

CRYPTO-ASSETS: THE TAXATION OF SECURITY TOKENS

By Harry Winter

The taxation of crypto-assets has been something of a hot topic of late, and one made all the more interesting by the lack of comprehensive guidance provided by HMRC.

Crypto-assets are conventionally (insofar as there are yet conventions) split into three – exchange tokens, utility tokens, and security tokens.

1. Exchange tokens are intended to be used as a method of payment and include cryptocurrencies such as bitcoin.
2. Utility tokens provide the holder with access to particular goods or services on a platform. A business or group of businesses might issue utility tokens and commit to accepting the tokens as payment.
3. Security tokens provide the holder with particular interests in a business, typically akin to loans or shares.

HMRC guidance currently covers only exchange tokens in the hands of individuals and companies. This note addresses security tokens in the hands of UK investors. I should in passing observe that utility tokens are likely to be regarded as prepayment for goods or services and taxed on that basis (including VAT), although one could potentially be regarded as trading in such tokens.

Traders

One point seems tolerably clear: if one is trading in security tokens, then one's profits will be taxed as trading profits. The test for this is likely to be similar to those applicable in deciding whether one is trading in other financial assets, for which a certain level of expertise tends to be required (typically because

of HMRC's reluctance to grant tax relief for the inevitable losses suffered by the unwary). As the charge to trading income takes priority over savings and investment income, tax would be chargeable at normal rates rather than dividend rates for sums arising from the tokens that would otherwise appear to fall within the definition of distributions. For companies which are trading, matters may be more complicated than for individuals. Credits and debits may well be calculated under the loan relationships and/or derivatives codes, depending on the exact nature of the security token, before being fed into the charge to trading income. Since the charge to trading income takes priority over the distribution exemption, there will be tax chargeable on sums arising from the tokens that would otherwise appear to fall within the definition of distributions.

Non-traders

Individuals holding security tokens but not trading are not out of the income tax woods. The deeply discounted securities rules may apply if (as I have seen), security tokens can be redeemed after a period for a substantial premium. Further, income from the tokens that constitutes distributions will be charged to income tax at dividend rates, and there may be interest or disguised interest to account for.

If an individual can successfully navigate through to capital gains tax and its lower rates, pooling and negligible value claims are likely to be in point. For companies, the loan relationships and derivatives codes have priority over capital gains rules: if they apply, credits and debits calculated under those codes would then be charged to tax under the loan relationships code. If they do not, then capital gains rules would be used.

Stamp taxes

Stamp Duty Reserve Tax will in theory be chargeable on some security tokens. However, between the exemption for securities

issued or raised by a company incorporated outside the UK with no UK register, the exemption for vanilla non-convertible loan capital, and the exemption for the issuance of new securities, SDRT will often not be in point. Stamp Duty is in principle payable on any instrument of transfer of security tokens (including an instrument constituting an agreement to transfer) which is executed in the UK or which relates to any matter or thing done or to be done in the UK. Again, the exemptions for the issuance of new securities and for vanilla non-convertible loan capital are likely frequently to apply. Further, given Stamp Duty is not a legal obligation, where the security token is issued by a foreign company and any instrument of transfer is executed and retained outside the UK, Stamp Duty will often not in practice need to be paid.

Inheritance tax

Crypto-assets are, as the name suggests, assets. Accordingly, if UK-situs, they will be chargeable to inheritance tax wherever the holder is domiciled, and, if foreign-situs, chargeable to inheritance tax if the holder is UK-domiciled or deemed domiciled. The situs of security tokens is likely to be the place where the obligations of the issuer fall to be enforced, being typically debts or choses in action. (This stands in contrast to the HMRC guidance on the situs of exchange tokens, which are said to be located where the beneficial owner is resident – likely to be a problem for non-doms.)

Conclusion

In the end, security tokens are unlikely to cause real problems for the tax system, at least in principle. Often, they amount to little more than a fancy way of dressing up a loan or share in the issuer and they will be taxed accordingly.