ICAEW
REPRESENTATION 60/23

THE TAXATION OF DECENTRALISED FINANCE (DEFI) INVOLVING THE LENDING AND STAKING OF CRYPTOASSETS

Issued 22 June 2023

ICAEW welcomes the opportunity to comment on The taxation of decentralised finance (DeFi) involving the lending and staking of cryptoassets published by HM Revenue & Customs on 27 April 2023, a copy of which is available from this link.

For questions on this response, please contact the ICAEW Tax Faculty at taxfac@icaew.com quoting REP 60/23.

This response of 22 June 2023 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

© ICAEW 2023
All rights reserved.
This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:
• it is appropriately attributed, replicated accurately and is not used in a misleading context;
• the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.
Where third-party copyright material has been identified application for permission must be made to the copyright holder.

ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK
T +44 (0)20 7920 8100 F +44 (0)20 7920 0547   icaew.com

The Institute of Chartered Accountants in England and Wales (ICAEW) incorporated by Royal Charter (RC000246)
Registered office: Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

KEY POINTS

1. ICAEW supports the government's aim to develop a taxation framework for DeFi. This will enable greater certainty in the taxation of DeFi and promote the government’s ambition for the UK to be a leader in the global fintech market. We hope that further work will follow on the taxation of the wider cryptoasset market.
2. It is key that any DeFi regime can cope with the rapid developments in the DeFi and wider cryptoasset market. While the regime should allow for a high degree of certainty, there will also need to be some measure of flexibility for rules to be adapted to new developments in DeFi, preferably without changes to the underlying rules becoming necessary.
3. The taxation framework decided upon should have the widest possible basis of application and comprehension for taxpayers. We have commented on some significant gaps in the DeFi market that the repo rules would not cover, making its application of limited use. To encourage a high-level of compliance among individuals, it would be preferable for the tax regime to be familiar to them, or easy to learn. Therefore, we consider the no gain/no loss (NG/NL) rules to be more easily applied to DeFi for the majority of the market, albeit, in order to reduce the reporting required by individuals (which is a key challenge in practice), changes would be required so as not to require reporting for NG/NL transactions.
4. Taxpayers should be able to elect that the rules that will be introduced have always applied to their tax affairs. This would not be imposing retrospective taxation as it would only apply where a positive election is made by the taxpayer. There is precedent for this as set out in Para 41.
5. We support HMRC’s efforts to seek simplification. It is important, however, that this does not come at the expense of tax neutrality. Any tax regime decided on should not overly distort the market through arbitrarily creating a more favourable outcome for some DeFi transactions over others or creating a more favourable outcome for DeFi over other types of financial service product. There is a tension, however, given the nature of cryptoassets and the sheer volume of transactions (far more than with traditional asset classes). We acknowledge that this is a challenge, and the government will need to strike a balance on this point.

GENERAL POINTS

Future-proofing

6. The core principles of what HMRC is trying to achieve (as set out in Section 3 of consultation paper) are based on the DeFi and wider cryptoasset market as it stands today. This sector is very fast moving and there is a danger that any legislation introduced may quickly become out of date due to changes in technology or regulation.
7. According to our Ten Tenets, it is preferable to have constancy of underlying rules. As such it is important that legislation applying to DeFi is sufficiently flexible to deal with future developments in the sector (to the extent this is possible given the fast development of technology and different uses of technology in this area).
8. We consider that the taxation framework for DeFi would benefit from the inclusion of definitions as a principles-based approach, while allowing flexibility, creates uncertainty over whether, or how, rules will apply in certain cases. We would also suggest that flexibility could be added through the inclusion of provisions that can be altered via secondary legislation such as the Investment Managers Exemption allow list.

Complexity and comprehension

9. Given the profile of investors in cryptoassets, unless the rules are simple and straightforward there is likely to be large-scale non-compliance, most of it inadvertent. Complex rules are also likely to increase the resource needed from HMRC in dealing with queries and compliance activity. Therefore, all tax rules being framed now should be

through a lens of simplicity, to increase comprehension for taxpayers and reduce contact being required between HMRC and the taxpayer or agent.

