

Analysis

Taxing token generation events

Speed read

The UK tax treatment of cryptocurrencies, particularly token generation events (often called an initial coin offering (ICO)), is uncertain. Whether token issuers will incur corporation tax will mainly depend on whether HMRC views the token as distinct from the underlying asset. Similarly, VAT treatment of tokens may be determined by analogy to similar assets. Token-issuing companies may have withholding tax obligations depending on the nature of return to token holders, especially if there are UK non-resident token holders. The sale of tokens are likely to be subject to capital gains tax, and transfers potentially subject to SDRT. For certain tokens, the enterprise investment scheme, entrepreneurs' relief and/or investors' relief could be relevant.

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The concept of attributing monetary value to data held on code, i.e. 'cryptocurrency', has existed since the 1980s, arguably originating with DigiCash. Recently, blockchain technology has changed the way data may be held, using a distributed ledger. This safer, more secure

way of holding a piece of data, referred to in this article as a 'token', has led to increasing popularity and global acceptance of the concept of using cryptocurrencies.

The increased acceptance of cryptocurrencies as a new asset class has led regulators and tax authorities to consider how such cryptocurrencies should be treated. HMRC accepts that cryptocurrencies as an asset class have 'unique characteristics' which are not entirely comparable with other existing asset classes or payment methods (see HMRC's *Capital Gains Manual* CG12100). Therefore, from a tax perspective, while analogous treatment to existing asset classes might provide some guidance to determine the taxation of cryptocurrencies, this is not definitive, making it imperative to analyse each new cryptocurrency on a case by case basis.

However, this can be difficult given the number of different cryptocurrencies (1,926 cryptocurrencies were listed with CoinMarketCap as of 8 September 2018). The difficulty surrounding these determinations is evidenced in the recent US case *United States v Zaslavskiy* 17-CR-647 (EDNY). The United States District Court for the Eastern District of New York effectively left open (on a non-tax matter) the question of whether a cryptocurrency constitutes a separate cryptocurrency asset in itself or a security, taking the position that this determination needs to be made on a case by case basis. This also illustrates that each jurisdiction may reach different decisions in relation to the nature of the same cryptocurrency.

The tax issues related to cryptocurrency tokens arise in relation to how these tokens are created, used and sold, and vary depending upon the nature and purpose of the token. The issues also highlight the fact that on one analysis a token is merely an entry in a ledger, albeit one held in a distributed form: talk of a token having an existence other than a piece of information about something else is false. In this context, it is necessary to consider the tax treatment of the holder, any purchaser and the creator or issuing entity of the token.

This article focuses on the creation or generation of tokens, or token generation events (TGEs). More commonly TGEs are referred to as initial coin offerings (ICOs), but given the variety of uses of tokens the more general term TGE is used in this article. The article first considers briefly the different types of tokens that can be created on a TGE, then focuses on TGEs used for fundraising and the tax and structuring considerations associated with such TGEs.

Token types: the BBH classification

A useful classification system is imperative to help streamline focus on the tax (and regulatory) analysis of tokens. The classification described in *Developing a cryptocurrency assessment framework: function over form* by A Burnie, J Burnie and A Henderson (2018), known as the BBH classification after the authors, differentiates between cryptocurrencies based on their underlying functionality to divide them into three categories: crypto-transaction tokens; crypto-voucher tokens; and crypto-fuel tokens.

Crypto-transaction tokens

Crypto-transaction tokens, such as bitcoin, constitute a peer-to-peer alternative to government issued fiat currency. They act as a store of value, which in turn is linked to the network of users; for example, the more merchants that accept a crypto-transaction token, the more useful it is as a means of making payment, and so the greater the value of that token.

Crypto-fuel tokens

Crypto-fuel tokens, such as Ethereum, generally form the basis for developing applications. For example, a crypto-voucher token (see below) may be built to the ERC-20 technical standard, which means that it is built using the smart contract technology on the Ethereum platform.

