TAX 101:
IS CRYPTO GROWING UP?

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INTRODUCTION

Crypto assets are rarely out of the news these days, and the last months have been no exception. The well-publicized troubles of the FTX exchange have made crypto headline news again, and depending on one's point of view, will simply underscore everything that some people think about the subject matter.

Some will say the FTX bankruptcy is exactly what was to be expected and confirms the view that crypto assets are some sort of Ponzi scheme.[1] Others will say this serves to justify the need for much greater regulation. And still others will say that this results from a rise in the power – and in some ways the monopoly – of the exchanges and that the concept of the exchange is exactly the sort of thing crypto was created to avoid.

But whatever one thinks, the author is confident that crypto in its broadest sense is here to stay because of the capability of the underlying technology to disrupt or enhance the financial services industry, and many other sectors as well.

RECOVERY OF ASSETS

But what if you are an investor and your crypto asset portfolio is held with an exchange such as FTX and the exchange has found itself in financial trouble, or worse still, seeks insolvency proceedings, resulting in liquidation? There are a number of challenges to investors having lost large or small fortunes.

The first challenge is the legal relationship between the investor and the exchange. In principle, one would expect the relationship to be fiduciary in nature, as between a trust and its beneficiary. Under this view, the exchange should have removed the investor's assets from the exchange balance sheet so that those assets would remain available for return to the investor, subject to liquidity, and any associated protocol terms. More importantly, they would not be part of the exchange's own assets, available to meet the demands of creditors in any liquidation.

However, the exchange has treated other people's assets as its own. Consequently, investors must join the long queue of other unsecured creditors. The likelihood of full recovery appears to be bleak.

There is much talk about the relationship between FTX and the Almeda hedge fund, which reportedly borrowed billions of dollars from FTX to make risky bets regarding

[1] According to Wikipedia, Charles Ponzi was a swindler and con artist who operated in the U.S. and Canada in the early 1920's. He promised clients a 50% profit within 45 days or 100% profit within 90 days, funding payouts to existing investors with funds invested by later investors.

cryptocurrencies. If true, the facts are no different in principle, if not in materiality, from those recounted in Agatha Christie's *Death on the Nile*, where the trustee of a trust for the benefit of Lynette Doyle, née Ridgeway, borrowed significant funds from trusts settled by her father for her benefit. The funds borrowed were then invested by the trustee, for his benefit, in risky investments.

The trust or agency point was the subject of case law in New Zealand. In the case of *Ruscoe v. Cryptopia Ltd.* (in liquidation),[2] the High Court ruled that there was a trust relationship, applying the general tests of trust to the facts as understood, *viz.*, certainty of subject matter, objects, and intention.

It will also be interesting to understand better the accounting and audit processes. It seems the accounting profession is under constant criticism over work done and standards applied. If any of the media speculation has foundation, we could well see yet another accounting scandal. The expert who oversaw the Enron corporate scandal in 2001, John J. Ray III, has been appointed and so clearly he will bring much needed experience of corporate scandal to the resolution process. In terms of accounting, the Enron scandal saw the end of Arthur Andersen. Already there are various comments in the media attributed to him, suggesting the systems were poor.

One of the challenges in the general area of crypto asset is the lack of experts who genuinely understand the industry and the specific risks associated with the practical applications of the technology. What many crypto natives would say is the source of its strength – the dispensing of intermediaries and third parties having a long history in regulated sectors, or quasi-regulated sectors such as tax – is in reality its weakness. Crypto account has a dire need for checks and balances to prevent just the sort of situation now apparently arising in FTX.

A major fear is the lack of regulation and any protection for investors. Whereas regulation is anathema to many in the crypto asset world, each exchange that fails strengthens the case for regulation, particularly among investors worrying whether all value in their portfolio is lost.

In the U.K., the E.U., and most likely the U.S., the regulatory environment focuses heavily on the protection of client assets. The U.K. implemented the MIFID 1 and MIFID 2 rules prior to its departure of the E.U., and so such regulations apply to regulated entities. Of course, crypto asset are not currently regulated in the U.K., other than for A.M.L. purposes. Consequently, protections are not required, and so it would seem that investors in crypto bankruptcies like FTX will be at the mercy of the organization's own operating and accounting practices. While little is known of the operating and accounting practices at FTX, time will clearly tell, and we will see in due course how customer crypto assets were or were not managed and protected for the benefit of the investor. A number of worrying statements have been released from those close to the insolvency by way of media statements.

