FIELD COURT TAX CHAMBERS

# FCTC DIGEST

12th Edition (September 2022)

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## EDITORIAL

**Patrick Soares**

This is the twelfth edition of the *FCTC Digest and it comes hot on the heels of the notorious mini-budget of 23 September 2022*.

***The Mini-Budget***

Dealing with the nation's finances is a serious business.

To rush through a budget slashing taxes financed through borrowings not realising the effects on the pound and the costs of borrowing is Alice in Wonderland-ish.

But that is what has happened and the country's finances will take some time to recover.

The main changes in the mini-budget are thus:

- The 1.25% national insurance charge for employers and employees will be abolished from 6 November;

- The proposed dividend increase will be abolished from April 2023 (i.e. the 1.25% additional charge on dividends);
- The corporation tax rate will stay at 19% – it will not be increased to 25% as previously announced with effect from April 2023;
- The additional rate of tax (45%) will be abolished from April 2023 (the top rate of income tax will therefore become 40%);
- The basic rate of tax (20%) will go down to 19% from April 2023;
- The most recent IR35 changes will be abolished from April 2023;
- As regards SDLT, the residential nil rate band will increase from £125,000 to £250,000 and for first time buyers the equivalent increases from £300,000 to £425,000;
- The Annual Investment Allowance will remain at the £1 million level, and will not drop to £200,000 as previously announced from April 2023;

- New Investment Zones will be created which will benefit from tax incentives (e.g. SDLT, council tax and employer's NIC).

**Articles in this edition**

The first article by myself is a **trust law survival kit for tax advisers** who must advise on the taxation of trusts. Trust lawyers are a different breed from tax advisers but we can learn to live with each other. My second article looks at the defences the taxpayer may have against an assessment under the **transfer of assets abroad code** (ITA 2007 s720 etc) on creating an offshore settlement. Finally, in a third article I look at *CS Properties Limited v HMRC* [2022] which tells you what not to do if the taxpayer wants to **incorporate a property letting partnership without CGT and SDLT charges.**

The fourth article is by **Patrick Way KC** who gives advice on **White Space disclosures** following the case of *Johnson and Johnson v HMRC* [2022]. The space should be used in cases where the taxpayer feels his/her tax analysis is correct (and the reasoning is set out in the space) and the return is done on that basis even though HMRC will or may disagree with it.

The fifth article is by **Peter Vaines** who looks at **the "exceptional days" relief under the statutory residence test rules.** This is especially important in the light of the covid lockdown. HMRC give a highly restrictive interpretation to the rules which may be incorrect taking into account the recent FTT case of *Taxpayer v HMRC* TC 8464

The sixth article is by **Katherine Bullock**. She looks at the case of *Gerald and Sarah Lee* [2022] which examined the meaning of **'period of ownership' for the purposes of the CGT Principal Private Residence Relief** where the house had been lived in since completion but the land had been owned for longer than the existence of the house. The case does give the taxpayer a planning opportunity and the article concludes (subject to certain caveats) thus: *it would be possible to hold land for a significant period, build a house on it and shelter the whole gain provided that the taxpayer occupies the house from completion to sale.*

The seventh article is by **Oktavia Weidmann** and is a God send if a problem concerning the **taxation**

**of the treatment of losses from crypto-currencies** fell on your desk and you did not know where to start (and you cannot pass the job on to someone else) – start here!

The final article is by **Oktavia Weidmann and Dilpreet K Dhanoa** and focusses in the main on the **VAT implications of dealings in crypto-currencies, non-fungible tokens and other digital assets**. Again a God send if a problem in these areas arrives on your desk.

Happy reading.

**Patrick C Soares**

**Editor**

# TRUST LAW SURVIVAL KIT FOR TAX ADVISERS

*Patrick C Soares*

Trust law strikes fear into the hearts of many a tax adviser but that need not be the case.

**First and foremost always do an epitome of the trust deed and keep it with the trust deed and any appointments.**

The epitome will set out the adviser's understanding of the deed and summarises its main terms and tax position.

## EPITOME OF SETTLEMENT

### Valid

Check the settlement was validly created and confirm this in the epitome

### Revocable or irrevocable

State if the settlement is revocable or irrevocable.

### Date

State the date of the settlement.

**Trustees**

State who the trustees are and check they have been validly appointed.

**Settlor**

State who the settlor is and is the settlor and the spouse for the time being of the settlor or his or her civil partner for the time being excluded from benefit. Check the trust clauses are effective in achieving this.

**The trusts of the settlement**

Is the trust discretionary or one which creates an interest in possession. Summarise the trusts of the settlement clause by clause and check for powers of appointment and who is entitled to the trust income for the time being.

**Beneficiaries**

State who are the beneficiaries and potential beneficiaries. State if the class of beneficiaries is closed.

**Accumulation period**

Can the income be accumulated and for how long.

**Perpetuity period**

How long can the trust last for. Check it has not already come to an end.

**Proper law**

What proper law governs the trust.

**Trust assets**

What are the trust assets.

**Administrative provisions**

Summarise the administrative powers.

**Charging clause and trustee protection**

Is there a trustee charging clause and protection clause.

**Taxation**

Set out the tax consequences of the deed. These include the following. Is the trust caught by the income tax settlement code or ITA 2007 s720 or s731. Does TCGA 1992 s86 or s87 apply to it. Is it caught by the IHT reservation of benefit code and does it suffer the 10 year IHT anniversary charges. How is the trust income taxed at the trust and beneficiary levels. How are gains taxed.

## THE TWELVE GOLDEN RULES

### Rule 1 – The trustees must follow the terms of the settlement

The trustees must obey the lawful directions of the settlement (Underhill and Hayton Law of Trusts and Trustees (*Underhill) article 43*).

### Rule 2 – The trustees must act fairly between the beneficiaries and make fair appropriations

Trustees must act fairly in the execution of the trust, and not exercise their powers so as to confer an advantage on one beneficiary or class of beneficiary at the expense of another unless this apparent partiality results from the exercise of the power in question for the purpose of which it was given, affording proper consideration to the matters which are relevant and excluding from consideration matters which are irrelevant; the trustees must act fairly in making investment decisions which may have differing consequences for differing classes of beneficiaries.

**Rule 3 – The trustees must act with care and skill**

The trustees must exercise such care and skill as is reasonable in the circumstances, having regard in particular to any special knowledge or experience that they have (*Underhill article 48*).

**Rule 4 – The trustees are not to delegate their functions or use nominees unless there are express clauses allowing the same**

Trustees must not collectively delegate their duties or powers either to a stranger or to a beneficiary or to a co-trustee *unless authorised by the settlement* (*Underhill article 51).*

**Rule 5 – The power of appointment may result in the creation of sub-trusts or can result in absolute appointments**

Trustees exercising a power of appointment may make settlements on objects of the power if the particular circumstances of the case warrant that course as being for the benefit of the objects of the power. Absolute appointments may also be made.

**Rule 6 – Do a safe appointment – do not cause a CGT charge to arise unnecessarily**

A line can be drawn between 'resettlement' cases where an advancement is made so that new trusts, powers and provisions supersede the original trusts, powers and provisions (even if the same persons happen to be trustees of the new trusts and the original trusts) and 'sub-settlement' cases where an advancement by way of allocation of part of the capital otherwise leaves the trusts, powers and provisions of the original settlement applicable thereto. In the former situation a capital gains tax charge will arise since the trustees of the separate new trust become absolutely entitled against the trustees of the original trusts within the Taxation of Chargeable Gains Act 1992, s 71 (*Hoare Trustees v Gardner* [1979] Ch 10, [1978] 1 All ER 791; *Roome v Edwards (Inspector of Taxes*) [1982] AC 279, [1981] 1 All ER 736, HL; *Bond v Pickford* [1983] STC 517, CA; *Swires (Inspector of Taxes) v Renton* [1991] STC 490, 64 TC 315) (*Underhill article 63*).

In appropriate cases the trustees must ensure no unnecessary charges to capital gains tax will arise from the appointment.

**Rule 7 Trustees must be kept informed of major developments in companies they own and not just rely on what is provided in annual general meetings.**

In *Bartlett v Barclays Bank Limited (No 2)* [1980] 2 ALL ER 92 the plaintiffs were the beneficiaries under a settlement of a trust fund which consisted of a majority shareholding in a property company. The trustee of the settlement therefore had a controlling interest in the company. The plaintiffs brought an action against the trustee alleging certain breaches of trust caused by the trustee's wilful default in permitting the company to engage in hazardous property speculation from the 1960s until 1973. The trustee was liable for the loss because it should have required the board to inform the trustee of such a major change so it could consider appropriate action.

Check to see if there are any trustee protection clauses.

**<u>Rule 8 The trustees must not act in a conflict of interest situation unless the trust deed so allows.</u>**

Is there a conflict situation? Check to see if there are any clauses which permit a trustee to act in a conflict situation.

**<u>Rule 9 The trustees can be protected if they have not been negligent or fraudulent</u>**

<u>The trustees may be protected from losses resulting from errors unless they have been fraudulent or negligent.</u>

<u>Check the trustee protection clause.</u>

**<u>Rule 10 The trustees can get the court's "blessing" if needs be.</u>**

The trustees must exercise their powers and cannot keep running to the courts.

The cases where the court considers the exercise of such powers was analysed in an unreported judgement quoted in *Public Trustee v Cooper* [2001] WTLR 901. The unreported judgement was that of Robert Walker J given in 1995 ibid at 922H thus:

> ‘At the risk of covering a lot of familiar ground and stating the obvious, it seems to me that, when the court has to adjudicate on a course of action proposed or actually taken by trustees, there are at least four distinct situations (and there are no doubt numerous variations of those as well).
>
> (1) The first category is where the issue is whether some proposed action is within the trustees’ powers. That is ultimately a question of construction of the trust instrument or a statute or both. The practice of the Chancery Division is that a question of that sort must be decided in open court and only after hearing argument from both sides. It is not always easy to distinguish that situation

from the second situation that I am coming to …. [He then gave an example]

(2) The second category is where the issue is whether the proposed course of action is a proper exercise of the trustees' powers where there is no real doubt as to the nature of the trustees' powers and the trustees have decided how they want to exercise them but, because the decision is particularly momentous, the trustees wish to obtain the blessing of the court for the action on which they have resolved and which is within their powers. Obvious examples of that, which are very familiar in the Chancery Division, are a decision by trustees to sell a controlling share in a family company. In such circumstances there is no doubt at all as to the trustees' powers nor is there any doubt as to what the trustees want to do but they think it prudent, and the court will give them their costs of doing so, to obtain the court's blessing on

a momentous decision. In a case like that, there is no question of surrender of discretion and indeed it is most unlikely that the courts will be persuaded in the absence of special circumstances to accept the surrender of discretion on a question of that sort, where the trustees are prima facie in a much better position than the court to know what is in the best interests of the beneficiaries.

(3) The third category is that of surrender of discretion properly so-called. There the court will only accept a surrender of discretion for a good reason, the most obvious good reasons being either that the trustees are deadlocked (but honestly deadlocked, so that the question cannot be resolved by removing one trustee rather than another) or because the trustees are disabled as a result of a conflict of interest. Cases within categories (2) and (3) are similar in that they are both domestic

proceedings traditionally heard in chambers in which adversarial argument is not essential though it sometimes occurs. It may be that ultimately all will agree on some particular course of action or, at any rate, will not violently oppose some particular course of action. The difference between category (2) and category (3) is simply as to whether the court is (under category (2)) approving the exercise of discretion by trustees or (under category (3)) exercising its own discretion.

(4) The fourth category is where the trustees have actually taken action, and that action is attacked as being either outside their powers or an improper exercise of their powers. Cases of that sort of hostile litigation to be heard and decided in open court. I mentioned that fourth category, obvious though it is, for a reason which will appear in a moment.'

**Rule 11 If a beneficiary has agreed a course of action in full knowledge of the facts and is adult with capacity he cannot later complain.**

It *may be* the agreement of all the relevant parties to certain courses of action can be obtained. This may include all the adult beneficiaries. The parties *may* want to consider indemnities binding on estates (which may be relevant to minors or unborn beneficiaries). One may even be in a class closed *Saunders v Vautier* (1841) Cr & Ph 240 situation so effectively the trustees can take the necessary steps without fear of being sued as all the adult beneficiaries have agreed and there are no other potential beneficiaries.

**Rule 12 No general duty to give reasons**

Lewin on Trusts at 29-234 states: "Trustees exercising a discretion are not in general obliged to disclose their reasons for taking a particular decision."