10. Regarding the proposed design of the new taxation framework, we consider that using a NG/NL basis of taxation would be simpler to apply for participators in the DeFi market, rather than the repo basis which the consultation sets out.
11. The vast majority of participants in DeFi are private individuals who will either be unrepresented or engage the services of a high-street accountant for assistance with their tax affairs. It is likely that most of the tax gap in DeFi, attributable to this section of the market, is due to misunderstanding or ignorance of the rules. We consider that it is preferable to have a tax regime that is easily understood by this population, to allow greater compliance with the rules from the largest section of the market.
12. It is important that the introduction of a taxation regime for DeFi is accompanied by an educational process to inform taxpayers of the rules and their obligations. As a large proportion of individual participants in the cryptoasset market are teenagers and young adults, thought will need to be given as to how best to engage with this demographic. Most people do not read HMRC guidance, as supported by findings in HMRC's research report - "Individuals holding cryptoassets: uptake and understanding" - that 72% of people surveyed had not seen HMRC's guidance. They may therefore seek information from other sources which may be less accurate or reliable. Alternative channels of education must be identified and pursued to encourage compliance with the rules.
13. Corporate participants in the DeFi market are more likely to engage the use of tax advisors, or to have specialised staff to deal with tax. Therefore, they are more likely to comply with current rules and more able to effectively learn, and apply, new rules.
14. We have heard concerns from members regarding a suggestion of having two regimes for DeFi, one to apply to individuals and the other to corporates. We strongly support having one set of rules only for the taxation of DeFi, as this will make applying the rules simpler and more certain, in accordance with our Ten Tenets.

Neutrality

15. It is important that any tax regime, whether bespoke or based on existing rules, does not introduce a more favourable outcome for DeFi than for other types of financial services product. The UK has a substantial financial services industry and care should be taken that the taxation regime for DeFi does not overly impact the rest of the financial services market.

ANSWERS TO SPECIFIC QUESTIONS

Question 1: Do you consider that the rules above are sufficiently wide to cover most DeFi lending and staking models available in the market? If not, please provide details of the models that would not be covered.

16. The scope, as proposed, would not cover transactions involving liquidity pools, which makes up a large part of the DeFi market. Therefore, a significant proportion of the DeFi market would fall outside these rules, undermining their importance, effectiveness and applicability. Cryptoasset industry participants will be better placed to comment further on the size and make-up of the market.
17. We consider that the rules appear to cover most centralised DeFi transactions that our members have come across. However, there may be specific examples identified by industry figures that these rules do not cover.
18. As set out in Para 6, technology usage is rapidly moving and may develop differently than is currently envisaged. This may mean that the scope set out does not ultimately cover future DeFi transactions that it was intended to.

© ICAEW 2023

Question 2: Do you consider that the rules above would give rise to any unintended consequences or significantly restrict the development of the DeFi lending and staking market? If so, please provide details.

19. Further to Para 16, there may be instances identified where the taxation framework only applies to some transactions. If the tax treatment provides a more favourable result compared with other taxation regimes, people may try to structure their holdings or transactions in such a way to fall within the taxation framework for DeFi. This may lead to development of more artificial arrangements and distortions in the market.
20. It is vital that the taxation framework for DeFi should not offer a more beneficial treatment than other taxation regimes, to ensure that the tax treatment does not influence the market. The UK has a thriving financial services market and care should be taken that any tax regime decided upon for DeFi does not adversely impact the UK's other financial services offerings.
21. Relying on a principles-based approach for the taxation of DeFi may increase uncertainty, especially at the boundaries of what is considered a DeFi transaction. We consider that introducing some definitions into what is considered DeFi would provide some clarity and increase certainty in the taxation of DeFi. There will need to be alignment of definitions used across legislation to avoid complexity arising from multiple definitions. However, we acknowledge that such definitions will need to be sufficiently flexible to adapt to changes in technology, regulation and the usage of DeFi. This could be achieved by including a definition of DeFi that is open to amendment by secondary legislation, perhaps using an allow-list methodology that can be updated periodically.

