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The situs of cryptocurrencies: an answer, but for how long?

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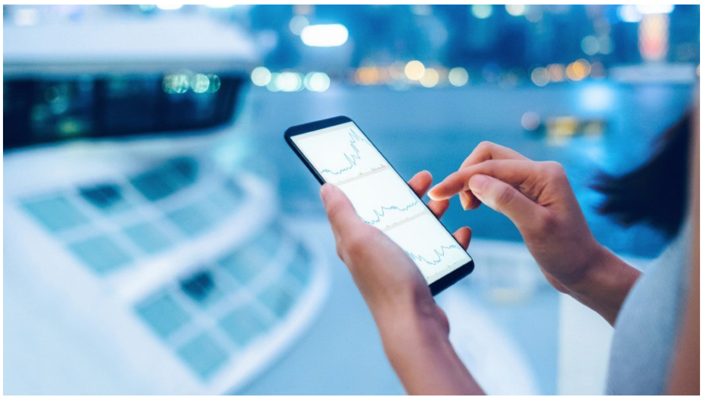

If you are an individual who invests in or trades in cryptocurrencies and you pay taxes in the UK, you should probably be aware that HMRC consider your virtual currencies to be firmly within their remit.

The much-discussed volatility of the cryptocurrency market means that it is not an investment for the faint-hearted. This is proving to be particularly true during the current coronavirus pandemic as it puts to the test the theory that cryptocurrencies are an 'uncorrelated safe haven', with dramatic results: the price of a Bitcoin dropped from $10,367 on 14 February to $4,944 on 16 March, performing far worse than global stock markets, although to date it has recovered somewhat.

Cryptocurrencies also pose challenges to HMRC, albeit of a different kind: how to obtain information about anonymous transactions which take place outside of the infrastructure of traditional financial institutions and how to tax this strange new breed of asset in a fair and consistent way. HMRC has, thus far, responded by announcing its intention to invest in technology to help close its intelligence gap by identifying blockchain participants who may be evading tax or committing money laundering offences, and by releasing a series of updates to its cryptocurrency tax guidance which it first published in 2014. It is also understood that a further HMRC cryptoassets manual dealing with some specific issues is being prepared.

Floating in the Ether

For a UK taxpayer wishing to correctly report their cryptocurrency holdings, the journey is fraught with issues. However, while there are many aspects of cryptocurrency usage which give rise to interesting, yet complicated, analyses from a tax perspective, one question which has gained attention recently is: where are cryptocurrencies located for tax purposes?

For UK resident and domiciled individuals, this answer to this question is unlikely to matter, since they already pay UK tax on their worldwide income and gains. However, for UK resident, non-domiciled individuals (RNDs), and possibly also for former RNDs who are still UK resident, the answer may have important repercussions for their tax liability. RNDs only pay UK tax on their UK-source income and gains and on their non-UK-source income or gains that are remitted to the UK.

On a strict reading, the question is doomed to be inconclusive: how can you identify the location, or situs, of an intangible, digital asset, which is essentially a string of numbers and letters, recorded on a decentralised ledger known as the blockchain? Many different approaches have been suggested to find a sensible rule that can be applied fairly to taxpayers. For example, one is that the situs should be where the wallet that holds the cryptocurrency can be accessed; another that it should be tied to the residence or domicile of the individual beneficial owner.

On 20 December 2019, HMRC released an update to its 2018 guidance, in which they indicated for the first time that they will treat an individual's 'cryptoassets' (at present limited to 'exchange tokens' such as Bitcoin and not, for example, security tokens received from an initial coin offering) as located in the jurisdiction in which that individual is resident. (It is assumed that 'residence' in this case means tax residence, although a small number of commentators consider that habitual residence is the proper test – the guidance is not specific).

How does the residence rule affect RND taxpayers?