**CONCLUSION**

The safe haven for trustees is all the beneficiaries are of full age and capacity, so one is in a *Saunders* *v Vautier* (1841) Cr & Ph 240 situation (or the like) and they all agree to the course of action. He or she who has agreed cannot later complain (provided he or she is adult, *compos mentis*, is aware of all the relevant facts and freely makes the decision).

# CAN TRUSTS HELP TO DEFEAT HMRC ASSESSMENTS UNDER ITA 2007 S720 (TRANSFER OF ASSETS ABROAD (TOAA))?

***Patrick C Soares***

## “WILL SUBSTITUTE” SETTLEMENTS

Is the intention to create a settlement which is a “will substitute” (i.e. a settlement which means on the death of the settlor no probates need be taken out with respect to the assets in the settlement which may be located in many jurisdictions) a defence against ITA 2007 s720 (part of the TOAA code)?

The relevant provision states:

> **737 Exemption: all relevant transactions post-4 December 2005 transactions**
>
> (1) This section applies if all the relevant transactions are post-4 December 2005 transactions.

(2) An individual is not liable to income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs—

(a) that Condition A is met, or

(b) in a case where Condition A is not met, that Condition B is met.

**(3) Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.**

…………………

CONCLUSION

If a taxpayer transfers property into a settlement to avoid having to take out probates possibly in a number of different countries it may not be one of the purposes of making the transfer to the settlement the avoidance of UK taxation and the tax avoidance defence may be available.

**“GOLDEN TRUSTS”**

**CAN THE CREATION OF A GOLDEN SETTLEMENT (PROTECTED SETTLEMENT UNDER ITA 2007 S721A) BE A TAX AVOIDANCE STEP WITHIN ITA 2007 S720 WHEN PARLIAMENT HAS SPECIFICALLY CREATED THE GOLDEN TRUST TAX RELIEFS TO ENCOURAGE LONG TERM NON-DOMS NOT TO LEAVE THE UK?**

In *IRC v Willoughby* [1997] STC 995 Lord Nolan at 1003 stated thus:

> In a broad colloquial sense tax avoidance might be said to have been one of the main purposes of those who took out such policies, because plainly freedom from tax was one of the main attractions. But it would be absurd in the context of s 741 to describe as tax avoidance the

> acceptance of an offer of freedom from tax which Parliament has deliberately made. Tax avoidance within the meaning of s 741 is a course of action designed to conflict with or defeat the evident intention of Parliament.

If a taxpayer transferred assets into a golden trust before he became deemed domiciled in the UK so benefitting from the IHT excluded property regime and the benefits basis of taxation for income tax and capital gains tax, is this a transfer which has as one of its purposes the avoidance of UK taxation?

RIALAS V HMRC [2019] UKFTT 520

In *Rialas v HMRC* [2019] UKFTT 520 this point was argued (unsuccessfully) when a taxpayer created an excluded property trust for IHT purposes. The point was dropped on the appeal to the UT (*Rialas v HMRC* [2021] STC 186 at [6]). The facts were not straight forward as a foreign company was created by the trust to own the UK asset but the decision dealt with the situation of the trust owning the UK asset direct.

The relevant paras of the FTT read thus:

> 78. The decision in *Willoughby v IRC* 70 TC 57 confirms that there is a critical distinction between acceptable tax mitigation, which would not affect the application of s741, and unacceptable tax avoidance, which would prevent the application of s741. The most widely accepted definition of this distinction was set out by Lord Nolan, as follows......:
>
> 79. Therefore, Mr Wilson submitted, where a taxpayer takes advantage of a freedom from tax clearly intended by Parliament, this will be tax mitigation, but where a taxpayer takes actions which are designed to conflict with or defeat the evident intention of Parliament, this will be tax avoidance.
>
> 80. Unfortunately it is not always easy to ascertain the evident intention of Parliament. Indeed, it is frequently not evident at all. ...

85. Mr Wilson argued that even though Mr Rialas had sought to protect his estate from Inheritance Tax what Mr Rialas had done was not tax avoidance because he had merely taken advantage of an opportunity which had been intended by Parliament by inserting a non-resident trust between 1 'himself and his UK assets…

88. We therefore agree ……. that the interposition of a non-resident trust …….did have a tax avoidance motive.

CONCLUSION

The reasoning in the case is not totally clear but it does indicate that making use of the golden trust status granted specifically by Parliament to convince non-UK doms to remain in the UK may not be a good defence against ITA 2007 s720.

# INCORPORATING A PROPERTY LETTING PARTNERSHIP – THE TAXPAYER FAILED IN THE CASE OF *CS PROPERTIES* – WHAT CAN WE LEARN FROM THIS?

***Patrick C Soares***

When a partnership letting business is being incorporated tax advisers must ensure there is a business being carried out in partnership if CGT and SDLT is to be avoided.

In *CS Properties Limited v HMRC* [2022] UKFTT 00214 (TC) 5 July 2022 H & W claimed they were partners in a single property letting business which they transferred to the family company.

The tribunal held there was no partnership business and CGT and SDLT, based on the market value of the property, was payable.

## One property

In the case there was only one property.

## One partner did not give evidence

The wife (a partner) did not give evidence.

**No partnership deed**

There was no partnership deed (para 55 of the judgment).

**Late registration with HMRC**

The husband claimed the partnership arose on 17 September 2014 but it was only *registered* with HMRC on 19 February 2019 (paras 38 and 72 of judgment).

**No commercial dealings in the name of the partnership**

There were no commercial dealings in the partnership name – "no bank account, no contracts, no invoices and no correspondence" (paras 72, 87 and 91 of the judgment).

**No reference to partnership in SDLT return**

No reference was made to a partnership in the SDLT returns (para 74(5) of the judgment).

**Adverse comments to HMRC**

Comments had been made to HMRC indicating there was no partnership.

**No firm profit motive**

There was also evidence to show the partnership never intended to make a profit (para 94 of the judgment).

**WHAT CAN BE LEARNT**

The tribunal case should be far removed from cases where taxpayers have set up property letting partnerships as *bona fide* commercial vehicles – there should be a partnership agreement, a partnership bank account and note paper, if needs be both partners will give evidence etc – but there is always something to learned from any case (in this case what not to do).

# WHITE SPACE DISCLOSURES

***Patrick Way KC***

## Speed read

*In Johnson and Johnson v HMRC, and in the Raymond Tooth case, the question of the reliability of white space disclosures was considered.*

*In the Johnson and Johnson case, it was held that the taxpayers had been careless in not including certain payments as business payments. The fact that they had referred to these payments in the white space disclosure on the basis, however, that the taxpayers considered the payments to be tax free (when they were not) did not stop a successful claim by HMRC for a penalty for carelessness. You cannot "get away with it" by saying that something that is taxable has not been returned as taxable. It either is or isn't.*

*In the Raymond Tooth case the relevant white space disclosure specifically invited HMRC to open an enquiry given the nature of the steps which he had taken. Here it was held that the disclosure was* *satisfactory to prevent a valid discovery assessment being made.*

***<u>Johnson and Johnson</u>***

In the case of *Johnson and Johnson v. HMRC* ([2022] UKFTT 00156 (TC)) taxpayers (Timothy and Alison Johnson) ran a dental practice. Separately, cutting a long story short, they had entered into a NatWest vanilla swap by reference to which they were, in due course, awarded compensation by NatWest: the Financial Conduct Authority judged this necessary.

The question was whether this compensation (a redress payment) should be added into the appellants' income as a business item.

Their adviser took the view that the sums were not taxable notwithstanding that there was sufficient evidence for him to have realised that those redress payments were fully taxable.

In an attempt to protect the position, however, there was a statement in the relevant white space box as follows:-

> "A compensation payment of £43,218 was received during the year from

> NatWest in respect of Interest Rate Hedging Products which is not considered to be taxable."

When the matter came before the First-tier Tribunal the question was whether the undoubted loss of tax was caused carelessly by the agent (and therefore effectively by the taxpayers themselves) pursuant to TMA 1970 s.29(4).

It was held that it was: there had been carelessness.

A defence had been put forward that the white space disclosure provided enough information to HMRC, in accordance with Statement of Practice SP1/06, for an officer to appreciate that the self-assessment in the appellants' tax return was insufficient and therefore there could not have been any carelessness: we told you we were wrong so how can we be careless?

The Tribunal held, however, that this defence was misconceived.

In a nutshell, a white space disclosure which aims to bring to the attention of a hypothetical officer what is clearly an error (and a careless one) is not sufficient to amount to a defence from that carelessness. If you like, knowing that you are wrong is no excuse: you cannot pass the buck to HMRC, “Well, I told you there was a problem. It was for you to challenge it.”

*Raymond Tooth*

In the case of *Raymond Tooth* (*HMRC v. Tooth* [2021] UKSC 17) a well-known solicitor entered into a tax avoidance scheme known as the Romangate scheme which ultimately proved unsuccessful.

The scheme aimed to produce an artificial loss which Mr. Tooth (along with other participants in the Romangate scheme) would have claimed.

Mr. Tooth went to considerable lengths, in his white space disclosure, to make the position clear. As an aside, one of the problems was that it was not readily obvious where in the tax return the relevant loss should be disclosed but that is not the issue I am addressing in this article. I focus on the last sentence of the white space wording which assumes that an enquiry will be made.

Mr. Tooth’s white space disclosure was as follows:-

> “Further, please note that although I have reported (and hereby claim the loss

> pursuant to s.128 ITA 2007) in Box 3 above I wish to make it clear that the deduction I am claiming on my return is not what you regard as a Loss for this tax year set-off against other income for 2007-08. For all these reasons I assume you will open an enquiry."

In due course, HMRC were out of time to make an enquiry within the one-year window. Accordingly, they sought to make an assessment ("a discovery assessment") on the basis that the loss had been brought about deliberately. Here there is a 20-year window for HMRC to issue a discovery assessment. (TMA 1970 ss.29 and 36(1A).)

As it happened, both the First-tier Tribunal and the Upper Tribunal concluded that there was no deliberate inaccuracy within the tax return to enable HMRC to make such a discovery assessment.

In due course, the Supreme Court found in Mr. Tooth's favour. They said the following:-

> "Although … at first blush [it might seem] that Mr. Tooth was claiming to have incurred a partnership-related loss … perusal by a reasonably well-informed

> and careful reader of the detailed explanations provided … revealed, to the contrary, that he was claiming to carry back an employment-related loss … derived from participation in a tax avoidance scheme, and doing so by entering the relevant figure in the partnership box because the form failed to provide any employment-related box within which to do so, contrary to his interpretation of a requirement that it should do so in order to reflect s.128 of the Income Tax Act 2008.
>
> **And he even invited the Revenue to open an enquiry into this return on the express basis that the Revenue would disagree with his understanding as his right to do so.**"

I am not sure whether the Supreme Court are right in saying that when, Mr. Tooth assumed that HMRC would raise an enquiry, this was on the basis that he had put the loss in the wrong box. It seems to me, in fact, that Mr. Tooth was assuming that it was because of the nature of the tax avoidance scheme itself that there would be an enquiry. (*I have done some egregious tax planning which has produced a loss – you will dispute this and probably want to make an enquiry*.)

In the event, the Supreme Court held that the loss of tax (mentioned in s.29(1)) was not brought about *deliberately* by him.

Essentially, this was because of the nature of the disclosure in the white box including his observation that HMRC were likely to raise an enquiry.

The question which arises from this is whether in future all taxpayers should invite HMRC to open an enquiry: does that prevent HMRC from making a discovery assessment?

My view is that this is not a good idea.

The *Raymond Tooth* case was a special case because he was entering into an aggressive tax avoidance scheme which it was reasonable to assume HMRC would dislike. If you like he was almost accepting that HMRC would consider his tax return to be wrong.

But I would advise against accepting, as it were, in a tax return as a matter of course that HMRC will consider the tax return itself to be wrong. This approach seems to me to create a disadvantage in most situations since as and when a dispute arises with HMRC, HMRC will be in a position to say "You told us there was a problem with your approach and we agree: there is."

After all, stepping back from this, the purpose of the self-assessment return is for a taxpayer to self-assess. In other words, they work out what they consider the correct tax is and "they go nap on that" in their tax return. To my way of thinking it is not appropriate when the requirement for the taxpayer is to finish off a tax return in a way which they consider to be correct to then say it may not be correct.

So my preference always is to do the following if a taxpayer is aware that they are adopting an approach with which HMRC will disagree.

Provided that the taxpayer is satisfied that their methodology is correct, they should say something along the following lines.

For example:-

> "I am adopting a [say] transfer pricing policy which I consider to be correct for the following reasons. I have considered carefully HMRC's counter approach but I consider that to be incorrect and I have therefore produced my transfer pricing outcome on the basis of what I consider to be the correct policy. This policy is as follows … and my justification for adopting this policy is as follows …"

## **Conclusion**

The white space disclosure is an important feature for a taxpayer to use where relevant.