Regarding the tax issues for investors, crypto assets on the FTX exchange will generally have been embodied in exchange tokens. It is almost certain that gains and losses will be characterized as capital in nature but for dealers. In many countries, disposals generating capital gains may be taxed at preferential rates for individuals. The tax benefits for losses may be ringfenced so that only lower-taxed capital gains will be reduced by the losses.

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[2] [2020] NZHC 728; [2020] 2 NZLR 809 (8 April 2020).

In terms of the loss of crypto assets, the U.K. capital gains rules do allow for assets becoming of negligible value. In such cases, a deemed disposal is said to take place which can potentially crystallize a loss. That might be useful to set off against an investor's other capital gains, provided the loss is absolute, rather than partial. Unfortunately, partial losses are not enough to trigger a tax benefit. Comparable issues exist with liquidations. In most cases, no disposal occurs until the liquidators make a final distribution. In a bankruptcy such as FTX, that could be a long way down the line.

There is much media activity around the FTX story and the hacking and theft of crypto assets. For U.K. tax purposes, the loss of an asset due to theft does not amount to a disposal, and so the investor will not be able to access any resulting loss. If it becomes clear there is no chance whatsoever that the assets can be recovered, possibly after a period of time, then a negligible value claim may be available and with it, access to the associated losses.

LAW, PROPERTY, SITUS

Significant work has been done in various countries to better analyze crypto assets from a legal perspective. The U.K. is no exception to this, and over the last number of years, we have seen excellent work done. The U.K. Government set up the Lawtech Delivery Panel in 2018. It is a unique group of leaders and experts from the public and private sectors collaborating to accelerate the digital transformation of the legal sector for the benefit of society and the economy, and to ensure the U.K.'s continuing leadership in legal and court services. In November 2019, the panel set up the U.K. Jurisdiction Taskforce ("U.K.J.T.") (one of several of groups) to look at a number of legal issues, most significantly whether crypto assets amount to property and can be protected as such.

The outcome of the U.K.J.T. consultation was a report confirming, *inter alia*, that crypto assets are property and meet some of the relevant criteria in prior case law. In particular, the case of *National Provincial Bank v. Ainsworth*[3] adopted a definition of property as an asset that is definable, identifiable by third parties, capable of being assumed by third parties, and having some degree of permanence or stability.

A number of cases in the U.K. courts treated crypto assets as property: *Vorotyntseva v. Money -4 Limited t/a as Nebeus.com* and *Liam Robertson v. Persons Unknown*.

The U.K.J.T. analysis was taken on board in a number of subsequent proprietary injunction cases in the U.K., including the High Court (Commercial Court) case *AA v. Persons Unknown*[4] and the unpublished case *Robertson v. Persons Unknown*.

Under U.K. common law there are two types of property, *viz.*, a chose in possession and a chose in action. This was set out in *Colonial Bank v. Whinney*,[5] where Fry J. said the following: "All personal things are *either* in possession or action. The law knows no *tertium quid* between the two."

As this article goes to print, there is already a further consultation taking place in

3 [1965] AC1175.

4 [2019] EWHC 3556.

5 [1885] 30 ChD 261.

the U.K., in short to establish the need or appetite for an additional (third) type of property, *viz.*, data objects.

WHAT ABOUT TAX?

The U.K. tax authority ("H.M.R.C.") has undertaken its own work, publishing comprehensive guidance on the taxation of crypto assets. Although comprehensive, with developing technology there will be changes required over time. Indeed, some areas of crypto asset have not yet been addressed. One example is Non Fungible Tokens ("N.F.T.'s"), where further guidance will be issued in due course. In broad terms, an N.F.T. IS linked to a unique digital asset that is not interchangeable. Typically, it is linked to artwork or collectibles. However, an N.F.T. can be linked to anything having value as long as it can be stored digitally.

"If the gains from a transfer of an N.F.T. or other crypto asset are considered to be U.K. situs income, adverse tax consequences will result for a non-dom living in the U.K. and electing to report income under the remittance basis."