Question 3: Do you consider that the rules would be open to abuse?

22. The proposed scope of the taxation framework would create significant gaps in coverage. As commented on in Para 19 to 21, this may influence taxpayer behaviour so that they choose to fall either within or outside the rules. Such tax-led behaviour is not desirable as it may create distortions in the market.

Question 4: Are the rights of the lender to receive the lent or staked tokens of a legal nature? Please respond to this question with reference to any specific DeFi models you have an involvement in, highlighting any legal uncertainties.

23. Some arrangements will have express legal rights attached to them; this depends on the nature of the arrangement and the legal documentation.
24. For instance, we can clearly see three scenarios which have different sets of rights. There may be different permutations within these scenarios.
    a. For a centralised lender the rights will generally be against that lender (akin to a chose-in-action), with those rights being represented off chain.
    b. For a decentralised lender, where there are rights as part of the smart contract this may only be represented as part of an express contract.
    c. For some tokens the contract may not be drafted in a way that makes it sufficiently clear whether there are any legal rights associated with the token.
25. There is a question of whether there should be differing tax treatments between these scenarios. While we have not explored options in detail, we note that from the point of view of simplicity, having the same tax treatment apply to all three scenarios would avoid inadvertent non-compliance.

Question 5: Other than (i) the sale of rights during staking or lending and (ii) the borrower not being able to return staked or lent tokens, are there any other situations in which the lender may cease to hold the right to receive back the lent/staked tokens?

26. While we have not provided details of situations, we consider that there will be other situations in which the repo rules will be difficult to apply in a satisfactory manner.
27. If a version of the NG/NL rules were instead used as a taxation framework, these issues would largely fall away.

Question 6: Do you favour a change in the rules to always treat the DeFi return as being of a revenue nature? What are the pros and cons?

28. While treating all DeFi returns as revenue would be a simplification in one way, there is a risk of ignoring the nature of the underlying transaction. Depending on the arrangement the underlying transaction may be of a capital or a revenue nature, and applying an override to this may itself create complexity and the opportunity for artificial planning.
29. We consider that it is preferable for taxpayers to make decisions based on the nature of the activity they are participating in, rather than the tax treatment, to avoid market distortions. As mentioned in Para 15, the taxation framework for DeFi should not offer a more beneficial treatment than other taxation regimes.
30. For taxpayers who do not consider themselves to be trading, if DeFi returns are treated as revenue, there is a question of what happens if the value of the tokens falls after the point of receipt. Would the fall in value be available as a revenue loss stream? We note that corporate taxpayers would likely prefer DeFi returns to be treated as revenue, as this would make it easier for them to utilise DeFi losses arising against profits rather than capital gains. Individuals, on the other hand would be less likely to be able to use non-trading income loss relief against their income.
31. Some taxpayers may consider that their DeFi transactions amount to trading activities, and so will not fall within the scope of miscellaneous income or capital treatment. We consider that it is more likely for corporate entities rather than individuals to be trading.
32. Individual taxpayers have a £1,000 trading and miscellaneous income allowance available to them. If DeFi returns were treated as revenue, there is a question of whether the trading allowance would be available to exempt some of this income. If so, it could help to lessen the administrative burden for individuals with small returns, as they would not need to report DeFi returns to HMRC if covered fully by the allowance. HMRC should publish guidance to clarify its position regarding the use of the trading allowance and DeFi returns, once this has been decided upon, to allow greater certainty for and compliance by taxpayers.
33. It is worth considering whether taxpayers could elect to have all DeFi returns treated as revenue, as a method of simplifying their tax treatment. This should not, however, be the default treatment.
34. It would be useful for HMRC to publish guidance regarding source of any income. This will particularly be the case if the decision is made to treat DeFi returns as revenue. Even if the current position is maintained, given that DeFi returns can give rise to income, the issue needs to be considered. We are fully aware that HMRC's view on the lex situs of digital assets, as detailed within the guidance at CRYPTO22600, that the situs will follow that of the beneficial owner where there is no underlying asset. However, no guidance has been published by HMRC as to how this will apply for income purposes as the guidance considers economic ownership. It is unclear where the damages could be pursued in the matter of DeFi platforms and few cases have been heard in court. The High Court considered jurisdiction in Ion Science v Persons Unknown – would that decision have cross applicability for the identification of source? This has other impacts such as on which category is applicable for offshore penalties.
35. It should be noted that members have found that HMRC’s current position on the situs of digital assets dissuades some taxpayers from coming to the UK, due to the unfavourable tax treatment compared with other jurisdictions.