It is plain from *Johnson and Johnson* that it cannot be used to "forgive and explain" a clear mistake.

In my view, however, it should not be used, except in rare cases, on the basis that the taxpayer considers that their approach is likely to be challenged by HMRC. That runs the risk of HMRC starting on the front foot with negotiations: "you knew that we would disagree because you knew that your approach was wrong." In other words, the taxpayer should work out what the correct position is, assess on that basis, but, where relevant, give the heads up to HMRC in the white space disclosure i.e. should explain how the taxpayer has reached their conclusion albeit that it is expressed to be on a basis with which HMRC will disagree. That does not move away from the important stance which is that the taxpayer considers their approach to be correct and they have self-assessed on that basis.

# UK RESIDENCE: EXCEPTIONAL DAYS REVISITED

***Peter Vaines***

In 2020 at the height of the COVID lockdown there was a great deal of concern about the tax position of people who got stranded in the UK, and the effect that the extra number of days which they spent in the UK could have on their residence status under the statutory residence test.

The important question is whether days spent in the UK unintentionally for this reason will be counted in determining their residence for tax purposes or whether such days can be disregarded on the basis of exceptional circumstances within the meaning of Schedule 45(22) FA 2013. A review of the legislation (and the HMRC Guidance) shows that taxpayers have good reason to be concerned.

The law on the subject is brief. Paragraph 22(4) provides that a day will not be counted as a day spent in the UK if:

a) The taxpayer would not have been present in the UK at the end of that day but for exceptional circumstances beyond his control that prevent him from leaving the UK, and

b) He intends to leave the UK as soon as those circumstances permit.

Paragraph 22(5) gives examples of such exceptional circumstances:

a) National or local emergencies such as war, civil unrest or natural disasters, and

b) A sudden or life-threatening illness or injury

That is all it says – apart from paragraph 22(6) which provides a statutory limit of 60 days which can be disregarded by reason of exceptional circumstances.

In the FCTC Digest No 1 these rules were discussed in detail, and it is clear that on a plain reading of the legislation it is are extremely difficult to satisfy the terms of paragraph 22(4). Unless you are in prison or in a coma it is unlikely that you will be prevented from leaving the UK. Even if there are no flights, you could always get on the Eurostar, or travel by ferry to lots of places. The rule is not that you cannot get home; the rule is that you are prevented from leaving the UK.

The HMRC Manual sets out their views on the meaning of exceptional circumstances but that is not very helpful. In some parts it is excessively strict, imposing additional restrictions which are not in the legislation, and in other places HMRC provide relaxations which are simply contrary to the legislation – as well as some idiosyncratic interpretation. However in response to the Coronavirus, HMRC announced some important relaxations – or at least sympathetic interpretations – which were widely welcomed. There were many people, who were trapped in the UK and were prevented from leaving by the virus – they may have been in hospital or quarantine. That sounds good – although it would not be enough unless they can prove that they intended to leave as soon as circumstances permitted.

It is highly unlikely that anybody other than a tax professional would have any idea of the strictness and complexity of the statutory rules – or how inconsistent is the guidance provided by HMRC. Taxpayers are bound to be anxious and confused, because they would know how important it is; their residence status – and their liability to tax – will depend upon it.

Two years on from the onset of these difficulties, the first case on the meaning of exceptional days has now reached the First Tier Tribunal *(Taxpayer v HMRC* TC 8464) which provides the only judicial guidance so far about how paragraph 22 should be interpreted.

The judgment is helpful in many ways – certainly to the taxpayer – but personally I have my doubts. It may be too helpful. It may be that the Tribunal was so sympathetic to the taxpayer that the decision might not be allowed to stand.

The case reveals the (excessively) strict approach that HMRC have taken to the meaning of exceptional circumstances, so we know what to expect when any dispute arises – even though their interpretations were given the thumbs down by the Tribunal.

The judge explained that the SRT is prescriptive and that Parliament acknowledged the need for some flexibility – and it did so by providing the rules for exceptional circumstances. He went on to say that the words in paragraph 22(4) are clear and non technical; they are not ambiguous or obscure. They are ordinary English words which do not need the deployment of synonyms or a thesaurus. He referred to the judgment of Lord Bingham in *R v Kelly [2000]:*

> "We must construe "exceptional" as an

> ordinary familiar English adjective, and not as a term of art. It describes a circumstance which is such as to form an exception which is out of the ordinary course, or unusual or special, or uncommon. To be exceptional, a circumstance need not be unique or unprecedented or very rare; but it cannot be one that is regularly or routinely or normally encountered"

The facts were complicated and will have little application to any other case. However there were some important points made by the Tribunal which will be of wide application.

HMRC claimed that to be exceptional circumstances, the events which prevented the taxpayer from leaving the UK had to be unforeseeable. Otherwise the taxpayer could plan ahead and avoid being prevented from leaving the UK. Furthermore, if they were foreseeable they were not outside his control.

Not so, said the Tribunal. Foreseeability could be relevant but it certainly not the determining factor as suggested by HMRC.

HMRC argued (and it is in their guidance) that you have to be in the UK when the relevant event occurred. If you come to the UK for example for medical treatment – no deal. The Tribunal said this was wrong. What you have to do is to look at the position at the end of each day and see whether or not the taxpayer is prevented from leaving the UK.

The Tribunal further explained that the events preventing the taxpayer from leaving the UK need not be just physical, like the closing of borders or lockdown restrictions; it included moral obligations and matters of conscience, such as being at the bedside of a sick relative (not just the limited group of persons set out in the HMRC guidance). That is clearly sensible, and very welcome; the arbitrary rule imposed by HRMC was completely unjustifiable.

However, I would suggest that there must be a limit. If we interpret "prevent" widely, it could encompass many things – from a shutdown at the airport preventing any flight departures, to "I could not possibly leave because my maid was off sick and there is nobody to feed the cat". It is clearly a question of degree, but we do not have any help in determining where events are on the spectrum from *Obviously Exceptional* at one end, to *Don't Be So Silly* at the other.

The Tribunal seemed not to be concerned about the obvious point that, short of physical restraint, there is little that actually prevents somebody from leaving the UK. They may not be able to get home but they can certainly leave the UK. Plane, train, ferry – one of them would nearly always be working. (In this case the taxpayer had – or had access to – a private jet so could have left the UK whenever she wanted).

The legislation is really tough but if the words used are clear and non technical, how do we get past them. There are endless examples of the courts saying that the law may be strict (and harsh) but the words are clear and unambiguous – as is the case here – and have to be applied. The taxpayer cannot ask the Court to add in words of relaxation because they feel it is too strict, any more than HMRC can add words of restriction of their own choosing– which they even tried to do in this case (as if the rules weren't already bad enough).

The approach taken by the judge was to give a wide meaning to "prevent" – that the taxpayer was not prevented from leaving the UK by the unavailability of transport but was prevented from leaving by the need to care for her sister.

It is clear that the highly restrictive interpretations that HMRC are giving to the concept of exceptional circumstances are unwarranted, and it will be interesting to see whether their approach will change in the future as a result of this case. I would suggest that this is too important a matter to be left at the First-Tier level and hope that further, more specific, and binding judicial authority will be forthcoming.

# CURIOUSER AND CURIOUSER!

# THE CASE OF GERALD AND SARAH LEE [1]

*Katherine Bullock*

## Introduction

The First Tier Tribunal (FTT) has once again been called upon to decide the meaning of 'period of ownership' for the purposes of Principal Private Residence (PPR) Relief; this time where the house has been lived in since completion but the land has been owned for longer than the existence of the house.

It is an important case for those building their own homes on land that they have purchased or demolishing a previous property and building a new home on the site.

It raises an interesting point about how much weight should be given to the codification of Extra-Statutory Concessions in determining the meaning of legislation.

[1] [2022] UKFTT 175 (TC)

Finally it highlights once again the difficulty for practitioners advising on this area of law where there remains little to be added to Balcombe LJ's comment in *Lady Rook* in 1992: "I do not find the current state of the authorities very satisfactory, and it is hardly surprising that different sets of General Commissioners have reached conclusions which are not always easy to understand."

## The Facts

In October 2010, Mr and Mrs Lee purchased a house for £1.7million. They demolished the house and built a new replacement house in its place. The new house was completed 29 months later and the Lees moved in four days later. On 22 May 2014, 43 months after they had purchased the original house, the Lees sold the new house for £6million.

After extensive correspondence, HMRC accepted that the disposal was not a trading transaction nor was the property acquired or expenditure incurred with a view to realising a gain. The transaction was not covered by ESC D49, which allows relief in respect of the first two years of ownership where a house is not occupied because it is under construction. All parties therefore agreed that PPR relief was available. The question was “how much?”.

## The Question

What was the period of ownership for PPR purposes? Was it the 43 month period of ownership of the land, that is from when the original house was acquired and the new house sold? If so, Mr and Mrs Lee would only be deemed to occupy the property for the final 18 month statutory period and CGT would arise on 29/43rds of the gain. Or was it the 14 months period of ownership in which the new house existed? In this case, Mr and Mrs Lee had occupied the property for the entire period of ownership and the gain would be fully relieved by PPR relief.

## The Law

It is perhaps helpful to pause here to set out the relevant legislation:

TCGA 1992 s.222 sets out the conditions for relief and provides as follows:

> *(1) This section applies to a gain accruing to an individual so far as attributable to the disposal of, or of an interest in –*

> *(a) A dwelling-house or part of a dwelling-house which is, or has at any time in his period of ownership been, his only or main residence ...*

> *(7) In this section and sections 223 to 226, "the period of ownership" where the individual has had different interests at different times shall be taken to begin from the first acquisition taken into account in arriving at the expenditure which under Chapter III of Part II is allowable as a deduction in the computation of the gain to which this section applies ...*

TCGA 1992 s 223 sets out how the amount of relief is calculated:

> *(1)No part of a gain to which section 222 applies shall be a chargeable gain if the dwelling-house or part of a dwelling-house has been the individual's only or main residence throughout the period of ownership, or throughout the period of ownership except for all or any part of*

*the last 18 months of that period.*

*(2)Where subsection (1) above does not apply, a fraction of the gain shall not be a chargeable gain, and that fraction shall be— (a) the length of the part or parts of the period of ownership during which the dwelling-house or the part of the dwelling-house was the individual’s only or main residence, but inclusive of the last 18 months of the period of ownership in any event, divided by (b) the length of the period of ownership.*

**Does ‘dwelling house’ include the land?**

HMRC contended that there was a single asset, an interest in land, registered under the same title at land registry. On the disposal of the interest in land, the cost of acquiring the land was allowable expenditure under TCGA 1992 s.38(1)(a) and the cost of building the new house was allowable expenditure under TCGA 1992 s.38(1)(b).

HMRC argued that ‘period of ownership’ referred to the 43 month period during which Mr and Mrs Lee owned that single asset, being the interest in land, whether or not the dwelling-house was on the land throughout that time, was renovated or changed entirely. There could not be ownership of the house separate from the land. For example, s.288(1) states that '*land* includes messuages, tenements, and hereditaments, houses and buildings of any tenure'.

In adopting this view, they relied on *Henke v HMRC [2006] STC (SCD) 561*. This was a special commissioner's decision and therefore not a binding authority. The facts of the case were similar and the Special Commissioner decided that PPR relief was only available for the last 18 months of ownership. The Special Commissioner stated as follows:

> "In my view the Parliamentary intention behind the legislation is clear; there is to be only one period of ownership, of the single asset consisting of the land and any buildings which may be erected on it during that period. It follows that an apportionment is required where land is held for a period and subsequently a house is built on it and

> occupied as the individual's only or main residence."

However, whilst the Tribunal cited the case and recognised the similarities, the decision in *Henke* was not considered further.

The Tribunal agreed that a single asset was bought and sold. For this reason, it disagreed with HMRC's alternative argument that if the ownership of the new house could be separated from the ownership of the land, Mr and Mrs Lee would have different interests at different times; the interest in the land with the dwelling house replacing the interest in the land without the dwelling house. If so TCGA 1992 s222(7) would apply to take the period of the first acquisition into account. In the Tribunal's view TCGA 1992 s222(7) was not in point because separate interests were not owned at different times.

However, the existence of one asset did not mean that the relief operated on the period of ownership of that asset. There were instead two separate steps. The legislation works to calculate a gain on an asset, and then to determine whether, and if so how much, relief applies to that gain.

