

6.5 Therefore, whilst we welcome a categoric decision on the status of rewards, we would urge them to be taxed as capital rather than income.

7 Remaining concerns

7.1 Whilst we broadly welcome these proposed changes to DeFi transactions, from a wider perspective of tax law and their application to cryptoassets, we need to see similar attention being paid elsewhere. We need a macro-scale review of the principles of tax and how they apply to cryptoassets and their unique traits. DeFi lending and staking is only one aspect and we need the same attention and recognition given to cryptoassets generally to see the economic reality of cryptoasset status, ownership and transactions reflected in tailored tax law. For

example, the line between crypto trading, investment (and even gambling[2]) is not always clear – it is for this reason we welcome the definitive categorisation of DeFi rewards. In the absence of tailored legislation, taxpayers have to rely on vague 'badges of trade' determinants, guided by historic cases concerning conventional tangible assets. If the tax status of cryptoasset ownership were enshrined in statute, or at the very least make clear within HMRC guidance, it would give the certainty that investors and traders need to know on which side of the line they are operating.

7.2 The situs of cryptoassets, for income tax, CGT and inheritance tax purposes, has long been an issue of concern with CIOT, ATT and other professional bodies. Despite guidance by HMRC, and recent discussion that confirm their view, that residence of the owner is in their view the only potential determining factor for situs, this has not been tested in the Courts and there is no case law[3] or legislation to back this view up. Placing rules in statute would put the issue beyond doubt. Likewise, lack of legislation and guidance on the application of cryptoasset transactions to VAT is causing great concern amongst practitioners. Codifying or clarifying the direct tax position of 'the badges of trade' (as mentioned above in 7.1) should also apply to VAT, so taxpayers and their agents are clear as to the difference between economic activity and private transactions.

7.3 Aside from guidance and legislation (or lack of it), we remain concerned about the lack of awareness, both amongst the public and some agents, about the application of the tax compliance rules to crypto transactions – including DeFi. Whilst these proposals go some way to address this with respect to DeFi by removing reporting requirements for some transactions, many unrepresented taxpayers will still be investing money into cryptoassets with little/no knowledge of the tax consequences and their obligations to report any profits (or the opportunity to claim any losses). The presence of a specific cryptoasset section within the CGT pages of the tax returns from 2024 will be a useful prompt, but many crypto holders will not know to complete a tax return in the first place.

7.4 As well as clear, concise legislation and guidance for agents and taxpayers, there needs to be a greater effort to spread the word to lay, unrepresented investors about the tax compliance obligations surrounding cryptoassets and at the very least encourage them to seek professional advice before investing.

7.5 We remain concerned that the lack of certainty around tax treatment of cryptoassets is starting to affect the UK's standing in the world amongst investors, with other jurisdictions offering more favourable conditions, but more importantly (and what we are calling for), certainty on the tax position.

8 Acknowledgement of submission

8.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the CIOT and ATT are included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation
The Association of Taxation Technicians
21 June 2023

[2] The Treasury Committee having recently recommended that trading in unbacked crypto closely resembles gambling due to the volatility and lack of regulation. Consumer cryptocurrency trading should be regulated as gambling, Treasury Committee says in new report - Committees - UK Parliament

[3] Though the High Court agreed obiter with HMRC's guidance in *Tulip Trading v Bitcoin Assoc [2022] EWHC 667*, (but that case was subsequently overturned by the Court of Appeal)