Another significant area where H.M.R.C. has provided guidance relates to the concept of situs of the asset and the situs of gain at the time of transfer. The current stance of H.M.R.C. is that, where the beneficial owner of crypto assets is a U.K. resident and there is no associated or underlying asset, the crypto assets are U.K. situs. Several types of income and gains can be recognized when holding an N.F.T. or any other crypto asset:

- The asset can be sold.
- The asset can be mined.
- The asset can be "air dropped" in return for a service.
- The asset can be licensed.
- The asset can be used to purchase a product.

If the gains from a transfer of an N.F.T. or other crypto asset are considered to be U.K. situs income, adverse tax consequences will result for a non-dom living in the U.K. and electing to report income under the remittance basis. The non-dom may find that the income or gains from the disposal of an N.F.T. or other crypto asset is immediately taxed in the U.K. even if the proceeds are not remitted to the U.K.

Note that some advisers argue that the situs of crypto, including an N.F.T. can be removed from the U.K. by placing the crypto asset in the ownership of an overseas trustee. The principal makes sense, but currently practical barriers exist in the implementation. Many trustees are reluctant to hold or invest in crypto assets because of risk around A.M.L. issues. Also, persons providing custodian services for N.F.T.'s are low in number.

TRANSPARENCY AND REPORTING

Many commentators have stated in recent weeks that the issues of FTX may not have occurred with much better regulation and transparency.

A significant step towards a more open and transparent crypto asset environment is the consideration of the Crypto Asset Reporting Framework ("C.A.R.F.") proposed by the O.E.C.D.

The C.A.R.F. likely would not have prevented the FTX bankruptcy. However, regulatory responsibilities such as International Tax Reporting would have placed suspect transactions under the microscope. By having exchanges invest in compliance procedures, such as International Reporting, wider conversations with accountants and regulators would have taken place which may have had the effect of identifying compliance shortcomings.

So how will the C.A.R.F. work?

The C.A.R.F. has been designed to require those providing crypto asset services to undertake the necessary due diligence to identify those persons using and holding crypto assets, where those users are a reportable person.

There are four principal component parts to the C.A.R.F.:

1. The scope of crypto assets to be covered.
2. The entities and individuals subject to data collection and reporting requirements.
3. The transactions subject to reporting, as well as the information to be reported in respect of such transactions.
4. The due diligence procedures to identify crypto asset users and the relevant tax jurisdictions for reporting and exchanging information.

CRYPTO ASSETS IN SCOPE

The O.E.C.D. proposal focuses on the use of cryptographically secured distributed ledger technology ("D.L.T.") to track the creation, holding, and transfers of crypto assets. The C.A.R.F. also contemplates the use of "similar technology" to ensure that new technological developments will be addressed.

The term "Relevant Crypto-Assets" as used in the C.A.R.F. are crypto assets that give rise to reporting in connection with Relevant Transactions. Three categories of crypto assets are excluded from reporting requirements because they are thought to pose limited tax compliance risks. They are the following:

- Crypto assets that the Reporting Crypto-Asset Service Provider has adequately determined cannot be used for payment or investment purposes
- Central Bank Digital Currencies, representing a claim in Fiat Currency on an issuing Central Bank or monetary authority, which function similar to money held in a traditional bank account
- So-called "Specified Electronic Money Products" that represent a single Fiat Currency and are redeemable at any time in the same Fiat Currency at par value as a regulatory matter, in addition to meeting certain other requirements

Reporting on Central Bank Digital Currencies and certain Specified Electronic Money Products held in Financial Accounts will be included within the scope of the C.R.S.

INTERMEDIARIES AND SERVICE PROVIDERS IN SCOPE

Intermediaries and other service providers facilitating exchanges (i) between Relevant Crypto-Assets and (ii) between Relevant Crypto-Assets and Fiat Currencies play a central role in the crypto asset market. As such, it is proposed that those Entities or service providers that effectuate Exchange Transactions in Relevant Crypto-Assets as a business for or on behalf of customers would be considered Reporting Crypto-Asset Service Providers.