## Meaning of 'period of ownership'

Period of ownership is not defined in the legislation. This was recognised by the Court of Appeal in *Higgins v HMRC [2019] STC 2312 (para 26)* and was argued by HMRC and accepted by the Special Commissioner in *Henke*. The Tribunal decided that the phrase should therefore be given its ordinary meaning and that the natural construction is that period of ownership refers to the period of ownership of the house sold.

The Tribunal did not agree that the definition of 'dwelling-house' included the land on which it was built. It did not follow that because the definition of 'land' included a house that the definition of 'dwelling-house' included land. The fact that the legislation uses 'dwelling-house' meant that it was capable of being treated separately. No mention was made of land in this connection.

The Tribunal considered that the decision of the Court of Appeal in *Higgins v HMRC [2019] EWCA 1860,* whilst concerned with a different question, leant credence to the view that 'period of ownership' is unlikely to start before the asset in question exists.

*Higgins* is, however, hard to reconcile with the facts in the case of *Gerald and Sarah Lee* given that the Court of Appeal itself did appear to draw a distinction between a non-existent flat and a building plot:

> *(Para 22) It would anyway be hard to see how Mr Higgins' "period of ownership" of the Apartment could have begun before late 2009. When contracts were exchanged in 2006, the Apartment was just a "space in the tower". The present case is thus distinguishable from one in which someone contracts to buy a plot of land on which a house is to be built.*

## The impact of codification of an Extra Statutory Concession on statutory interpretation

It was agreed that the purpose of the legislation was to enable the proceeds from the sale of a dwelling-house to be invested in a new residence. The Tribunal agreed with the position as stated in *Sansom v Peay* [1976] 1 WLR 1073: "*The justification for the exemption is that when a person sells his home he frequently needs to acquire a new home elsewhere. The evil of inflation was evident even in 1965. It* *must have occurred to the legislature that when a person sold his home to buy another one, he may well make a profit on the sale of one home and lose that profit, in effect, when he buys his new home at the new, inflated price. It would not therefore be surprising if parliament formed the conclusion that, in such circumstances, it would be right to exempt the profit on the sale of the first home from the incidence of capital gains tax so that there is enough money to buy the new home.*[2]"

The taxpayers argued that Parliament would not therefore have legislated to deny self-builders full relief. Surprisingly the Tribunal decided that Mr and Mrs Lee's circumstances were unusual and would not have been contemplated when the legislation was drafted. However, it did not agree that the codification of ESC D49 was intended to address an unintended oversight in the legislation.

The taxpayers argued that there was no oversight in the legislation. The legislation was never intended to reduce the exempt amount because the land had been owned for a period before the house was built. Whilst it might be possible to avoid a chargeable gain

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[2] at p 1077 B-C

on land by building a house and living in it, this was prevented by TCGA 1992 s224(3). It was only HMRC's incorrect interpretation, that required the introduction of ESC D49. ESC D49 was therefore unnecessary.

HMRC agreed that ESC D49 would not be needed if the taxpayer's reading of the legislation was correct. However, they argued that the codification of ESC D49 into law must therefore mean that Parliament agreed with HMRC's interpretation.

The Tribunal agreed that the legislation must be looked at on its own and the existence or not of an Extra Statutory Concession had no bearing on how the legislation should be interpreted.

### The Decision

The decision of the Tribunal was therefore to allow the appeal on the following basis:

- In the absence of definitions, the legislation should be read with its natural construction, unless doing so would lead to a clear anomaly contrary to the wishes of Parliament;

- There is no definition of the period of ownership.
- The natural reading is that ‘period of ownership’ means period of ownership of the house that is being sold;
- There is no compelling reason to depart from the natural reading of the legislation.

**Comments**

The Tribunal was not convinced by the ‘anomalies’ adduced by either side. However, the decision clearly creates opportunities for taxpayers. For example, it would be possible to hold land for a significant period, build a house on it and shelter the whole gain provided that the taxpayer occupies the house from completion to sale. There does remain a risk of a successful argument in these circumstances that the taxpayer has developed the land or that TCGA 1992 s.243 applies.

It remains to be seen whether HMRC choose to appeal this decision. As it stands, the decision does not create a precedent. Sadly, whilst the Tribunal cited the various decision on this point, it chose not to analyse them. *Gerald and Sarah Lee* may therefore stand as yet another curious First-Tier Tribunal decision that adds to the ‘pick-and-mix’ of judgements on this issue which stand ready to be deployed in aid of either side where PPR relief is in dispute. As the King told Alice, “*If there’s no meaning in it, that saves a world of trouble, you know, as we needn’t try to find any.*”

# FROM CRYPTOASSETS TO THE VIRTUAL WORLD: TO IMPAIR, OR NOT TO IMPAIR?

## HOW TO TREAT LOSSES FROM CRYPTOCURRENCIES?

**Oktavia Weidmann**[1]

*'Nothing will come of nothing.'* William Shakespeare, King Lear

In the 10th FCTC Digest, David Southern KC and I dealt with general taxation aspects of cryptoassets.[2] We mainly focused on explaining how cryptocurrencies work and discussed income and capital gains taxation of cryptocurrencies in the hands of individuals. We also outlined the issue of the location of cryptocurrencies for legal and tax purposes and the tax treatment of *Bitcoin & Co* for resident, non-domiciled individuals.

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[1] Dr Oktavia Weidmann is a Teaching Fellow at Queen Mary University of London in banking and finance law. Oktavia specialises in the taxation of investment funds, derivatives and cryptoassets.

[2] David Southern QC and Oktavia Weidmann, Cryptoassets: 'A New Weapon of Massdestruction?' 10th edition, FCTC Digest, April 2022, 111-140.

Back in April 2022, we suggested that cryptocurrencies may melt in the digital wallets of their users like snow in the sun. That has happened. While one Bitcoin had a value of 35,000 GBP beginning of April, it had dropped to almost 15,000 GBP by mid-June 2022. Since then, Bitcoin has 're-bounced' to 17,000, but it is still far away from its former heights.

The warnings of Luke Ellis, CEO of Man Group, come into mind: 'There is no inherent worth in it whatsoever. It's a tulip bulb.'[3]

Warren Buffett agreed with Ellis, suggesting:

> It's ingenious and blockchain is important but Bitcoin has no unique value at all, it doesn't produce anything. You can stare at it all day and no little Bitcoins come out or anything like that. It's a delusion basically.[4]

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[3] Jamie Crawley, *Coindesk*, 2021, https://www.coindesk.com/markets/2021/07/26/tulip-bulb-crypto-has-no-inherent-worth-man-group-ceo-says/, accessed 28 August 2022.
[4] CNBC, February 2019, https://www.youtube.com/watch?v=m4vDTAelhCM

One year later, Buffett insisted:

> "Cryptocurrencies basically have no value and they don't produce anything. They don't reproduce, they can't mail you a check, they can't do anything, and what you hope is that somebody else comes along and pays you more money for them later on, but then that person's got the problem. In terms of value: zero."[5]

As Bitcoin and other cryptocurrencies have been bruised quite a bit, it is time to take a closer look at the accounting and tax treatment of cryptocurrency losses.

## THE ISSUE

The accounting and tax treatment of impairment losses on cryptocurrency is relevant because of the sharp decline of cryptocurrencies in the first half of this year.

US companies that have heavily invested in Bitcoin & Co as part of their overall strategy, like Tesla, MicroStrategy, Block, and others, reported

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5 CNBC, February 2020, https://www.youtube.com/watch?v=d6yqrwOZVjY

impairment losses in Q 2 of 2022.[6] However, their cryptocurrency holdings often still stood at an overall gain on a fair value basis.[7]

Why can some US companies reduce their overall tax liability while the Bitcoin holdings still stand at an overall gain?

For example, MicroStrategy reported a total of US$ 918 million in impairment losses in Q 2 2022, which they coined as 'digital impairment charges' or 'non-cash charges', and a total of US$ 425 in Q 1 2022. MicroStrategy is a healthy company with a solid net income. But they do not pay any taxes because of the heavy impairment losses.[8]

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[6] MicroStrategy, Q2 Financial Results, https://www.microstrategy.com/content/dam/website-assets/collateral/financial-documents/events-presentations/Q2-2022_microstrategy-earnings-presentation.pdf, accessed 28 August 2022.
[7] Oluwapelumi Adejumo, Public companies holding Bitcoin face impairment losses amid market crash, https://cryptoslate.com/public-companies-holding-bitcoin-face-impairment-losses-amid-market-crash/, accessed 28 August 2022.
[8] *Francine McKenna, Taxes are a wild card for public companies holding crypto,* https://finance.yahoo.com/news/taxes-wild-card-public-companies-145853836.html, accessed 28 August 2022.

In a recent Forbes article, *Shehan Chandrasekera,* sums up the US GAAP treatment of *Bitcoin & Co* as follows:

> Currently, digital assets like bitcoins are classified as "intangible assets with indefinite lives" under GAAP. In simple terms, this accounting treatment requires companies to report a loss when digital asset prices fall below the cost; however, it prohibits marking up digital assets to it's true value if prices later recover.[9]

How are those cryptocurrency impairment losses treated for UK accounting and tax purposes?

We must consider the IFRS accounting classification and measurement of cryptocurrencies to understand the UK tax treatment of cryptocurrency losses.

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[9] Shehan Chandrasekera, Bitcoin's Accounting Treatment Is Depressing MicroStrategy's Bottom Line, June 2022, https://www.forbes.com/sites/shehanchandrasekera/2022/06/01/bitcoins-accounting-treatment-is-artificially-degrading-microstrategys-bottom-line/?sh=d9dd55233e11, accessed 28 August 2022.

The topic is highly complex and, therefore, will be dealt with in more than one article to make it more palatable for our learned readers.

The following questions are of relevance:

1. How are cryptocurrencies treated for accounting purposes classified, and why? How are cryptocurrency losses measured for accounting purposes, and what does the impairment mean for the financial accounts?

2. How do businesses holding cryptocurrencies as an investment treat cryptocurrency impairment losses for tax purposes?

3. How do corporates holding cryptocurrencies as an investment treat cryptocurrency impairment losses for tax purposes?

4. How are cryptocurrency losses treated for private individuals?

I will discuss only the accounting treatment for cryptocurrency losses in this article. A second will discuss the tax treatment of cryptocurrency losses for businesses and the third for corporates.

This article does not take a shortcut by largely repeating what has been written elsewhere. Instead, the accounting treatment of cryptocurrency will be analysed thoroughly as only a complete understanding of the accounting position is a basis for the later discussion of the tax treatment.

## ACCOUNTING OF CRYPTOCURRENCIES

### a) Classification

In the Whitepaper, Bitcoin: *A Peer-to-Peer Electronic Cash System*, which was published in 2009, the founder of Bitcoin, Satoshi Nakamoto, identifies the purpose of Bitcoin as follows:

> Commerce on the Internet has come to rely almost exclusively on financial institutions serving as trusted third parties to process electronic payments. [...] The cost of mediation increases transaction costs [...], and there is a broader cost in the loss of ability to make non-reversible payments for non-reversible services. [...] These costs and

> payment uncertainties can be avoided in person by using physical currency, but no mechanism exists to make payments over a communications channel without a trusted party. **What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party**.[10]

Bitcoin was intended as a peer-to-peer **electronic cash system** by its founder.

For accounting purposes, the various characteristics of cryptocurrency are summarised by IFRS Interpretations Committee as follows:

a) a digital or virtual currency recorded on a distributed ledger that uses cryptography for security,

[10] Satoshi Nakamoto, Bitcoin, A Peer-to-Peer electronic cash system, https://bitcoin.org/bitcoin.pdf, accessed 10 August 2022.

b) not issued by a jurisdictional authority or another party, and

c) does not give rise to a contract between the holder and another party.[11]

If one considers the accounting treatment without prejudice based on the economic properties of cryptocurrencies, the following choices should be considered: **IAS 7, IAS 32, IFRS 9, IAS 38 and IAS 40.**

**A) IAS 32/ IFRS 9**

Accounting cryptocurrencies as a financial asset at FVTPL in accordance with **IFRS 9** would have the policy advantage of having a ready system that measures cryptocurrencies in a timely manner. To be able to do so, cryptocurrencies must meet the definition of **IAS 32**.

If a cryptocurrency is a **financial asset within IAS 32**, it must be an asset that is:

[11] IFRS Interpretations Committee Meeting, Holding of Cryptocurrencies, Agenda Decision to finalise, June 2019, https://www.ifrs.org/content/dam/ifrs/meetings/2019/june/ifric/ap12-holdings-of-cryptocurrencies.pdf, accessed 9 May 2022, page 1.

