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Consultation on the UK taxation of DeFi transactions

*The UK tax authority, HM Revenue & Customs (**HMRC**), has launched a consultation on the taxation of decentralised finance (**DeFi**) cryptoasset lending and staking transactions. Under consultation is a legislative change to disregard the disposal of beneficial ownership when tokens are lent or staked in a DeFi transaction for tax purposes. Instead, a chargeable disposal would only arise when the tokens are economically disposed of. HMRC's primary aim is to better align the tax treatment and underlying economic substance of these transactions. This is welcomed, but is HMRC missing a trick by legislating only to deal with these specific transactions and not to answer some of the more fundamental questions on the tax aspects of cryptoassets?*

Following certain updates to HMRC's Cryptoassets Manual in February 2022, concerns were raised regarding the application of the current tax rules to DeFi cryptoasset lending and staking transactions.

A particular concern was that the UK tax system can treat DeFi loans and staking as disposals for capital gains purposes, notwithstanding that a loan or staking of tokens does not involve a disposal of the economic ownership of those tokens. There could be a mismatch between tax outcomes and the underlying economic substance of transactions, and possibly a 'dry' tax charge in circumstances where no actual gain has been realised from which to meet the tax liability. Moreover, being subject to a chargeable gain on disposal (with the possibility of a dry tax charge) means there is a potential, seemingly unjustified, disparity in treatment compared to the lending or borrowing of traditional financial assets such as shares under the repo and stock lending rules contained in ss 263A and 263B of the Taxation of Chargeable Gains Act 1992.

A second key concern was that treating DeFi loans and staking as disposals created the need to determine and record the market value of assets at each step of the transaction (i.e. when the tokens are lent/staked, when the tokens are returned at the end of the transaction and when any other chargeable event occurs). This represents a disproportionate administrative burden, particularly in the light of the volatility typically found in cryptoasset markets.

The Call for Evidence

Therefore, in Summer 2022, HMRC conducted a Call for Evidence on the tax treatment of DeFi lending and staking, looking at whether the treatment of such transactions could be better aligned with the underlying economics. The Call for Evidence outlined three possible reforms:

- Option 1: bring DeFi lending and staking within the existing repo and stock lending rules, by expanding the definition of 'securities' under those rules to include cryptoassets.
- Option 2: create separate rules for DeFi lending and staking, based around the repo and stock lending rules.
- Option 3: treat the transfer of cryptoassets for DeFi lending and staking as 'no gain no loss' transactions, deferring any tax liability until the assets are economically disposed of.

HMRC has confirmed that respondents to the Call for Evidence were more or less unanimous in their support for changes to be made to the tax rules applying to DeFi transactions.

However, most respondents were concerned that Option 1 would not work well in practice. In particular, respondents highlighted the possible further administrative burden that would be created if each DeFi contract had to be analysed to determine if the repo/stock lending rules applied. It was also noted that those rules were not designed to be applied to DeFi markets or the types of investors who typically participate in such markets.

While Option 3 received some support from respondents for its flexibility and simplicity, concerns remained around the administrative burden imposed by even ‘no gain no loss’ transactions. By adopting an approach that followed general CGT principles, and so focused on disposal of beneficial ownership, Option 3 risked increasing administrative difficulty by requiring an analysis of each individual transaction to establish whether they resulted in a disposal of beneficial ownership. Taxpayers would also still be required to keep records of all transactions where disposals have been made but tax has been deferred, notwithstanding that they retained economic ownership at all times.

Although Option 2 did not receive unanimous support, respondents generally felt that Option 2 would better reflect the economic reality of DeFi lending and staking, and would impose a lesser administrative burden than Option 3. It was also observed that a specific DeFi regime could be easily updated to accommodate market developments without having knock-on effects for other areas of the tax code (and, presumably, conversely be updated to avoid unintended consequences of amendments to other parts of the code).

The consultation

HMRC also favours Option 2, and is now consulting on the viability, scope and policy design of a legislative change whereby the potential disposal of beneficial ownership that may arise when tokens are lent or staked in a DeFi transaction is disregarded for tax purposes, in circumstances where the participant retains the economic interest in the lent or staked tokens. Instead, a chargeable disposal would only arise when the tokens are economically disposed of.

Although the consultation document largely focuses on DeFi transactions undertaken by individuals, the government has indicated that it is also equally considering the feasibility of applying the new rules to companies engaged in the lending and staking of cryptoassets, and to so-called ‘Ce-Fi’ transactions undertaken through an intermediary.

The consultation will run for 8 weeks from 27 April 2023 to 22 June 2023 and responses should be sent to financialproductsbai@hmrc.gov.uk.

The proposed new rules

HMRC has indicated that a transaction is intended to fall within the proposed new rules if it satisfies the following conditions:

(a) there is an initial transfer of cryptoassets from one party (the ‘lender’) to another party (the ‘borrower’) and/or there is a transfer of cryptoassets through the use of a smart contract;

(b) the borrower has an obligation to return to the lender the borrowed tokens and/or the smart contract allows the lender to withdraw the tokens;

(c) the tokens can be returned at the instigation of the lender, at the request of the borrower, or automatically at the end of a pre-determined period; and

(d) the lender has the right to withdraw at least the same quantity of the same type of tokens that were originally lent or staked.