Question 7:

a) Do you agree that the proposed treatment of DeFi transactions has been applied correctly in each of Examples 1 to 5?

b) Do you foresee any practical difficulties applying the proposed treatment to situations similar to those in these examples?

c) Please provide any further examples of DeFi transactions that you think would be helpful, including an explanation of how the proposed tax treatment would apply.

d) Please provide examples of any DeFi transactions where you consider it would be problematic to apply the proposed new rules, with an explanation. If you think a different treatment would be easier to apply, while retaining broadly the same level and timing of tax charges, please set this out.

36. We agree that the application of the proposed rules to the examples is correct. However, we consider that the examples included do not reflect the full scope of the reality of the market.
37. Transactions occur far more frequently in reality than is illustrated. Also, as set out in Para 16, the proposed scope of rules also does not apply to liquidity pools, which we understand to be a type of transaction that occurs with reasonable frequency in practice (though we expect that participants in the DeFi market would be able to comment more fully in answer to this question).

Question 8:

a) Do you think that the transaction in Example 6 should be within the scope of the proposed tax rules for DeFi? On what principles have you based your response?

b) If you think that this transaction should be within the scope of the proposed DeFi rules, how should they treat the economic conversion between the 2 types of token while the tokens are staked as a pair, given that crypto to crypto transactions are taxable?

c) Noting that this transaction does not meet all the conditions for the proposed rules, how could those rules be modified to provide a fair outcome for this transaction?

d) Do you foresee any difficulties for users who engage in these and similar transactions to establish the value of the DeFi return? If so, please provide examples where this may be an issue.

38. We consider that crypto to crypto transactions should fall within the proposed tax rules for DeFi. To exclude these transactions from taxation would allow a marketplace that is outside the scope of UK taxation provided that assets are not converted into fiat currency. This would likely encourage artificial tax planning to ensure that transactions do not fall to be taxed, while still allowing real term value to be exchanged.
39. In practice it may be difficult to establish values of transactions involving alterations of the proportion of crypto tokens. Similarly, this would present an issue if the NG/NL basis were used and would merit further exploration. There is also a question over whether the value of one token is accurate in the context of the frequency of transactions inherent in the DeFi market.
40. We note that other phenomena may need to be considered as falling within the scope of the DeFi rules on a principles-based approach, such as wrapped tokens and auctions. Consideration should be given as to how and whether these rules are intended to apply to them.

Question 9: Do you have any general comments regarding the proposed tax framework for DeFi that you have not included in the previous questions?

41. We consider that it should be possible for taxpayers to make a retrospective election to apply any new DeFi taxation framework to previous tax years. This would allow previously non-compliant taxpayers to bring their affairs up to date in line with any rules introduced.

This type of permissive retrospective election has previously been permitted. FA 2003 changed the law on deferred unascertainable consideration by introducing an election for treatment of losses with respect to the *Marren v Ingles* chose in action. The legislative was effective from 6 April 2003 with the taxpayer being able to elect for the legislation to apply to one or both of the two prior tax years. The changes to the dividend exemption for corporates were also retrospective (this time with the option of electing out of the retrospection). For the avoidance of doubt, we favour an election into retrospection, not an election out, but the fact that both have happened shows that either is possible. It is important that the indirect tax treatment of DeFi is considered in the taxation framework, and that guidance is provided for these purposes. We take this opportunity to comment that it is our preference for the application of indirect taxation to cryptoassets to be considered in general (ie, for all cryptoassets – not just DeFi transactions).

Question 10: What impact do you expect the proposals in this document, if implemented, to have on administrative burdens and costs for users of DeFi?