(a) **cash**

(b) **an equity instrument** of another entity

(c) **a contractual right**

i. to receive cash or another financial asset from another entity; or

ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) **a contract** that will or may be **settled in the entity's own equity instruments** and is:

i. a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

ii. a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro-rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.[12]

## 1. 'Digital' cash?

**IAS 7** concerns **cash and cash equivalents**.

IAS 7 does not define cash, however. Thus, to determine if cryptocurrency is digital cash, we must look at IAS 32 'Financial Instruments: Presentation', which says that

[12] IAS 32.11.

**currency** (cash) is a **financial asset** because it represents the medium of exchange and is, therefore, the basis on which all transactions are measured and recognised in financial statements.[13]

**The case against digital cash:**

In a traditional currency setting (a fiat-based system), a currency or cash is anything the state orders to be, and the market accepts as being money. Thus, a legal tender takes place, and central banks issue the countries' currency in return for securities. In theory, the monetary system is open-ended, and a currency is unlimited.[14]

However, the value of a currency is related to the general outputs of an economy. In theory, depending upon central bank policies, the money supply expands and contracts as the economy grows and shrinks.

By contrast, most cryptocurrencies are not issued or backed by any government, except for the *Digital*

[13] IAS 32.AG3.
[14] Southern/Weidmann, page 125.

*Yuan*. There is no legal tender.[15] Bitcoin and other cryptocurrencies only exist in a finite number of electronic units, and the value of the units depends upon the operation of a market, bringing buyers and sellers together.[16]

The IFRS IC states that

> it is not aware of any cryptocurrency that is used as a medium of exchange and as the monetary unit in the pricing of goods or services to such an extent that it would be the basis on which all transactions are measured and recognised in financial statements.'[17]

[15] PWC, Cryptographic assets and related transactions: accounting considerations under IFRS, December 2019, https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-16/cryptographic-assets-related-transactions-accounting-considerations-ifrs-pwc-in-depth.pdf, accessed 8 May 2022, page 5.

[16] Southern/ Weidmann, page 126.

[17] IFRIC Update March 2019, Holding of Cryptocurrencies, Agenda Paper 4, https://www.ifrs.org/news-and-events/updates/ifric/2019/ifric-update-march-2019/#1, accessed 6 May 2022.

Thus, IFRS IC argues cryptocurrency is not cash because it cannot be readily exchanged for any good or service.[18]

The accounting community does not regard cryptocurrencies as cash because (i) it is not backed by a government or central bank, and (ii) they are not considered legal tender in almost all jurisdictions.

**The case for digital cash:**

The majority view that qualifies cryptocurrencies not as currency or cash can be contested. Therefore, I will try to find arguments favouring the qualification of cryptocurrency as digital cash.

First, the classification of cryptocurrency for accounting purposes is a moving target. For example, the *Digital Yuan* meets the criteria of a currency and money,[19] and the Central Bank of the Bahamas issued

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[18] IFRS Viewpoint, Accounting for cryptocurrencies – the basics, https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/ifrs/ifrs-viewpoint-9---accounting-for-cryptocurrencies--the-basics.pdf, page 4.

[19] Sharecast, What does China's Digital Yuan mean for Bitcoin?, https://www.sharecast.com/promoted/cryptocurrencies/what-does-chinas-digital-yuan-mean-for-bitcoin.html, accessed 7 August 2022.

the *Sand Dollar* in 2020. Ten countries have fully launched a digital currency, and 105 countries, representing 95% of the global GDP, are at least exploring the launch of *Central Bank Digital Currencies* (CBDC).[20] Thus, the legal tender argument does not apply to CBDCs.

Second, some merchants accepted cryptocurrencies as a payment means for their goods before their sharp decline in 2022.[21] Thus, we already have tendencies in the market that Bitcoin is seen as means to pay for goods and services. Microsoft accepted Bitcoin as a payment method as early as 2014.[22]

Third, Bitcoin was sold at 'ATMs' in the UK and is now sold at cash machines in Germany. In the UK, a total of 85 Bitcoin cash machines, where people could

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[20] Atlantic Council, Central Bank Cryptocurrency tracker, https://www.atlanticcouncil.org/cbdctracker/

[21] Rohit KVN, After Bitcoin, Tesla now accepts Dogecoin cryptocurrency for merchandise purchase, Deccanherald, https://www.deccanherald.com/business/technology/after-bitcoin-tesla-now-accepts-dogecoin-cryptocurrency-for-merchandise-purchase-1071023.html, accessed 20 August 2022.

[22] Cointelegraph, Bitcoin as a payment method, https://cointelegraph.com/explained/who-accepts-bitcoin-as-payment, accessed 11 August 2022.

buy cryptocurrency at an ‘ATM’. The FCA shut down those unregulated ‘cash machines’ in March 2022.[23] Still, Bitcoin has the appearance of cash.

Fourth, the old proverb if it looks like a duck and walks like a duck, it is a duck applies if we take a closer look at what Bitcoin stands for.

1. The intention of the inventor of Bitcoin as a peer-to-peer electronic cash system speaks for categorising the same as cash.

2. The behaviour of cryptocurrency can be seen as cash but without the backing of a government. The public sees it as something that symbolises monetary value. It is seen as a means of storing value outside a traditional government and monetary system.

Fifth, the classification as an intangible asset does not fit the character of cryptocurrencies. Compared to goodwill, trademarks and copyrights, which have been built up in a business and contain a substantial

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[23] BBC, Bitcoin cash machines ordered to shut down in UK, 11 March 2022, https://www.bbc.com/news/technology-60709209, accessed 10 August 2022.

economic value built up over the years, cryptocurrencies are highly volatile, as can be seen by the many ups and downs in recent years. Cryptocurrencies behave more like high-risk financial assets or volatile currencies like the Turkish Lira.[24]

Sixth, cryptocurrencies like Bitcoin can be converted into cash at a Bitcoin exchange or a third-party broker against a fee. Of course, the value of Bitcoin depends on supply and demand. Bitcoin sellers can sell their Bitcoin at such a decentralised exchange and convert it into cash if a buyer is willing to pay the amount requested, although the prices are highly volatile.

Lastly, if cryptocurrencies are something other than digital cash, that will also have consequences for the tax treatment. Classification as a financial asset could benefit (tax) policy reasons. The accounting and taxation rules for financial assets are a well-developed system that can deal with many issues regarding loss recognition, ring-fencing of losses and avoidance schemes. However, a classification as a

[24] Wikipedia, https://en.wikipedia.org/wiki/2018–2022_Turkish_currency_and_debt_crisis, accessed 1 September 2022.

financial asset and not as an intangible asset is necessary for this approach.

That said, the accounting world does not – as of now – see cryptocurrency as digital cash – like Nakamoto originally intended.

## 2. Cash equivalent?

'Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.'[25]

It is argued that because cryptocurrencies are highly volatile, they cannot be regarded as cash equivalent.[26] That argument seems quite strong. If one compares: the maximal US Dollar against Turkish Lira volatility is 82% according to the GARCH volatility analysis, whereas the maximum

[25] IAS 7.6.

[26] Grant Thornton, IFRS Viewpoint, Accounting for Cryptocurrencies – the basics, https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/ifrs/ifrs-viewpoint-9---accounting-for-cryptocurrencies--the-basics.pdf, accessed 24 August 2022.

US Dollar against Bitcoin volatility is 430%.[27] Still, Bitcoin has only been around for thirteen years, and it may become less volatile over the years.

The *Digital Yuan* can be seen as cash-like as there is legal tender and as good and services in China's retail sector can be bought with it.[28]

### 3. Contractual right?

Does cryptocurrency provide a contractual right

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity?

If we take *Bitcoin*, one will have to conclude that Bitcoin does not give any right to receive cash or another financial asset from another entity.

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[27] Volatility calculator, https://vlab.stern.nyu.edu/volatility/VOL.BTCUSD%3AFOREX-R.GARCH, accessed 2 September 2022.

[28] China Daily, China's digital yuan can leverage the Road Initiative. https://www.chinadaily.com.cn/a/202208/12/WS62f9a7d1a310fd2b29e722e9.html, accessed 16 August 2022.

The IFRIC Agenda Paper therefore concludes that traditional cryptocurrencies like Bitcoin do not give rise to a contractual right for the holder and it is not a contract that will or may be settled in the holder's own equity instruments.[29]

In the previous article, we have outlined why cryptocurrencies cannot be regarded as derivatives.[30]

## B) IAS 40: Investment Property

Before the recent crash of cryptocurrencies in 2022, Bitcoin & Co were often described as 'digital gold'. Cryptocurrency firms were ready to claim that people would make the deal of their lifetime if they bought cryptocurrencies. The claim is at least doubtful. If we see the recent decline of cryptocurrencies, one must be cautious. It is without a doubt that cryptocurrencies are a risky and volatile investment.

Investment property is property (land or a building or part of a building or both) held (by the owner or

[29] IFRIC Update March 2019, Holding of Cryptocurrencies, Agenda Paper 4, https://www.ifrs.org/news-and-events/updates/ifric/2019/ifric-update-march-2019/#1, accessed 6 May 2022.
[30] Southern/Weidmann, pages 126-128.

the lessee under a finance lease) to earn rentals or for capital appreciation.

Thus, although cryptocurrencies are often held for capital appreciation, they would not fall in any real estate category mentioned in IAS 40. Simply speaking, they are digital and cannot be touched.

### C) IAS 38: Intangible Assets

As cryptocurrencies do not fall in any other category, they are commonly regarded as intangible assets under IAS 38 unless it is ‘held for sale in the ordinary course of a business’, according to the IFRIC; in the case of the latter, IAS 2 Inventories, applies.

The IFRIC Agenda Paper cites IAS 38, paragraphs 8 and 12 and maintains,

> The Committee observed that a holding of cryptocurrency meets the definition of an intangible asset in IAS 38 because (a) it is capable of being separated from the holder and sold or transferred individually, and (b) it does not give the holder a right to receive a fixed or

> determinable number of units of currency.[31]

PwC states:

> Holding a unit of a cryptocurrency typically does not give the holder a contractual right to receive cash or another financial asset, nor does the cryptocurrency come into existence as a result of a contractual relationship. Moreover, cryptocurrencies do not provide the holder with a residual interest in the assets of an entity after deducting all of its liabilities. Therefore, cryptocurrencies that we have seen so far (November 2019) do not meet the definition of a financial asset.[32]

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[31] IFRIC Update March 2019, Holding of Cryptocurrencies, Agenda Paper 4, https://www.ifrs.org/news-and-events/updates/ifric/2019/ifric-update-march-2019/#1, accessed 6 May 2022

[32] PWC, Cryptographic assets and related transactions: accounting considerations under IFRS, December 2019, https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-16/cryptographic-assets-related-transactions-accounting-considerations-ifrs-pwc-in-depth.pdf, accessed 8 May 2022, page 5.

## What are the grounds for it?

IAS 38 'Intangible Assets' defines an intangible asset as "an identifiable non-monetary asset without physical substance".

Do the definition criteria apply?

### 1. Identifiable?

Bitcoins do not have unique identities. However, Bitcoin balances are stored in uniquely identifiable 'transaction outputs' that can only be spent by the owner of the recipient address.[33]

According to the definition of IAS 38, an asset is identifiable if it either:

(a) is **separable**, ie. is capable of being separated or divided from the entity and **sold, transferred, licensed, rented or exchanged, either individually or together with a related contract**, identifiable asset or liability, regardless of whether the entity intends to do so; or

[33] Ivy Wigmore, Bitcoin Address, https://www.techtarget.com/whatis/definition/Bitcoin-address, accessed 1 September 2022.

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations”.[34]

*Grant Thornton* maintains: ‘Cryptocurrency holdings can be traded on an exchange or in peer- to-peer transactions, and therefore meet this part of the definition.’[35]

It is argued that because they are capable of being separated from the holder and sold or transferred individually, they are also identifiable.[36]

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34 IAS 38, para 12.

35 Grant Thornton, IFRS Viewpoint, Accounting for Cryptocurrencies – the basics, https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/ifrs/ifrs-viewpoint-9---accounting-for-cryptocurrencies--the-basics.pdf, accessed 24 August 2022.

36 Crowe, Accounting for cryptocurrencies in financial statements, https://www.crowe.com/my/insights/how-should-cryptocurrencies--be-accounted--for-in-the--financial-statements, accessed 1 September 2022; ACCA, Accounting for Cryptocurrencies, https://www.accaglobal.com/in/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/technical-articles/cryptocurrencies.html accessed 16 August 2022.

It is said that cryptocurrencies like Bitcoin are easily transferrable in peer-to-peer transactions or on an exchange. It should be noted, however, that Bitcoins can only be transferred in the Bitcoin system if miners propose the next block for settlement in the Blockchain. Thus, talking about a peer-to-peer transactions is confusing as they can only be moved within the Bitcoin system when the next block is settled. I agree, however, that Bitcoins can be purchased and sold at decentralised Bitcoin exchanges.