Whether a crypto asset service provider is a Reporting Crypto-Asset Service Provider will depend on whether it meets any of the following criteria:

- It is tax resident in a jurisdiction adopting the rules.
- It is both incorporated in or organized under the laws of a jurisdiction adopting the rules and has legal personality or is subject to tax reporting requirements in a jurisdiction adopting the rules.
- It is managed from a jurisdiction adopting the rules.
- It has a regular place of business in a jurisdiction adopting the rules.
- It effectuates Relevant Transactions through a branch based in a jurisdiction adopting the rules.

REPORTING REQUIREMENTS

The C.A.R.F. seeks to identify "crypto assets users" and their relevant jurisdiction for reporting purposes. A crypto asset user is an individual or an entity that is a customer of a crypto asset service provider.

The C.A.R.F. defines a crypto asset service provider as any individual or entity that, as a business, provides a service putting into operation "effectuating" exchange transactions for or on behalf of customers, including by acting as counterparty or an intermediary to such exchange transactions or by making available trading.

The following three types of transactions are Relevant Transactions that are reportable under the C.A.R.F.:

- Exchanges between Relevant Crypto-Assets and Fiat Currencies
- Exchanges between one or more forms of Relevant Crypto-Assets
- Transfers (including Reportable Retail Payment Transactions) of Relevant Crypto-Assets

DUE DILIGENCE

The C.A.R.F. rules require crypto asset service providers to determine crypto assets users who are "reportable persons." This is done by way of identifying the user's tax residence. The service providers will require self-certifications from users at the point of commencing a new relationship, or, for pre-existing relationships, within 12 months of the new rules coming into existence.

The rules also apply to entity users, and in those circumstances, as well as determining the tax residence of the entity, the crypto asset service provider is also required to determine "controlling persons" by way of the KYC documentation, and then whether those controlling persons are reportable persons, again by way of self-certifications.

RESTRICTIONS ON TRANSPARENCY

On the subject of transparency, and what many see as the ever greater burden placed on commercial organizations to collect and report information, some readers will be aware of the recent Judgment of the European Court of Justice in relation to public ownership registers.[6] Whether these rulings will impact the exchange of information for tax purposes will no doubt become clearer over time, but given the fact that the information collected by the C.A.R.F. is for the use of the various tax authorities, tax authorities will argue that the information collected is for the sole use of tax authority for a legitimate reason. Such information can be exchanged with tax authorities in treaty partner jurisdictions for tax administration purposes. Read this way, there is infringement to expectations of privacy.

U.K. REGULATION

The U.K. Government set out in April 2022 its ambitions for crypto assets. The then Chancellor of the Exchequer, now Prime Minister, Rishi Sunak stated the goal of making the U.K. a global hub for crypto asset technology. In particular, the U.K. government recognized that crypto technology and stablecoins provide significant opportunities for efficiency in payment systems and platforms.

With a view to introducing regulation, consultations have been held over the past year regarding the regulation of stablecoins, D.L.T., and crypto asset promotions. Many organizations providing crypto services have been brought within the U.K. Money Laundry Regulations and are Obliged Entities under the rules, requiring them to undertake client due diligence. We would expect to see an acceleration of some of the regulation being considered. In light of FTX, the new rules likely will be directed at protection of investor assets.

WIDER TAX ISSUES AND HURDLES TO DEVELOPMENT

One of the key challenges currently for crypto asset in terms of taxation is the nature of D.L.T. and capital gains rules. Capital gains tax looks to tax any profit at a point of disposal. Because of the general approach of verification for D.L.T. (primarily blockchain) events, and the cancellation of the earlier blockchain record, this can trigger a "disposal" under the U.K. rules (Section 22 TCGA 1992).

It is important to analyze properly all crypto asset transactions, as lazy assumptions could well result in noncompliance, including paying tax on transactions that are not disposals. The same applies to N.F.T.'s, where sloppy analysis can lead to a completely incorrect taxation. This is also the case in terms of the commercial

[6] *Luxembourg Business Registers*, Joined Cases C-37/20 and C-601/20.

transaction itself. Many people mistakenly view the N.F.T. as the sole asset that is owned. However, an associated license agreement is attached to the N.F.T., which frequently is overlooked or misunderstood. This may result in significant legal disputes when a person will have paid a huge amount for an N.F.T. only to find that the really valuable part remains owned by someone else.

The world of intangibles is always thought provoking, but it is getting a whole lot more complex with the onset of cryptographically secured D.L.T.