Where the rules apply:

(a) the transaction will be disregarded from CGT for both the lender and the borrower;

(b) any sale of rights related to the lent or staked tokens will be seen as a disposal of the tokens to which those rights relate;

(c) any financial return for the lending or staking (‘DeFi return’) which accrued on the tokens prior to the sale of such rights is taxable on the lender at the time the rights are disposed of;

(d) the buyer of rights to lent or staked tokens is treated as acquiring the lent or staked tokens (with no further CGT consequences therefore arising when those rights are actually exercised); and

(e) the lender will be treated as having disposed of the staked or lent tokens if the borrower is not able to return the borrowed tokens. This will occur at the point in time the borrower loses the ability to return them.

The new framework would also treat DeFi returns as being revenue in nature, charged to a new miscellaneous income charge for cryptoasset transactions. The return will be taxed when it arises (i.e. when received), and treated as being an amount equal to the market value of the tokens or assets constituting the return, at the time they are received.

HMRC goes on to explain how the rules would apply across the lifecycle of a typical DeFi lending or staking transaction. The model transaction that HMRC adopts has the following three stages:

1. **The transfer of tokens to another party**. At this stage the lender transfers cryptoassets to the borrower/liquidity pool or makes tokens available as liquidity through a smart contract. The borrower has an obligation to transfer back the same number of tokens of the same type at will, on demand and/or at the expiry of the term of the transaction. The lender may receive another type of token representing their right to receive the original cryptoassets back.
2. **The term of the loan/stake**. For most lenders, no events will occur during this period (other than possibly the receipt of a DeFi return). However, some lenders may sell their rights in the lent or staked cryptoassets during this stage.
3. **The return of the lent/staked tokens**. Generally, the lender will receive the lent/staked tokens back when the term of the agreement has come to an end or when termination rights are exercised. In some circumstances the lender may receive fewer tokens than originally lent (e.g. due to the insolvency of the borrower).

Under the proposed rules, the taxation of the events which might occur at each stage is as summarised in the following table:

Event	CGT event	Taxation of DeFi return
Stage 1: The transfer of tokens to another party		
Lending/staking of tokens.	No CGT consequences.	Taxed when received by the user.
Receipt of tokens representing the right to return of the lent/staked tokens.	Treated as a holding of the original tokens.	Taxed when received by the user.
Stage 2: The term of the loan/stake		
Tokens remain lent/staked.	No CGT consequences.	Taxed when received by the user.
Sale of rights in lent/staked tokens.	Disposal of lent/staked tokens when rights are sold (and deemed acquisition of lent/staked token by the buyer of the rights).	The accrued return on the tokens which were sold is taxed at the time of sale.
It becomes apparent that the borrower will not be able to return some/all of the tokens at the end of the term.	Disposal of tokens when it becomes known that the borrower will not return them.	Taxed when received by the user.
Stage 3: The return of the lent/staked tokens		
Return of all of lent/staked tokens at the end of the agreement.	No CGT consequences.	Taxed when received by the user.
At the end of the agreement the borrower does not return some/all of the tokens.	Disposal of unreturned tokens at the end of the agreement.	Taxed when received by the user.

If adopted, the new rules would apply to transactions satisfying the conditions outlined above where the initial lending or staking occurs after the commencement date. DeFi transactions which started before the commencement date will continue to be taxed under general CGT rules.

Comment

HMRC is to be commended for seeking to enact specific, targeted legislation in this space, rather than relying on existing rules that do not obviously apply to DeFi lending and staking transactions, and which might lack the flexibility to accommodate ongoing developments in DeFi markets. This represents a first step towards a more comprehensive tax regime for cryptoassets, one that recognises their status as a distinct asset class.

Moreover, if enacted, these rules will give participants in DeFi markets welcome certainty and reduced administrative burden in respect of lending and staking transactions. In particular, the onus would be removed from taxpayers to demonstrate to

HMRC why a given DeFi transaction does not involve a disposal for CGT purposes, with a corresponding reduction in compliance risk.

However, DeFi lending and staking transactions represent just one part of a broader cryptoasset market. Doubtless there will be calls for guidance and engagement on other specific cryptoasset transactions before too long. There are also more fundamental questions on the tax treatment of cryptoassets that remain unanswered (other than by HMRC guidance) and it does seem a bit curious that we will have some bespoke provisions to cater in particular for lending and staking without any provisions dealing more generally with tax aspects of cryptoassets.

This consultation on lending and staking is based on a tacit assumption amongst HMRC, DeFi market participants and tax practitioners that buying and selling of cryptoassets falls within the scope of CGT. Whilst there has been some debate on the point, the boundary between trading, investing and gaming is particularly blurred in the case of cryptoassets given their nature. For many cryptoassets there is nothing inherent that drives value and they offer no investment return in the normal sense, such that many participants are doing no more than 'betting' on the prospect of other market participants being willing to pay more in the future.

Similarly, the debate about the *situs* of cryptoassets for tax purposes (relevant for CGT and inheritance tax) could easily be resolved by the introduction of some statutory rules, rather than just relying on guidance (even if LJ Falk might seem to agree with HMRC's approach on this – see *Tulip Trading Ltd v Bitcoin Association for BSV* [2022] EWHC 667 (Ch)).

Is HMRC missing a trick by legislating to deal with specific transactions without providing statutory answers to some more fundamental questions?. A more 'first-principles' approach would arguably promote consistency and coherence across the cryptoasset tax regime as it grows, and reduce the risk of disputes arising in the future.

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