Crypto-voucher tokens

Crypto-voucher tokens are cryptocurrencies which carry rights in relation to underlying assets. The nature of the underlying asset could be anything; for example, equity, bonds or data storage space. The token's value derives from the underlying asset in that the token gives the holder a claim on the underlying asset; i.e. by presenting the token, as one presents a voucher, the token holder receives the value of the asset or the asset itself where, for example, the asset is cash.

Token generation events generally

There are multiple ways in which the user base of a new cryptocurrency can develop. They can grow organically (bitcoin). They can be created through forking an existing cryptocurrency (i.e. splitting a new cryptocurrency from a pre-existing one using an update, such as Ethereum Classic and Ethereum). (Forking is specifically discussed in the recent HMRC capital gains tax guidance with respect to determining the acquisition cost of cryptocurrencies post-forking (CG12100).) They can also develop through TGEs. As more cryptocurrencies have developed, TGEs have become particularly popular (and the term ICO particularly prominent), as a relatively quick mechanism for promoting new cryptocurrencies and increasingly for fundraising.

While TGEs can create any of the above categories of cryptocurrencies, this article focuses on the creation of crypto-voucher tokens and, in particular, tokens where the underlying asset is either equity or debt and the TGE has a fundraising purpose.

As alluded to above, the question arises about overloading the term TGE. The activity giving effect to the event is no more than the recording of information on a ledger with the effect that the token is no more than information; i.e. the arrangement of a string of letters and numbers which in turn makes up the code of the token.

A difficulty with leaving it at this is that, at present, English law does not recognise the concept of information (e.g. information held as an electronic database) as a form of property over which a person can exercise a lien (*Your Response Ltd v Datateam Business Media Ltd* [2014] EWCA Civ 281).

If one accepts, however, that a token is a 'thing' that is capable of: (a) transfer by movement from one token wallet recognised on the blockchain to another wallet; and (b) being lost, insofar as a private key which gives access to the wallet can be lost, then one becomes comfortable that the token has value as property. Here, even if there is no clear generic property classification for tokens, an English criminal court has taken the view that bitcoin was 'realisable property' under the Proceeds of Crime Act 2002 (*R v Teresko (Sergejs)* [2017] (unreported)).

The law of property analysis is, however, unclear.

Taxing token generation events

It is sensible to start a consideration of the tax implications of TGEs with a strong warning that there is very little guidance or clarity on their tax treatment in the

UK. As noted above, any tax analysis requires a detailed consideration and understanding of the nature of the particular token being created as part of the TGE.

The absence of guidance and clarity on taxing TGEs derives from the lack of consensus on some key policy issues, particularly whether on a TGE the token holder acquires a new asset (i.e. the token), or whether it merely registers an existing interest in an underlying asset. As set out above, the general law position is unclear. A further key issue is whether (under certain structures at least) the token holder is the beneficial owner of the underlying asset.

In most cases, therefore, it is necessary to seek to determine the tax treatment of TGEs and the subsequent holding and transactions related to the issued tokens applying general taxation principles and by analogy to equivalent assets.

Tax issues for the token issuer

Corporation tax

This article assumes that the issuer is a UK company and therefore the key potential tax issue on a TGE is likely to be corporation tax. The corporation tax analysis will largely depend on whether it is considered that a new asset is created by the token-issuing company and sold to token holders for consideration, or whether it is considered that no new asset is created.

If the former view is adopted and assuming a single raise TGE (i.e. where funds are raised by only one issue of tokens), based on general tax principles corporation tax on chargeable gains should be payable (currently 19%) on any gains realised from the sale of the assets. Further, since the tokens are effectively created on the TGE, there is unlikely to be any material base cost to the tokens, making the whole consideration received on the TGE potentially taxable.

If there are multiple raises (i.e. funds are raised through multiple issues of tokens periodically), arguably this could constitute trading and therefore taxable as trading profits of the token-issuing company. For a UK corporate, the tax rate would be the same but different computational provisions would apply (for example, in relation to losses).

If the view is taken that the token does not constitute a new asset (since, for example, the rights and legal construct of the token are such that the token represents direct beneficial ownership of the underlying asset), then tax should apply as if the token represents the underlying asset. Therefore, in relation to equity or debt as the underlying asset, there should be no UK tax for the issuing company on the TGE.