42. If a taxation framework based on the repo rules is introduced, it is likely that individuals will need to incur additional advisory fees in order to be compliant. The repo rules are not familiar to most individuals or smaller agents. Nor are the repo rules simple to operate. As the majority of holders of digital assets will be private individuals, they may struggle to understand the rules and may face higher fees as smaller agents need to undertake training to familiarise themselves with the rules. We consider that using the repo rules will increase the complexity of reporting and may lead to increased non-compliance through error in applying the rules or ignorance of the rules.
43. It is difficult to see how the repo rules would interact with the pooling rules, for instance in the case where one set of a token is used for staking and another set is exchanged on the open market for a different token. This would increase the administration required to track and document the costs of different sets of the same token. It would also make it impossible for HMRC to have any idea of the position with respect to taxpayers. HMRC might receive information from the crypto exchanges but given the complexity of the pooling it would be even more meaningless than the information currently being received (which also does not take account of multiple wallets with the same crypto assets held across these wallets).
44. Using a NG/NL basis would require less administration for record keeping purposes than the repo basis and the current basis of reporting, provided changes are also made to reporting requirements whereby NG/NL DeFi transactions do not need to be reported. Additionally NG/NL is far more widely understood by private individuals and smaller agents so is less likely to increase complexity (and cost) to the same extent as using the repo rules.
45. HMRC's research report - "Individuals holding cryptoassets: uptake and understanding" - found that 96% of respondents were not liable for CGT on gains realised. This was based on the 2019/20 tax year when the individual annual exempt amount (AEA) for capital gains tax (CGT) was £12,000. With the reduction of the AEA to £6,000 for 2023/24 and £3,000 for 2024/25, it is likely that more taxpayers will have taxable gains that need to be reported, increasing the administrative burden on affected individuals. There is a risk that some taxpayers are not aware of their reporting obligations or are unfamiliar with HMRC systems, which may result in non-compliance.
46. The s104 Taxation of Capital Gains Act 1992 rules regarding pooling also increase the administration burden. It may be an option to allow an election to calculate capital gains on a wallet by wallet basis, rather than an aggregate basis. If such an election were introduced, it would be necessary for the treatment to apply to all pooled assets (eg, shares) so as not to create distortions in behaviour.
47. Whichever basis is decided upon, an educational campaign will need to be undertaken to inform taxpayers of the new rules applying to DeFi. HMRC's research report - "Individuals holding cryptoassets: uptake and understanding" - found that 25% of holders of

cryptoassets surveyed were between 18 – 24 years old. This population is likely to have far less engagement with HMRC than older populations. The report also highlighted that 72% of all respondents had not seen the HMRC guidance on cryptoassets, and 81% did not have a professional advisor. We suggest that it would be preferable to allow the greatest level of comprehension of the taxation of DeFi by choosing a basis that individuals are familiar with and can comply with without significant effort or cost.

48. The quality of information available to taxpayers differs greatly, making it difficult for many taxpayers to comply with their reporting obligations.
49. Due to the decentralisation of the market, we appreciate that it is not practical to require platform operators to produce tax packs for investors (no matter how desirable that would be).
50. To encourage reporting by platform operators, a preferential penalties regime could be introduced. Platforms that comply with reporting requirements to different standards could be considered differently for calculating penalties, akin to the territory categorisation for offshore penalties regime. There would need to be a requirement for platforms to let taxpayers know the platform’s reporting status, to allow informed decision making by the taxpayer.

Question 11: Are there any other impacts, benefits or costs arising from the proposals in this document, if implemented?

51. We welcome the government’s ambition for the UK to be one of the leading fintech centres globally. We support changes to the taxation of DeFi to make it simpler and more certain for taxpayers to understand and comply with their obligations.
52. We are keen to engage with government and HMRC to explore other changes and simplifications that could be made to the UK’s taxation of the wider cryptoasset market.

Question 12: How common is direct lending of tokens between 2 parties compared to the use of staking?

53. We are uncertain what the purpose of the question is, as this information is unlikely to be available. We would be happy to discuss what HMRC seeks to understand through this question further.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).

© ICAEW 2023