Cryptocurrencies – The Basics

The emergence of cryptocurrencies such as Bitcoin has seen a number of our clients query the tax implications. Such currencies have become mainstream with tax laws beginning to catch up with this innovative new form of asset. Here we will cover the most common questions we receive surrounding cryptocurrency and the implications for individuals considering investment.

What is a cryptocurrency?

Cryptoassets or cryptocurrency are cryptographically secured digital representations of value or contractual rights that can be transferred, stored or traded electronically.

Unlike traditional currencies, cryptocurrencies are entirely intangible and utilise encryption (or cryptography) to provide security over transactions it is involved in.

What are the potential income tax implications?

This completely depends on the manner in which an individual is involved in cryptocurrency, here are the main activities involving cryptocurrency:

Mining

What is mining?

This is the system by which an individual using a computer can calculate the complex algorithms that verify each part or transaction in a blockchain. After this has been done, the "miner" is then given cryptocurrency.

How would this be taxed?

The main implication here is whether such activity amounts to a trade, which in turn depends on factors such as how much mining is taking place, how organised is the operation and other requirements similar to HMRC's "badges of trade" used to determine whether or not an individual is a trade or not.

It is worth noting at the outset that only in "exceptional circumstances" HMRC would expect individuals selling and buying crypto assets be considered a trade. If it was considered, then Income Tax would take priority over Capital Gains Tax and will apply to profits (or losses) and be considered as a business.

If it is deemed a trade, any profits generated would be liable to the same taxes as a typical trade such as income tax and national insurance, with expenses and income needing to be translated to sterling, Any expenses claimed would need to relate solely and specifically to the trade of mining.
If the mining activity does not amount to a trade, the pound sterling value (at the time of the receipt of the crypto asset) will be taxable as income, with any appropriate expenses reducing the amount chargeable. If the individual keeps the awarded asset, they may have to pay Capital Gains Tax when they later dispose of them.

Airdrops

What is an airdrop?

Airdrops are where someone will receive an allocation of cryptoassets, for example due to a marketing or advertising campaign.

How would this be taxed?

Income tax will not apply to these if:

- They have been received without doing anything in return (eg. they are unrelated to any service or other conditions)
- The individual is not part of a trade or business involving cryptocurrency or mining

If they are provided in return for a service, they are subject to income tax as either miscellaneous income or as part of receipts for an existing trade.

The disposal of a cryptoasset may result in a chargeable gain for Capital Gains Tax, even if it is not chargeable to Income Tax when received.

What if I make a loss?

An individual who is trading can offset losses from their trade against future profits or other income If profits from the activities are taxable as miscellaneous income, these can be carried forward to later years.

What about Capital Gains Tax?

This is the most likely form of tax for individuals involved in cryptocurrency. This would typically happen when trading.

How do I trade cryptocurrency?

This is where you would acquire a cryptocurrency such as Bitcoin and hold it, before selling it on. On the sale of a cryptocurrency the tax treatment is treated as a foreign currency, and is therefore deemed as chargeable assets for Capital Gains Tax purposes. The tax will only crystallise when the cryptocurrency is converted into either another currency or cryptocurrency.

If Income Tax has been charged on the value of tokens received, any consideration will be reduced by the amount already subject to Income Tax.

Certain costs can be allowed as a deduction when calculating the chargeable gain or loss:

- The amount originally paid
- Transaction fees paid before the transaction is added to a blockchain
- Advertising for a purchaser or vendor
- Professional costs to draw up a contract for the acquisition or disposal of the cryptoassets
- Costs of making a valuation or apportionment to be able to calculate gains or losses

What are the potential tax pitfalls?

Costs that are not allowable include:

- Any costs deducted against profits for Income Tax
- Costs for mining activities

If a cryptoasset is given away to another person who is not a spouse or civil partner, the individual must work out the pound sterling value of what has been given away. For Capital Gains Tax purposes the individual is treated as having received that, even if they did not receive anything.

What if I bought a large amount of cryptocurrency and only sold some of it?

Pooling under S104 Taxation of Capital Gains Act 1992 made Capital Gains Tax calculations simpler. At present HMRC believes cryptoassets fall within the described requirements included in the Act, and therefore must be pooled, similarly to shares.

Different Cryptocurrencies are kept in separate pools, with the sterling equivalent originally paid considered the "pooled allowable cost".

There are special pooling rules to be applied if an individual acquires tokens of a cryptoasset within 30 days of selling it. If these apply, the new cryptoassets and the costs of acquisition are kept separate from the main pool, with the gain or loss calculated using the costs of the new tokens of the cryptoasset that are kept separate. If the number disposed of exceeds the amount acquired, then the calculation may include an appropriate proportion of the pooled allowable cost.

What if I make a loss on disposal?

Allowable losses can be used to reduce the overall gain, but the losses must be reported to HMRC first.

There are special rules for losses when disposing to a connected person.

What if I lose access to the cryptoasset?

If an individual is unable to access the cryptoasset due to misplacing their private key, this will not count as a disposal for Capital Gains Tax purposes. However, if it can be shown there is no prospect of recovering the private key or accessing the cryptoassets held in the wallet, a negligible value claim could be made. If HMRC accept this claim, the individual will be treated as having disposed of and re-acquired the cryptoasset they cannot access so they can crystallise a loss.

What if I am defrauded and can't access my cryptoasset?

HMRC does not consider theft of cryptocurrency to be a disposal, as the individual still owns the asset and has a right to recover them, therefore victims of theft cannot claim a loss for CGT.
Those who do not receive cryptocurrency that they pay for may not be able to claim a capital loss.
Those who pay for and receive cryptoassets may be able to make a negligible value claim if they turn out to be worthless.

What about inheritance tax?

Cryptoassets will be considered property for the purposes of Inheritance Tax.

As crypto continues to grow in popularity, the laws surrounding how it is taxed will no doubt continue to change radically in the near future, so make sure you seek up to date advice before investing.

If you have any further queries or wish to take advice, then please do not hesitate to contact us directly.

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