VAT

The VAT treatment of cryptocurrencies is a complex area already considered in some detail in a previous article in this journal ('Initial coin offerings and VAT' (Etienne Wong), *Tax Journal*, 15 March 2018). Certain aspects of the VAT treatment of cryptocurrencies have also been considered by HMRC, which considers that classic cryptocurrencies (i.e. crypto-transaction tokens) can effectively be treated for VAT purposes as equivalent to fiat currency and are therefore exempt from VAT. However, this guidance is unlikely to be applicable to crypto-voucher tokens with a different function and different features to fiat currency.

This HMRC guidance is however instructive and supportive of an approach that looks at the features of a

token and then adopts the VAT treatment of equivalent assets where the VAT treatment has already been determined. For example, in the case of equity-linked tokens issued in a TGE, where the rights associated with the token are almost identical to those of a share, then logically the treatment of the token issue for VAT purposes should be akin to that of a share issue (exempt from VAT) (see *Kretztechnik* (Case C-465/03)). The same should be the case for debt-linked crypto-vouchers.

However, as discussed, the facts and legal/economic structure of the token is key. Material differences from a comparable asset class will make reliance on the VAT treatment of that comparable asset more difficult.

Tax issues for token holders

Enterprise investment scheme relief

Starting on a positive note, in relation to tokens with rights to underlying equity in companies that are qualifying companies for enterprise investment scheme (EIS) purposes, could investments in such tokens qualify for EIS relief? From a policy perspective, and assuming the token has equivalent rights to EIS qualifying shares and, of course, that the investor conditions are met, there seems to be no reason why EIS reliefs should not be available.

However, like the rest of the UK legislative code, the EIS legislation does not (currently) appear to fit that well with the crypto environment. A key hurdle in relation to receiving EIS relief may be that EIS is only available in relation to an issue of 'ordinary shares' (ITA 2007 s 173). To the extent that HMRC adopts the position that a token is nothing more than beneficial ownership in the underlying shares, there may be a possibility of receiving EIS relief. However, in the event that HMRC adopts the view that the beneficial rights in the shares are not vested in the token holders, and that the token is a separate asset and the token holder only owns the token, this would make the EIS analysis more challenging.

This is likely to be an important issue going forward. Equity crypto-voucher tokens (appropriately regulated) represent a new source of accessible and cost effective equity funding for exactly the types of companies the EIS relief was introduced to support and encourage. Therefore, it seems logical that EIS should apply, or be adapted to apply, to equity TGEs, subject to satisfaction of all the existing applicable conditions.

Withholding tax

For holders of tokens that have rights to payments generated in respect of the underlying assets (e.g. dividends or interest), withholding tax may apply. From a UK perspective, this is particularly relevant in relation to token payments in the nature of interest or linked to underlying interest payments where ITA 2007 s 874 could impose a withholding tax obligation on the issuing company. This will be particularly relevant since many token holders are likely to be individuals.

Further, given the international nature of the crypto environment, withholding tax will be particularly relevant as it would apply more generally to most foreign token holders and subject them to UK taxation and potentially double taxation if their home jurisdiction also taxes the token payment. In such circumstances, relief under any applicable double taxation treaty should be considered, although whether the treaty can be relied upon or the associated administrative requirements applicable to token structures is relatively untested.

Tax on the sale of tokens

Although less immediately relevant to the TGE itself, potential investors will want to understand how they might be taxed on a future disposal of tokens. Of course, this will depend upon the particular tax treatment of the token holder and the jurisdiction in which the token holder is based, but for UK-based token holders HMRC guidance states that a gain/profit on the disposal of a token could either be taxed as capital gains, income/corporation tax, or gambling profits (CG12100).

For token holders receiving tokens as part of a TGE principally designed to raise funds, the most likely tax treatment will be as a capital gain. However, given the multi-functionality of some tokens (often tokens issued to raise funds are also intended to have currency-like qualities in relation to the platform on which they are created), the capital analysis should not be assumed and again the facts will be key.