Thus, as long as there are buyers and sellers, Bitcoin holders can convert their Bitcoin into cash, just like any other currency. Therefore, as cryptocurrencies can be traded at an exchange, Bitcoin & Co should be considered identifiable.

## 2. Non-monetary asset?

Cryptocurrencies are regarded neither as cash nor cash equivalent, see above. IAS 21 defines monetary assets as 'money held and assets to be received in fixed or determinable amounts of money.'[37]

It has been argued that the value of a cryptocurrency

[37] IAS 38.8.

‘is not fixed or determinable but subject to major variations that arise from supply and demand and cannot be predicted. Therefore, it is not monetary but non-monetary in nature.’[38]

The value of cryptocurrency is not fixed. It fluctuates like other currencies as well, just with higher volatility. Through decentralised currency exchanges, cryptocurrency can be exchanged into a precisely determinable amount of fiat currency. Like every other traditional currency, Bitcoin also depends on the market of buyers and sellers, even if it is not backed by the economic growth of an economy and even if it is not legal tender.[39]

### 3. Without physical substance?

As cryptocurrencies are digital, they do not have a physical presence.

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[38] https://www.grantthornton.global/globalassets/1.-member-firms/global/insights/article-pdfs/ifrs/ifrs-viewpoint-9---accounting-for-cryptocurrencies--the-basics.pdf, accessed 28 August 2022.

[39] NDTV, Can cryptocurrency Be converted into Cash? 31 October 2021, https://www.ndtv.com/business/can-cryptocurrency-be-converted-into-cash-read-on-to-find-out-2594499, accessed 17 August 2022.

In summary, accounting firms regard the treatment of cryptocurrencies as intangible assets under IAS 38 as appropriate based on the above considerations.

### b) Measurement of cryptocurrencies

In the case of individuals, gains or losses are recorded on a realisations (cash) basis.

For **businesses and companies**, there are the following possibilities: cost model, revaluation model or fair value model.

The **fair value model** will be applied if cryptocurrencies are held in the context of **trading activity**.

For **businesses and companies** holding cryptocurrencies as an **investment**, the **cost or revaluation model** should apply.

If the **cost model** is used, intangible assets are measured at cost upon initial recognition. They are subsequently measured at cost, less accumulated amortisation and impairment losses.

If applying the **revaluation model**, intangible assets can be accounted for at a revalued amount if there is an active market for them. That is the case for major cryptocurrencies like Bitcoin, but it may not be the case for illiquid cryptocurrencies. It should be noted that the same measurement model should be used for all assets in an asset class.

Hence, if a business is holding different cryptocurrencies for investment purposes and there is not an active market for all cryptocurrencies held, those assets should be measured using the **cost model**.

## Critical voices

In a 2019 paper, *Smith, Petkov and Lahijani* differentiate between externally and internally created cryptoassets. They propose to 'record [externally created cryptoassets] at cost and amortize based on their useful life (if such can reasonably be determined. Alternatively, test for impairment on a periodic basis.'[40] They suggest that the different accounting treatments for externally acquired versus

[40] Sean Stein Smith, Rossen Petkov and Richard Lahijani, Blockchain and Cryptocurrencies – Considerations for Treatment and Reporting for Financial Services Professionals, The International Journal of Digital Accounting Research Vol. 19, 2019, pp. 59-78, at page 69, http://www.uhu.es/ijdar/10.4192/1577-8517-v19_3.pdf, accessed 17 August 2022.

internally generated intangible assets present earnings management opportunities.[41]

The Australian Accounting Standards Board (AASB) maintains that neither the cost model nor the revaluation model in IAS 38 provides relevant information on cryptocurrencies.[42]

It is interesting to read the reasoning of the AASB:

> **We do not believe that IAS 38's measurement guidance provides relevant information**, because:
>
> - IAS 38 is written from the perspective of assets (without physical substance) used in the production of cash flows. It is not designed to deal with items held for speculative or investment purposes or for

[41] Ibid, page 69-74. Also, Pearl Tan and Tracey Zhang, Cryptocurrency Framework, https://abmagazine.accaglobal.com/global/articles/2021/feb/technical/cryptocurrency-framework.html, accessed 29 August 2022.

[42] ASSB, Digital Currency – A case for standard setting activity, https://www.aasb.gov.au/admin/file/content102/c3/AASB_ASAF_DigitalCurrency.pdf, page 12, accessed 28 August 2022.

items with cash-like features used for the payment of goods or services;

**Cost approach:**

- Cost is a historical measurement and does not provide current information;

- Amortisation reflects the pattern of consumption which is irrelevant for items held for investment purposes;

- Impairments would only recognise decreases in value;

**Revaluation approach:**

- IAS 38 only allows a revaluation approach when active markets exist for an intangible asset. Under IAS 38, if a market becomes inactive, the entity will not be permitted to continue the use of the revaluation and records only subsequent amortisation and impairment from the point when the market became inactive. On the other hand, IFRS 13 Fair Value Measurement guidance adequately and robustly considers fair value measurements in scenarios where markets become inactive;

- Revaluation changes are not always reflected in profit or loss. Consequently, profit and loss is not appropriately reflecting the performance of an asset held for speculative purposes or for items with cash-like features.[43]

Most companies and businesses are likely to apply the cost model. Given that there is not yet definitive categorisation (financial instrument, inventory, cash equivalent, intangible fixed asset), there will be a temptation to choose a classification that accords with the preferred accounting and tax outcome.

Thus, if the cost model is applied, impairments are recognised, and increases in value above cost are not recognised (that means, no accruals), the taxation of earnings can be deferred by allowing deductions for impairment losses for tax purposes, even if the digital assets are not sold and stand at an overall gain

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43 ASSB, Digital Currency – A case for standard setting activity, https://www.aasb.gov.au/admin/file/content102/c3/AASB_ASAF_DigitalCurrency.pdf, page 16-17, accessed 28 August 2022.

because of subsequent price increases. Also, one cannot rule out the possibility of tax hedges.

The next article in this Digest will deal with all those exciting questions in detail.

# FROM CRYPTOCURRENCIES TO THE VIRTUAL WORLD:

## Cryptocurrencies, NFTs, Skins, Virtual Gaming Items and UK VAT Implications

**Oktavia Weidmann[1] & Dilpreet K. Dhanoa**

*"Accordingly, the most important point to stress is that we should not, like sheep, follow the herd of creatures in front of us, making our way where others go, not where we ought to go."* [2]

This article is the first of two articles dealing with the seemingly esoteric world of cryptocurrency. In this article, we will mainly focus on the VAT implications in relation to cryptocurrencies, non-fungible tokens ('NFTs') and other digital assets. It goes beyond the discussion of cryptocurrency and discovers the universe of NFTs and begins to explore virtual items in games. The second article in this series will take a deeper dive into the detail of the taxation of virtual items in online games.

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2 Lucius Annaeus Seneca, Dialogs and Essays, On the Happy Life, To Gallio.

An analysis of contract law is needed to understand the new asset class of cryptoassets and their qualification for tax purposes. Thus, questions of classification and enforceability of so-called 'smart contracts' have to be discussed in more detail to find the correct answer for transactions in cryptoassets for VAT purposes. The authors do not always agree with HMRC's current view, or at least would like to initiate a discussion in the tax community about a coherent treatment of cryptoassets for both indirect and direct tax purposes.

An overview of the direct tax aspects relating to cryptoassets for individuals and businesses can be found in the article by David Southern KC and Oktavia Weidmann, 'Cryptoassets: A New Weapon of Massdestruction?', published in the 10th edition of the FCTC Digest.[3]

## 1. Terminology

We will briefly define the *types of cryptoassets* this article concerns before discussing their tax treatment.

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[3] David Southern KC and Oktavia Weidmann, Cryptoassets: 'A New Weapon of Massdestruction?' 10th Edition, FCTC Digest, April 2022, 111-140.

Cryptocurrency

Cryptocurrencies represent a ‘vision of how individuals could digitally hold, send and receive items of value without a trusted intermediary in the middle.’[4] For a detailed analysis of the functioning of cryptocurrencies and an outline of how the mining of *Bitcoin* works, we relate to the *Southern/Weidmann* article.[5]

NFTs

**Non-fungible tokens**, commonly known as NFTs, fall under the wide umbrella of cryptoassets.

‘NFTs are unique pieces of software, powered by smart contracts, stored on a blockchain.’[6]

NFTs – unlike cryptocurrencies – have unique identification codes that distinguish them from each other. They are a *digital representation* (blockchain-based tokens) *of physical assets*, like

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4 Ibid, 118.

5 Ibid, 120-122.

6 Ian Bradley, EY, How Taxes on Cryptocurrencies and digital assets will soon take shape, https://www.ey.com/en_gl/tax/how-taxes-on-cryptocurrencies-and-digital-assets-will-soon-take-shape, accessed 20 August 2022.

artwork, sports cards and rarities.[7] NFTs are held on or through a single computer. NFTs, like other cryptoassets, can only be accessed by an encrypted electronic key personal to the holder. NFTs have recently been used in private equity and real estate deals as a digital representation of physical assets.[8]

NFTs exist predominantly outside the gaming world, but in some cases, NFTs are also in-gaming items. That may create additional taxation issues if in-game NFTs are bought and sold.[9]

Virtual gaming items

Virtual gaming items usually belong to a different category than NFTs (although there are exceptions to NFTs used in games).[10]

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7 OpenSea is the largest market place for buying and selling NFTs. See: Discover, collect, and sell extraordinary NFTs, https://opensea.io, accessed 21 August 2022.

8 Southern/ Weidmann, 113.

9 Hirsh Chitkara, 2021, NFT games are fun. Filing taxes afterwards is a nightmare. https://www.protocol.com/nft-game-tax-scholarships, accessed 20 August 2020.

10 A lot of gamers are children and teenager, which triggers questions of how those children can acquire in-game items and if those purchases are legally valid and if those buying and selling of in-game digital items constitute gambling and thus, should be prohibited for children at all. But this is not the

In-game items are usually called Skins.[11] They are primarily special weapons that gamers use in games, but they can also be other digital goods, such as special clothes used in games. Gamers need to pay for the Skins.

The prices of Skins range from a few pounds to thousands of pounds, depending on their scarcity, and the main trading platform for Skins is Steam.[12] Gamers trade those Skins among each other, and the prices can fluctuate substantially. The Skins

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concern of this article and we have to accept that gaming and the purchase of in-game items is also popular with for many adults. For this topic, the Royal Society for Public Health Vision, Voice and Practise RSPH) has published a leading article, discussing the notion of gambling: RSPH, Skins in the Game, https://www.rsph.org.uk/static/uploaded/be3b9ba8-ea4d-403c-a1cee2ec75dcefe7.pdf, accessed 20 August 2022.

11 We will use the terms *digital goods* and *Skins* and *gaming items* interchangeably throughout this article.

12 There are thousands of articles on the internet on how to buy and sell Skins on Steam, but this article gives a flavour to our readers what it is all about: Tom Senior, 2022, The Best Steam Skins, https://www.pcgamer.com/the-best-steam-skins/, accessed 20 August 2022.

market was estimated at $ 40 billion in 2020 and is expected to grow to $ 50 billion in 2022.[13]

2. The framework of taxing of cryptoassets

Revenue authorities worldwide are interested in taxing the trading activities in cryptocurrencies and, more recently, targeting the NFT and Skins market.

Taxes may be levied by way of

(1) direct taxes

(2) VAT or sales taxes on digital goods,[14] or

(3) an alternative virtual (consumption) tax on those digital items.[15]

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13 Janusz Gądek, Skinwallet, Digital goods in computer games and their value: skins, 27 May 2020, https://thcpathfinder.com/digital-goods-in-computer-games-and-their-value-skins/, accessed 20 August 2022.

14 In the US, there are recent discussions if US sales taxes apply to virtual goods: Gail Cole, Selling goods in a virtual can have real tax implications, Avalara, Blog, 2022, https://www.avalara.com/blog/en/north-america/2022/04/selling-goods-in-a-virtual-world-can-have-real-tax-implications.html, accessed 25 August 2022; David Lingerfelt, Will emerging NFTs lead to future sales tax controversies?, LinkedIn, 2022, https://www.linkedin.com/pulse/emerging-nfts-lead-future-sales-tax-controversies-lingerfelt-esq-/, accessed 25 August 2022.