Firstly, it appears HMRC are essentially disallowing the remittance basis in respect of cryptocurrencies, an unprecedented decision setting cryptocurrencies apart from all other categories of property. The new rule means that a RND purchasing, say, 10 Bitcoin using funds from a mixed offshore bank account, makes a remittance of offshore income or gains (with the income treated as being remitted in priority to the gains) at the moment of purchase, even if that transaction takes place wholly offshore. An individual moving to the UK for even a short time who owns cryptocurrencies will, without appropriate planning, make an immediate remittance of his or her entire portfolio of tokens regardless of whether they are used in the UK or even accessible in the UK (if the private key were, for example, kept in a locked safe offshore meaning no transactions could take place while the owner was in the UK). It is not clear in this situation whether an event that HMRC consider taxable, such as an exchange of one type of cryptocurrency for another, that occurs while the owner is non-UK resident, should be taxable once they become UK resident, which might be a particular concern for those caught by the temporary non-residence rules. However, for some RNDs the rule may actually work in their favour as it simplifies the remittance analysis considerably and they do not have to worry about making future remittances.

Secondly, HMRC have not given any guidance or assurances about how these rules will be applied retrospectively, if at all, and if tax is owed, whether interest and penalties would also be charged. Many RNDs and former RNDs who are still living in the UK may therefore need to review their historic reporting and decide whether to re-open earlier tax returns or otherwise make a disclosure to HMRC, in order to bring their tax reporting into line with this guidance. This might not be a concern if they are not planning to stay much longer in the UK or are planning to gift their holdings, but if they plan to sell off some of their cryptocurrencies or carry out another transaction which would be reportable while UK resident, it may be necessary to give this some consideration.

Thirdly, as the guidance has been issued unilaterally without international cooperation, there may be instances where the UK's rules conflict with other countries' rules as they develop, which could affect individuals with dual residence, for example, and give rise to a complicated analysis of relevant double tax treaties.

An individual's UK tax residence usually has no bearing on his exposure to UK inheritance tax (IHT). This rule appears materially eroded if tax residence now determines where an individual's cryptocurrency is located for IHT purposes. If this is correct, some RNDs may find that their potential exposure to IHT has substantially increased if they die while UK resident and owning cryptocurrencies. This may mean that some individuals need to reassess their estate planning and testamentary arrangements or the amount of life insurance cover they take out. The new rule also implies that common pre-deemed domicile planning strategies such as settling an offshore trust with non-UK assets to shelter such assets from IHT will not be possible for cryptocurrencies, and non-UK individuals who have already settled cryptoassets into trust (a topic on its own) will need to take advice if they intend to move to the UK. Confirmation from HMRC as to whether it is possible to use a situs blocker such as an offshore company to hold cryptocurrency would be welcome.

Finally, a quirk of the rules is that an individual with no connection to the UK who gifts cryptocurrency to a UK resident individual will now find that they have made a potentially exempt transfer, which could result in UK IHT being levied at up to 40% on the value of the gift (after taking their available nil rate band into account) if they survive less than 7 years from making the gift. This is because the asset becomes UK situs as soon as it is received by the UK resident individual and the general rule for IHT is that, for non-UK domiciled individuals, IHT is only charged on their UK situs assets.

Will the rules stick?

HMRC's duty is to come up with a rule that can be consistently and fairly applied in order to provide certainty to taxpayers. The new guidance certainly has the advantage of being very straightforward, in an area of great complexity. One of the more plausible alternatives would have been to link the situs of a person's cryptocurrency holding to the location of the private key, since the private key is what gives ultimate control over the asset. This would have been much more difficult to assess since private keys can be held in a variety of ways, such as on a computer, on email or on paper, and they may also be split into parts for security. Moreover, a private key itself is not property as it is easily replicable, like a password.

However, while HMRC's solution may be relatively straightforward to apply (subject to the comments made above) and may be advantageous for some who now do not have to be concerned about making future remittances, it may have potentially inequitable results on some individuals. Given the complexity of the technology and the variety of ways in which it is used and accessed, it would not be surprising to see this rule changed or developed in future.

It is to be expected that the rules, in some form or another, will be enshrined in legislation in future, which would (hopefully) provide more certainty as to their application. Despite the potential headache that the new rule may cause for some taxpayers, it is positive that HMRC is engaging with the difficulties of taxing this unique asset class which is still itself developing.

If you own cryptocurrencies and are concerned that you may have made a taxable remittance or have other undeclared liabilities in respect of your cryptocurrencies, or if you wish to take advice about dealing with cryptocurrencies in your estate plan, please contact your usual Withers contact.

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