



## TAX AND ESTATE **PLANNING**

# DECRYPTING A DIGITAL WORLD

Since the creation of Bitcoin in 2009, there has been a steady increase in the ownership of cryptocurrencies across the world, with an estimated 40 million blockchain wallet users worldwide.

Understanding how cryptoassets work, how they will be taxed and how they will pass from generation to generation has therefore never been more important as individuals branch out into these new and uncharted investments. In this guide we provide an overview of some of the key areas of interest in relation to cryptoassets, their legal treatment in the UK, and how they should be considered in tax and estate planning.

## I. CRYPTOASSETS: HOW THEY WORK

At its most basic, a cryptoasset (be it Bitcoin, Ether, or any one of the other thousands of cryptocurrencies currently on the market) is a tradable unit of value whose ownership is managed by distributed ledger technology ("DLT"). There are no physical assets which determine how cryptocurrencies are held, as there are for notes or coins, nor is there a register of owners, as there is for shares. Rather, cryptocurrencies such as Bitcoin are generated by mining and their ownership is recorded using DLT, the most famous example of which is blockchain (see below).

While it is not necessary to understand all of the technical processes of mining for the purposes of tax advice, it is worth noting that bitcoins are created when members ('nodes') of the network solve a complex algorithm and communicate this to other nodes across the world. The network could comprise thousands of devices, across numerous countries and jurisdictions.

The majority of "crypto-owners" will not mine for Bitcoin, but will purchase it on an exchange using fiat currency or other cryptoassets. They will do so using a "private key"; a cryptographically-generated list of numbers and letters which is known only to the owner and contains no personal data. A private key is not itself a cryptoasset – it is more similar to a passcode allowing an owner to access their assets.

People will often generate and store their private keys using a "wallet", a piece of software that stores the public and private keys of the user. This is known as 'hot storage'. Alternatively, they might print out their keys and keep them securely on a piece of paper, or use a hardware storage device such as a USB stick. This is known as 'cold storage'.

## TAX AND ESTATE **PLANNING**

### BLOCKCHAIN

A blockchain is a record of transactions, in which each collection of transactions, or 'block', added to the chain makes a reference to the previous block. Each cryptocurrency will have its own blockchain.<sup>1</sup>

A copy of the blockchain is stored on every device connected to the system. The bitcoin blockchain is perhaps the most famous, although no longer the largest. At the time of writing it has 9489 nodes spanning 93 countries.

## 2. SITUS

The situs, or location, of an asset can have a significant impact on how it is taxed and the rules governing succession. We will consider the effect of situs for various taxes in the sections below, but it seems apparent that in private client legal matters, where a cryptoasset is situated is crucial and the answer 'we don't know' is unlikely to suffice.

When we talk about the situs of an asset, we often wish to focus on different aspects, for example where it physically is (for immoveable property), where its ownership is registered (for shares) or from where it can be recovered (for choses in action). Those questions are of little use for cryptocurrencies, which are a brand new beast for HM Revenue and Customs ("HMRC").

Having an understanding of how cryptoassets work goes some way to explain the difficulties in determining where a cryptoasset is situated for the purposes of tax. There is no jurisdiction within which one could argue a cryptoasset is created, since mining involves nodes from all over the world and in a similar way, blockchain decentralises the register of owners, meaning that it exists at the same time in numerous places. A wallet, whilst being the access point for a crypto-owner, is not an asset in itself and, moreover, someone could have any number of wallets containing the same information in different countries (for example, a phone in the UK and a USB in Switzerland).

UK legislation does not currently designate a situs

for cryptoassets and HMRC has remained completely silent on the issue. Nevertheless, for the purposes of UK tax law, a bitcoin must be situated somewhere and therefore the following are some suggestions:

#### 1) **The cryptoasset is situated in the place in which the crypto-owner can make a transfer**

If access to one's cryptoassets can only occur through the use of the private key, one approach that HMRC could take is to say that a cryptoasset is situated in the place where both the owner and their private key reside from time to time.

This would look different in different cases, particularly as private keys can be stored on hardware, software or a piece of paper.