### 3. VAT on cryptocurrencies

Broadly speaking, VAT is a consumption tax levied on the provision of certain goods and services.[16] The legislative definition of 'goods' and 'services' clearly envisaged a more traditional definition of the same. For example, services are defined as *"anything which is not a supply of goods but is done for a consideration"*.[17] Cryptoassets like NFTs and Skins could technically be considered goods – but there is no physical tangible asset, so should

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15 In 2006, the US have considered designing and introducing a virtual consumption tax into the tax legislation. A virtual tax was a proposed USA tax on internet gamers for items bought or traded solely within the virtual world (Internet game worlds).
See: Wikipedia, https://en.wikipedia.org/wiki/Virtual_tax#cite_note-6, accessed 25 August 2022; also: Paul Caron, Virtual Taxes: The Next Frontier in Virtual Property Rights in On-Line Gaming? https://taxprof.typepad.com/taxprof_blog/2004/12/virtual_taxes_t.html, accessed 22 August 2022; Daniel Terdiman, Are virtual assets taxable?, 2006, accessed 25 August 2022, https://www.cnet.com/tech/gaming/are-virtual-assets-taxable/, accessed 25 August 2022; Julia Layton and Dave Roos Can the IRS tax virtual money?, 2006, updated 2013, HowStuffWorks.com, https://money.howstuffworks.com/personal-finance/personal-income-taxes/virtual-tax.htm, accessed 25 August 2022.

16 Value Added Tax Act 1994, section 4.

17 Value Added Tax Act 1994, section 5(2)(b).

they be treated as a provision of services? The distinction is critical as depending on place, location and who is supplying to who (business to business or business to customer), there is a difference in VAT treatment. Even HMRC does not quite seem to be able to precisely define cryptoassets. It states: *"VAT is due in the normal way on any goods or services sold in exchange for cryptoasset exchange tokens."*[18] HRMC considers that the *"value of the supply of goods or services on which VAT is due will be the pound sterling value of the exchange tokens at the point the transaction takes place."*[19] The difficulty with this approach is that it does not clearly identify for the seller precisely which category cryptoassets fall into. That determination is left to the seller, and in the event the classification is incorrect there are invariably penalties.

HMRC has previously attempted to provide some guidance on the issue. It makes clear that a supply of goods takes place where the seller passes 'exclusive ownership' of moveable items to another

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18 HRMC Internal Manual: Cryptoassets for businesses: Value Added Tax (VAT) (CRYPTO45000).

19 Ibid.

person.[20] A definitional problem with this is: what amounts to a moveable item? In the digital world, it does not necessarily mean physical movement of an item. It goes on to state that a supply of services is something *"other than supplying goods, for consideration"*[21] (thus adopting the broad legislative definition).

Again, the issue arises: if the way in which the cryptoasset is treated by the seller (i.e. they treat is as a good, as opposed to a service), there is a real risk that they will face penalties. Furthermore, to be within the UK VAT system a supply must be made in the UK.  Supplies made outside the UK are, in theory, outside the scope of UK VAT. However, in the world of cryptoassets and gaming, physical borders are not as rigid. What happens in circumstances where a gamer (for example) is trading NFTs based outside the UK, but they themselves are physically located in the UK? The place of supply therefore becomes important depending on whether a good or service has been supplied.

20 HRMC VAT Guide (VAT Notice 700), para. 4.4.
21 HRMC VAT Guide (VAT Notice 700), para. 4.5.

HMRC has attempted to keep within the parameters of the VAT legislation (originally drafted almost thirty years ago), and one can see that there will be particular issues that arise with the world of cryptoassets and NFTs that is likely to necessitate a change in how government seeks to tax this arena. It has stated that for VAT purposes:

> …bitcoin and similar cryptoassets are to be treated as follows.
>
> Exchange tokens received by miners for their exchange token mining activities will generally be outside the scope of VAT on the basis that:
>
> - the activity does not constitute an economic activity for VAT purposes because there is insufficient link between any services provided and any consideration; and
> - there is no customer for the mining service.
>
> When exchange tokens are exchanges for goods and services, no VAT will be due on the supply of the token itself.

It should be noted that for digital services, separate place of supply rules have been established. The onus is placed on the digital platform to account or VAT correctly.[22] Digital services include: radio and television broadcasting services; telecommunications services (including phones, mobiles and the internet); and, electronically supplied services (be that images or text, music, films, games, online content, distance programmes, software etc.). The problem even with these broad categories is that cryptoassets do not fit neatly into one or another – as discussed further below.

The VAT treatment of cryptocurrencies is still heavily influenced by the EU VAT Directives introduced into UK law. Even after Brexit, UK VAT law still relies on those Directives. Hence, looking at the European cases already decided is important, as HMRC suggested that it will not apply any changes retroactively.

Relating to cryptocurrencies, we discuss the following activities for VAT purposes:

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22 HMRC Guidance, VAT rules for supplies of digital services to consumers.

a) Mining of new Bitcoins & Co

HMRC suggests that cryptocurrencies received by miners[23] for mining activities are generally outside the scope of VAT.[24]

The reasons that HMRC gives are as follows: 'the activity does not constitute an economic activity for VAT purposes because there is an insufficient link between any services provided and any consideration received.'[25]

Further, HMRC maintains that there is no customer for the mining service.[26]

Elsewhere, it is argued that mining is not subject to VAT 'due to the absence of a contractual

[23] A detailed description of mining can be found in: Southern/Weidmann, ibid. footnote 1.
[24] HMRC, Cryptoassets Manual, February 2022, CRYPTO45000 - Cryptoassets for businesses: Value Added Tax (VAT), https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto45000, accessed 21 August 2022; similarly: HMRC, VAT Finance Manual, 22 June 2022, VATFIN2330, https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330, accessed 21 August 2022.
[25] Ibid, VATFIN2330.
[26] HMRC, Cryptoassets Manual, CRYPTO45000.

relationship between the 'miners' and other persons.'[27]

We must be careful here to accept this argument blindly; the world of crypto is a fast-moving environment, and what may have been true today may be different tomorrow. Maybe, the view was never the only one, however.

To better understand the tax issues, we have to dive deeply into English contract law, which also constitutes a basis for categorising cryptocurrencies being taxable or non-taxable for VAT purposes.

i. What are smart contracts?

*Nick Szabo* (inventor of smart contracts in 1996 before Bitcoin came to light) can be quoted as such:

> The basic idea behind smart contracts is that many kinds of contractual clauses

[27] BDO, Guidance issued on the VAT treatment of cryptocurrency transactions, Czech Republic, Tax News April 2022 https://www.bdo.global/en-gb/microsites/tax-newsletters/indirect-tax-news/issue-2-2022/czech-republic-guidance-issued-on-the-vat-treatment-of-cryptocurrency-transactions, accessed 21 August 2022. This article concerns the Czech VAT treatment but is informative nonetheless as the problems are similar.

> (such as collateral, bonding, delineation of property rights, etc.) can be embedded in the hardware and software we deal with in such a way as to make the breach of contract expensive (if desired, sometimes prohibitively so) for the breacher.[28]

Reading this article confirms that Szabo used the means of traditional contract law to describe and define those newly emerging smart contracts.

IBM defines **smart contracts** as:

> **programs stored on a blockchain that run when predetermined conditions are met**. They typically are used to **automate the execution of an agreement** so that all participants can be immediately certain of the outcome

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[28] Nick Szabo, Formalising and Securing Relationships on Public Networks, First Monday (peer reviewed internet journal), https://firstmonday.org/ojs/index.php/fm/article/download/548/469, 1996.

> without any intermediary's involvement or time loss.[29]

Or said differently: 'A smart contract is a sort of program that encodes business logic and operates on a dedicated virtual machine embedded in a blockchain or other distributed ledger.'[30]

IBM explains that smart contracts work by

> following simple "if/when…then…" statements that are written into code on a blockchain. A network of computers executes the actions when predetermined conditions have been met and verified. These actions could include releasing funds to the appropriate parties […] The blockchain is then updated when the transaction is completed. That means the transaction cannot be changed, and only

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29 IBM, What are smart contracts on Blockchain, https://www.ibm.com/topics/smart-contracts, accessed 23 August 2022.

30 Shivam Arora, Simplilearn, What is a Smart Contract in Blockchain and How Does it Work?, July 2022, https://www.simplilearn.com/tutorials/blockchain-tutorial/what-is-smart-contract, accessed 20 August 2022.

parties who have been granted permission can see the results.[31]

ii) Are 'smart contracts' legally binding under English law?

The creation of contracts requires three basic elements under English law, namely (1) an agreement, comprising of an offer and an acceptance, (2) a consideration and (3) an intention to create legal relations.

English contract law does not specify the form of a contract (with certain exceptions relating to land, for example). Thus, it is possible that a piece of computer code satisfies the conditions of the contract under English law.[32]

*Crawford* maintains that 'the terms of a smart contract are specified in code to eliminate the need for human execution, arbitration, or enforcement,

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31 IBM, What are smart contracts on Blockchain? https://www.ibm.com/topics/smart-contracts, accessed 23 August 2022.

32 Maria G.Vigliotti, What Do We Mean by Smart Contracts? Open Challenges in Smart Contract, 2021, https://www.frontiersin.org/articles/10.3389/fbloc.2020.553671/full, accessed 23 August 2022.

and since that code is stored on the blockchain, the terms of the contract can't be tampered with.'[33]

The *Law Commission* also suggests that smart contracts can, in principle, for a valid formation of a binding and enforceable contract.[34]

It defines smart legal contracts as 'legally binding contracts in which some or all of the contractual obligations are defined in and/or performed automatically by a computer program.'[35]

The Law Commission identified three features of a smart legal contract, namely:

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33 Max Crawford, Bitcoin Ecosystem, An Overview of Bitcoin Smart Contracts and How They Work, 2022, https://www.hiro.so/blog/bitcoin-ecosystem-an-overview-of-bitcoin-smart-contracts-and-how-they-work

34 Law Commission, Smart Legal Contracts, Advice to Government, https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2021/11/Smart-legal-contracts-accessible.pdf, accessed 23 August 2022; Law Commission, Smart Legal Contracts, Summary https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2021/11/6.7776_LC_Smart_Legal_Contracts_2021_Final.pdf, accessed 23 August 2022.

35 Law Commission, Smart Legal Contracts, Advice to Government, https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2021/11/Smart-legal-contracts-accessible.pdf, accessed 23 August 2022.

(1) some or all of the contractual obligations under the contract are performed automatically by a computer program ("automaticity");

(2) the contract is legally enforceable; and

(3) the computer program is deployed on a distributed ledger.[36]

The *Legal Statement by the UK Jurisdiction Taskforce* maintains that 'whether a smart contract is capable of giving rise to binding legal obligations will depend on whether the parties to the smart contract were capable of:

(1) reaching objective agreement as to its terms;

(2) intending to create a legally binding relationship and;

(3) providing something of benefit – consideration.'[37]

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36 Ibid, chapter, 2.12. page 11.

37 UK Jurisdiction Taskforce (UKJT) Legal statement on cryptoassets and smart contracts (Legal Statement), paras 136-142, https://35z8e83m1ih83drye280o9d1-wpengine.netdna-

iii) Cryptocurrencies use so-called smart contracts

Smart contracts were first explicitly used for the cryptocurrency *Ethereum*.

Furthermore, the Blockchain technology of Bitcoin that enables peer-to-peer transactions without the intervention of third parties or intermediaries is viewed by many as a form of a smart contract.

The *cryptographic protocols* of Bitcoin & Co are the definitional component of smart contracts.[38]

*Vigliotti* observes:

> By contrast, a smart contract on the blockchain is taken at face value: it is a piece of code that represents the terms of an agreement among parties. The

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ssl.com/wp-content/uploads/2019/11/6.6056_JO_Cryptocurrencies_Statement_FINAL_WEB_111119-1.pdf, accessed 23 August 2022; Osborne Clarke, Cryptoassets, Smart Contracts, Legal Status in English Law https://www.osborneclarke.com/insights/cryptoassets-smart-contracts-legal-status-english-law, accessed 22 August 2022.

38 Maria Vigliotti, What Do We Mean by Smart Contracts? Open Challenges in Smart Contract, 2021, https://www.frontiersin.org/articles/10.3389/fbloc.2020.553671/full, accessed 23 August 2022;

obligations are enforced via the consensus process when the parties deploy the contract.

A smart contract on the blockchain enables participants to:

1. Inspect the code to ensure it meets the agreed clauses
2. Be reassured that an agreed contract, once registered on the blockchain, is tamper-proof
3. Be reassured (to a certain degree) that the contract executes in the same way for all participants.[39]

*Shinobi* maintains:

> **Bitcoin is literally a smart contracting platform.** That's what it is, what it always was, what it was designed to be. The Bitcoin network functions as a giant distributed arbitrator enforcing the proper execution of smart

39 Ibid.

> contracts without relying on a single central authority to do so. It provides a mechanism for contracts to be observable, verifiable and enforceable.[40]

In order to decide, whether there is a contractual relationship between the miners and the 'Bitcoin network', that means all other participants, one needs to consider the functionality of miners within Bitcoin.