In relation to equity-linked tokens, for UK individuals a capital gains treatment raises the question of whether entrepreneurs' relief or investors' relief may be available to reduce any tax applicable on disposal (subject to the applicable conditions being met). It is likely that some of the same issues as are relevant for EIS will impact the availability of these reliefs. For debt-linked tokens, consideration should be given to whether the token could be exempt from capital gains tax pursuant to TCGA 1992 ss 115 and 251.

As mentioned, more frequent disposals of tokens or short-term holding periods, or even the underlying nature of the token itself, could result in a token holder being considered to be trading in tokens for tax purposes. This would cause any profits to be taxed as trading income – in most cases in the UK at higher tax rates – and without the potential reliefs and/or exemptions discussed above.

Finally, it is indicative of the still relatively new and unsettled world of cryptocurrencies that HMRC considers that profits on tokens may constitute gambling/betting profits and if so would not be taxable. This would usually only be available if the transaction was 'highly speculative' (CG12100). As the use of tokens matures and TGEs become more sophisticated, structured and regulated, it seems unlikely that this analysis could be applied.

Stamp duty and SDRT

For TGEs linked to equity or debt in UK companies, stamp duty and stamp duty reserve tax (SDRT), need to be considered in relation to both the TGE and future transfers of tokens created pursuant to the TGE.

In relation to stamp duty, the very nature of a token effectively removes the need for more detailed analysis. A token should not be created or conveyed by way of any physical instrument and therefore only SDRT and not stamp duty should potentially be relevant.

For SDRT, in relation to the creation of a token on the TGE itself, by analogy to the SDRT treatment of the issue of actual shares or loan capital, it is not anticipated that any SDRT would arise.

In relation to the transfer of tokens, since the definition of 'chargeable securities' for SDRT purposes is broad and encompasses 'interests in, or in dividends or other rights arising out of, stocks, shares or loan capital' (FA 1986 s 99), depending on the specific rights associated with the token, it is possible that there may be an SDRT charge for a purchaser on a transfer of tokens.

Structuring a TGE

Although the above commentary is focused on the tax treatment of a UK issuer and UK-based token holders, in practice crypto businesses tend to be somewhat jurisdiction agnostic or connected to multiple jurisdictions. The business development and expansion to be funded by TGEs is usually global and, by virtue of the early-stage funding nature of TGEs, yet to be established to a material degree at the time of the TGE.

This can make the ties of a crypto business to any particular jurisdiction less strong and therefore allows a degree of flexibility around the location of operational capability for the business. This could provide potential benefits from a staffing, cost, accessibility and of course tax perspective.

In relation to tax, provided there is alignment to the substance of the business, there would be the potential to establish the corporate structure for a business preparing for a TGE in jurisdictions with a clearer and more certain tax treatment of TGEs and token transactions; or a simpler tax system that does not impose the potential tax burdens of jurisdictions such as the UK. However, recent BEPS and equivalent EU measures introduced, including various measures in relation to substance and hybrid arrangements, will require careful analysis in this context.

The choices and flexibility here will also be driven by the applicable facts (the nature of the business, its customers, staffing and infrastructure requirements, etc.) but aligning operations with a jurisdiction that can give tax certainty should be an important business consideration and sensible to investigate when a TGE is being considered.

As yet, there are no jurisdictions that have clearly achieved the right blend of operational effectiveness and tax certainty, but there is constant and growing evolution in this area, as countries grapple with the increasing prominence of cryptocurrencies.

Conclusion

The tax treatment of tokens is not clear and presents significant uncertainty in what is a burgeoning area of fundraising. To the extent that the government intends to support the growth in TGEs and support the UK's development as a centre for such activity, much more clarity is required in relation to the tax treatment of TGEs and tokens generally. Last month the Commons Select Treasury Sub-Committee published a report on regulating crypto-assets (see bit.ly/2QKUKjB), wherein it considered various issues associated with regulating cryptocurrencies. However, to provide greater certainty a similar analysis should be undertaken in relation to taxing cryptocurrencies since in the absence of such clarity, tax issues and uncertainty will continue to be problematic with taxpayers being required to determine the tax treatment of tokens by (potentially imperfect) analogy. ■

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