The U.K. Tax Treatment of Initial Coin Offerings

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What are some of the tax issues that arise when initial coin offerings are conducted through a U.K. resident issuer vehicle?

Initial coin offerings or "ICO"s, sometimes referred to as "token sales", are an increasingly common funding technique involving the raising of capital through the allocation to investors of a cryptocurrency in the form of digital "tokens."

What are ICOs?

ICOs rely on the blockchain "distributed ledger" technology which has driven the recent boom in cryptocurrencies. A blockchain is a database of electronic records which is maintained through a distributed computer network. Alterations to the database can only be made by consensus between the computers participating in the network. Blockchains can therefore be used to effect transactions, for example in units of a digital currency, in a way which offers the potential for better cybersecurity than the traditional centralized banking system, whilst also eliminating many of its costs.

Blockchain technologies such as Ethereum permit tokens incorporating "smart contract" technology, so that detailed terms can be built into a token issued as part of an ICO. This could be used, for example, to give a token features comparable to those of a debt security (such as rights to interest payments) or shares (such as dividends or voting rights).

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HM Revenue & Customs' ("HMRC") published guidance on the U.K. tax treatment of cryptocurrencies is very limited, and ICOs are barely addressed at all. HMRC Brief 9 (2014) in relation to Bitcoin and similar cryptocurrencies indicates that each case will be considered on the "basis of its own individual facts and circumstances." It appears therefore that one must assess each transaction by reference to first principles. The difficulty with this is acknowledged by HMRC in the Brief itself: "cryptocurrencies have a unique identity and cannot therefore be directly compared to any other form of investment activity or payment mechanism," a comment which applies with even greater force where the basic "currency" is overlaid with a smart contract. A token is typically a legal and economic chimera—a novel instrument which does not fall neatly into any of the categories with which the U.K. tax code is equipped to deal.

Corporation tax

How is a U.K. company raising funds through an ICO charged to corporation tax? There may be a compara-

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tively simple answer to this if the token is economically equivalent to a loan or debt security because it would then fall within the accounts-based loan relationships regime.

If this is not the case however, the position may depend on whether the allocation of tokens is a capital or trading transaction. If the company makes regular transactions in tokens it is not inconceivable that that they could be seen as forming part of some trading activity so that the ICO proceeds are taxed as income, presumably in accordance with the company's GAAP compliant accounts.

A more realistic view is likely to be that the ICO is, like the more familiar IPO, a capital raising exercise. In that case, though, one might see the token as an asset for capital gains purposes, in respect of which the company has no obvious base cost. If so, should the company be viewed as disposing of an existing asset which it has created and subjected to corporation tax on the full issuance proceeds, or alternatively treated in the same way as an issuer of shares—where the share is treated as created rather than disposed of by virtue of the issuance—so that no tax charge arises? It would seem a capricious result if ICO proceeds were subject to corporation tax where the economic function of the ICO is equivalent to an equity issuance.

Another question to consider is whether any return paid by the issuer in respect of the tokens would be deductible. Unless the return can be treated as interest in relation to a loan relationship (in circumstances where the distribution rules or other deductibility restrictions do not apply), the answer in many cases may well be no.

VAT

HMRC's guidance on the VAT treatment of cryptocurrencies and the CJEU case of *Hedqvist* (http://src.bna.com/wmT) address the VAT treatment of cryptocurrencies in rather more detail. In summary, it appears that cryptocurrencies will be viewed in a similar way to traditional currencies. When a cryptocurrency is exchanged for a traditional currency, no VAT is due on the value of the cryptocurrency itself. Presumably this is because the transfer is not a chargeable event at all, rather than an exempt supply. There would be a supply equal to the value of the consideration for any exchange service, but that supply would be exempt. Supplies of goods and services in exchange for cryptocurrencies are subject to VAT in the normal way (the value of the supply of goods or services being the sterling value of the cryptocurrency at the time of supply).

This all assumes that the cryptocurrency serves no other purpose than as a currency. This will not always be the case for tokens, which may well have additional features. What effect do these additional features have for VAT purposes? If the tokens have terms which make them comparable to other financial securities, the sensible answer ought to be that the same VAT exemptions should apply to tokens as apply to those securities. Whether the principle in *Kretztechnik* (http://src.bna.com/wmU) would apply to treat the whole ICO as outside the scope, rather than an exempt supply, is a further unanswered question, but one which may significantly affect the issuer's VAT recovery position.

As for corporation tax, these questions are not merely academic—the risk is a possible 20 percent VAT charge on token issuance proceeds, not to mention the potential compliance difficulties associated with identifying and applying the right VAT treatment in respect of each token holder.

Withholding Tax

Tokens may or may not give a right, or at least an opportunity, to receive some form of return from the issuer, possibly linked to the value of, or income from, some underlying asset or project. It may be that this return can be analyzed as interest. If so, payments by the company to token holders could be subject to withholding tax under section 874 of the Income Tax Act 2007, subject to any available exemption. If the return is not interest, then to the extent that it is a recurring payment of an income nature which represents pure income profit in the hands of the recipient, there is also a possibility that the return could be subject to U.K. withholding tax as an "annual payment" (although one might take the view that withholding is disapplied under section 904 of the Income Tax Act 2007).

In either case, the economic costs of withholding, and the mechanics to ensure that the issuer can identify and apply the rules correctly in respect of each token holder, will need to be considered carefully.

Stamp Duty

Unsurprisingly, the treatment of tokens for stamp tax purposes is similarly uncertain. While it is debatable whether tokens are marketable securities (are they "securities" capable of being sold on a stock market in the U.K.?), one would expect it to be rare for a transfer to be effected by way of a physical instrument. Presumably tokens are not "stock, shares or loan capital" for stamp duty reserve tax purposes (at least where not economically equivalent to a loan), and will not typically be "interests" in stock, shares or loan capital.

Final Thoughts

Whilst cryptocurrencies have received some mixed press coverage and criticism from regulators over recent months, not to mention a bumpy ride on currency markets, it is nonetheless clear that ICOs potentially represent a novel and innovative means for start-ups and other businesses to raise capital. Given the potential economic benefits, it is to be hoped that HMRC will take an approach which both provides greater clarity on the tax treatment of U.K. ICOs, and puts issuers and investors in no less favorable a tax position than those involved in more traditional types of capital raising.

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