> Miners can propose a new block only if they solve the current mathematical puzzle. If a miner is able to successfully add a block to the blockchain, they will receive 6.25 Bitcoins (as of 2022) as a reward. This payment is what incentivises miners to perform the work necessary to verify transactions and maintain the database.[41]
>
> Once a miner solves the mathematical puzzle, it can post the solution and propose a block of transactions to the

[40] Ibid.
[41] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, 2008, page 4.

> network. Other members of the network then check the work. If the transactions are valid and the solution is correct, network participants update their copy of the database to reflect the new transactions.[42]

The question if the code awarding miners constitutes an enforceable smart legal contract ultimately goes beyond the scope of this article. However, we must acknowledge that the successful mining activities are seen by some authors as the fulfilment of a smart legal contract with the new Bitcoin as the consideration upon successful completion of the activity.[43]

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[42] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, 2008, page 3; see also: David Southern KC and Oktavia Weidmann, Cryptoassets: 'A New Weapon of Massdestruction?' 8th ed, FCTC Digest, April 2022.

[43] Norton Rose Fulbright, Smart Contracts, November 2019, referring to a chapter of The Contents of Commercial Contracts: Terms Affecting Freedoms was co-written by Dr Adam Sanitt, Head of Disputes Knowledge, Innovation and Business Support, Norton Rose Fulbright and Professor Sarah Green, University of Bristol, Law Commissioner for England, https://www.nortonrosefulbright.com/en/knowledge/publications/1bcdc200/smart-contracts, accessed 23 August 2023.

It has also consequences for the tax analysis if there is a smart contract between the miners who receive Bitcoin as a reward for solving the mathematical puzzle and the other participants of the Blockchain.

One could maintain that the Bitcoin is awarded the Bitcoins ('the consideration') against the work performed, i.e. solving the puzzle and adding a new block to the blockchain, based on the computer code of the Bitcoin network.

If a legally binding smart contract was concluded, the mining activity would be consequentially subject to VAT.

Thus, miners should be careful to rely on the promise that there is no VAT on mining activities. The current view by HMRC may change swiftly as an understanding of Blockchain technology grows in the legal profession. A wider acceptance of those contracts as legally binding may also lead the tax authorities to revise their current view.

<u>b) Proving exchange facilities for parties to trade cryptocurrencies against traditional currencies</u>

We need to revert to the Court of Justice of the

European Union (CJEU)[44] judgement of *Skatteverket v David Hedqvist Case C-264/14.*[45]

Mr Hedqvist wanted to set up a Bitcoin exchange and wanted to clarify the VAT position beforehand.

The CJEU regarded the exchange of Bitcoin for traditional currency as a supply of services, and not as a supply of goods.[46]

It ruled that the **exchange of Bitcoin for a traditional currency** fell within Art 135(1)(e) of the VAT directive which states that transactions 'concerning currencies, bank notes and coins used as legal tender' (the so-called 'currency exemption') are **exempt from VAT**. [47]

It based its view on the following considerations:

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44 Court of Justice of the European Union, formerly European Court of Justice (ECJ).

45 Judgment of *Skatteverket v David Hedqvist* Case C-264-4, https://curia.europa.eu/juris/document/document.jsf?text=&docid=170305&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=6151804, accessed 25 August 2022.

46 Ibid, para 26.

47 Judgment of *Skatteverket v David Hedqvist* Case C-264-4, https://curia.europa.eu/juris/document/document.jsf?text=&docid=170305&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=6151804, accessed 25 August 2022, paras 52-58.

> Transactions involving **non-traditional currencies**, that is to say, currencies other than those that are legal tender in one or more countries, in so far as those currencies have been accepted by the parties to a transaction as an alternative to legal tender and have no purpose other than to be a means of payment, are **financial transactions**.[48]

Thus, the CJEU regarded the transactions as a **financial transaction** that falls under Art 135 of the VAT Directive.

The CJEU decision is surprising, giving that there is consensus that cryptocurrencies are no legal tender. However, the court maintained that

> It therefore follows from the context and the aims of Article 135(1)(e) that to interpret that provision as including only transactions involving traditional currencies would deprive it of part of its effect.

[48] Ibid, para 49.

In the case in the main proceedings, it is common ground that the ‘**bitcoin**’ **virtual currency has no other purpose than to be a means of payment** and that it is accepted for that purpose by certain operators.

Consequently, it must be held that Article 135(1)(e) of the VAT Directive also covers the supply of services such as those at issue in the main proceedings, which consist of the **exchange of traditional currencies for units of the ‘bitcoin’ virtual currency** and vice versa, performed in return for payment of a sum equal to the difference between, on the one hand, the price paid by the operator to purchase the currency and, on the other hand, the price at which he sells that currency to his clients.[49]

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49 Ibid, paras 51-53.

Thus, even if a traditional currency is exchange against a cryptocurrency (which is no legal tender), the VAT Directive will apply.

The view of the CJEU should be noted also insofar as the court does not seem to regard cryptocurrencies as intangible assets but indeed as a form of non-traditional currency.

The CJEU thereby seems to contradict the majority view in the accounting world, and also the HMRC's *Manual on Cryptoassets* that state that *Bitcoin & Co* are no cash or cash equivalent, or currency, but instead that they qualify as intangible assets.[50]

The HMRC Manual on Cryptoassets stipulates:

> It is important to note that HMRC does not consider any of the current types of cryptoassets to be money or currency.
>
> This means that any Corporation Tax legislation which relates solely to money or currency does not apply to exchange tokens or other types of cryptoassets.[51]

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50 HMRC, Cryptoassets Manual, CRYPTO41050-41150.
51 Ibid, CRYPTO41050.

Hence, it seems that HMRC's Manual on Cryptoassets and HMRC's VAT Finance Manual,[52] directly contradict each other.

We question if that contradiction should still be upheld, given that the UK has decided to leave the EU, or whether HMRC's *Manual on Cryptoassets* and HMRC's *VAT Finance Manual* relating to cryptocurrency and other digital items should be made coherent insofar as either cryptocurrency is regarded as an intangible asset throughout both manuals (with the respective tax consequences for direct and indirect taxes) or if they are indeed a form of non-traditional currency, with the consequence that they would qualify as cash or cash-equivalent, and thus as financial assets.

<u>c) Buying and selling of cryptocurrencies, and exchange for goods and services</u>

HMRC states in the *VAT Finance Manual* that: 'When Bitcoin is exchanged for goods and services

[52] VAT Finance Manual, VATFIN2330, Money (including transfer of money) and related services: examples of services and products falling within item1: Bitcoin and similar cryptocurrencies, https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330, accessed 25 August 2022.

no VAT will be due on the value of the Bitcoin itself.'[53]

This view is only coherent if Bitcoin is seen as a quasi-currency by HMRC.

It is however incoherent with the treatment of cryptocurrencies as intangible assets for direct tax purposes, as stated in the HMRC *Cryptoassets Manual*.[54] Based on the accounting qualification, HMRC regards cryptocurrencies in this manual neither as cash nor cash-equivalent, nor as a financial asset, but as an 'intangible asset'.

Hence, it is difficult to argue that no VAT will be due on the value of the Bitcoin itself as it is not money or money-equivalent according to HMRC's *Cryptoassets Manual*.

It is inconsistent to say that cryptocurrencies constitute intangible assets for direct tax purposes, whereas HMRC treats cryptocurrencies as a digital currency for indirect tax purposes, suggesting in this respect: 'Bitcoin is seen as the world's first

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53 Ibid, VATFIN2330.
54 HMRC, Cryptoassets Manual, CRYPTO41050.

decentralised digital currency, otherwise known as a "cryptocurrency"'.[55]

It seems particularly odd that HMRC deals with the VAT questions for Bitcoin & Co for indirect tax purposes under the **heading**: **VATFIN2330 - Money (including transfer of money) and related services**: examples of services and products falling within item1: Bitcoin and similar cryptocurrencies, whereas HMRC's **Cryptoassets Manual states that, 'HMRC does not consider cryptoassets to be currency or money.'**[56]

If cryptocurrencies are indeed (intangible) assets, the barter and setoff provisions may apply, meaning that if I receive goods from your customers in return

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55 HMRC, VATFIN2330 - Money (including transfer of money) and related services: examples of services and products falling within item1: Bitcoin and similar cryptocurrencies, https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330, accessed 23 August 2022.

56 HMRC, Cryptoassets Manual, CRYPTO10100 - Introduction to cryptoassets: what are cryptoassets, https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto10100, accessed 22 August 2022.

for supplying them with goods or services, VAT is due as assets are exchanged.[57]

We believe cryptoassets should be qualified as belonging to the same category, namely either intangible assets or as a currency/cash or cash-equivalent for direct and indirect tax purposes. To create a distinction for the taxes would be artificial. Cryptoassets clearly have value. There may be no end customer in the traditional sense (when mining, for example), but that does not diminish the commercial reality which underpins this new technological world: namely, that there is clearly significant value to be attached to esoteric assets that are clearly accumulating value and can be traded. Else it begs the question: how can something with purportedly no value be traded for something with value, and how can the asset of purportedly no value be turned into actual sums?

4. Taxing NFTs

57 HMRC, Guidance VAT; part-exchanges, barters and set-offs, https://www.gov.uk/guidance/vat-part-exchanges-barters-and-set-offs, accessed 23 August 2022.

Part of the inherent problem in the taxation of NFTs is the language used appears at first blush to be terms we use in common vernacular. However, they are distinct terms of art and have specific meanings in the digital world of cryptoassets. Even HMRC concedes that: *"the terminology, types of coins, tokens and transactions can vary. The tax treatment of cryptoassets continues to develop due to the evolving nature of the underlying technology and the areas in which cryptoassets are used."*[58] Yet the government is still trying to understand what precisely cryptoassets entail.[59]

What this means for an investor in NFTs is that they will be required to check *each individual circumstance* for any sale of an NFT and what the current VAT rules are. Due to the nature of the tokens – it might appear that they represent the same or very similar physical assets, but in essence

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58 HMRC Internal Manual: Cryptoassets Manual (CRYPTO10000) – Introduction to cryptoassets.

59 KANTAR PUBLIC, Individuals holding cryptoassets, uptake and understanding, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1089224/Individuals_Holding_Cryptoassets_Uptake_and_Understanding.odt (February 2022), accessed 30 August 2022.

could be very different when considering what the token actually represents. NFTs are distinct to Bitcoin as the latter is treated as currency, and therefore outside the scope of VAT. However, NFTs go further and represent physical assets of significant material value. Yet on the face of it are tokens which can be exchanged – similar to Bitcoin. However, Bitcoin (and Ethereum) is fungible, whereas NFTs are not as they are not mutually interchangeable.

Yet purchasing or disposing of a NFT is akin to acquiring or disposing of an asset, as opposed to currency. From a VAT perspective, the tricky question of whether this is a good or service arises; and from a direct tax perspective queries of Capital Gains Tax ('CGT') and what this means for income and inheritance tax will invariably come to bear.

The position adopted by government makes this a difficult horizon to track.  HMRC has confirmed that whilst purchasing an NFT with fiat currency will not be considered taxable for the purchaser, it will be liable to CGT for the seller, and purchasing an NFT with cryptocurrency will likely result in a charge to CGT. Minting NFTs is not considered taxable, but farming NFTs could be subject to CGT or income tax, and gifting an NFT could further be liable to CGT. The USA has adopted a broadly similar approach. The position leaves room for too many variables and alternative methods to avoid taxation, due to a lack of deeper understanding of the nature of these transactions.

## Conclusion

The inherent lack of understanding and increasing use of varied terminology alters the way in which such items are viewed, and therefore taxed. Despite Bitcoin arguably being the most well-known of the cryptoassets, it is simply an example of a store of value.[60] There are also utility tokens, platform token, security tokens – the list continues. At the heart of what they are designed to achieve is that they use cryptography and a public, decentralised ledger to identify and track ownership, secure and verify transactions.[61] Yet who uses them, how, where they are used and the form that cryptoassets

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60 KPMG, Keeping up with crypto: the tax implications, https://home.kpmg/uk/en/home/insights/2021/06/keeping-up-with-crypto-the-tax-implications.html, accessed 30 August 2022.

61 Ibid.

adopt can shift the liability to tax. This confusion in terminology, and an approach that we consider does not account for the rapid pace of development in the world of cryptoassets is demonstrated in the world of virtual gaming – which we will explore in the next article.