So if a crypto-owner has a mobile wallet from which he can transfer tokens, the situs of his assets will be the country where the holder and his mobile phone are situated from time to time. However, if the crypto-owner had printed off his private key and/or was storing it in cold storage in another country, that country would be the situs of the assets (provided he did not also have a mobile wallet on his phone).

#### 2) **The cryptoasset is situated where the wallet provider containing the private key is located**

Wallet providers themselves will be registered companies, and it may be that, as for shares, HMRC will deem the situs of the wallet provider to also be the situs of the cryptoassets.

This is a slightly more tenuous link, since wallets store the keys, and not the cryptoassets themselves. However, the advantage of this approach is an increased certainty, since the situs of the wallet provider will be an identifiable fact on which the situs of cryptoassets could be based.

#### 3) **The cryptoasset is sited where the exchange with which it is associated operates**

It's also possible to store your cryptocurrency on an exchange, in which case, as above, HMRC could deem its situs to be the jurisdiction in which the exchange operates.

<sup>1</sup> There are different kinds of blockchain, including private and permission blockchains. For the avoidance of doubt, blockchain in this paper refers only to public blockchains.

## TAX AND ESTATE **PLANNING**

Likewise, many wallets are associated with exchanges, and so the same might apply even if the cryptocurrency is stored on a wallet that is associated with an exchange.

The above are mere suggestions, but they may prove useful in shaping the way that clients manage their bitcoin at this stage, even if HMRC are yet to provide any guidance on the issue.

### 3. PERSONAL TAX

In December 2018, HMRC released a paper entitled 'Cryptoassets for individuals' which sets out its view on how individuals who own cryptoassets will be taxed. Although it is clear that this is not its final view on the matter, it does provide clarity on which taxes HMRC expect to apply and guidance on how they may be applied.

#### 4.1. Income Tax: Cryptoassets as 'income'

It is clear from the guidance provided that HMRC does not anticipate many cases where an individual will have to pay income tax as a result of owning cryptoassets.

It is likely that income tax will only be relevant where an individual:

- 1) receives cryptoassets from their employer as a form of payment;
- 2) receives cryptoassets as a result of mining, airdrops (free distributions of cryptocurrency, usually used as a form of marketing) or confirming transactions; or
- 3) purchases and sells cryptoassets with such 'frequency, level of organisation and sophistication' that it could be said they are 'trading' in cryptoassets.

(For these purposes 'trading' takes on the same meaning as when trading shares or other financial instruments, and existing case law will apply)

As the circumstances above are likely to be of less relevance to private clients, this paper will not consider them in any further detail. More information can be

found in the guidance from HMRC.

#### 4.2. Capital Gains Tax ("CGT"): Cryptoassets as an 'investment'

Where a cryptoasset has a realisable value and is capable of being owned, it is a chargeable asset according to HMRC.

As such, when a UK resident, who owns cryptoassets, disposes of those assets, they will be required to pay UK CGT at a rate for 20% (for higher or additional rate taxpayers) on any gain that they realise as a result of the disposal.

For the purposes of CGT, a disposal encompasses the sale of cryptoassets, the exchange for a different cryptoasset, the use of a cryptoasset to pay for goods or services and the gift of cryptoassets.

#### DEDUCTIBLE COSTS

As with other assets, certain costs will be taken into account when calculating a gain, which include the consideration originally paid for the cryptoasset and the costs associated with its disposal (such as transaction fees, advertising, costs for drawing up a contract for sale or purchase and fees for valuing the assets).

It is worth noting that costs for mining activities will not be deductible, as these are not considered by HMRC to be 'wholly and exclusively' for the acquisition of cryptoassets.

#### POOLING CRYPTOASSETS

As a cryptoasset bears similarities to a share – in that one bitcoin is equal to another bitcoin – HMRC have deemed that it is possible to pool each type of cryptoasset in order to simplify calculating CGT. A client owning bitcoin would have a pool of bitcoin (built up of various purchases of bitcoin) which would have a pooled allowable cost for use on disposal. Likewise Ether would be placed in its own pool, as would Litecoin etc.

Pooling allows you to spread the costs of purchase between all the tokens of one type that you own, and

## TAX AND ESTATE **PLANNING**

when tokens from a pool are sold, the corresponding proportion of the pooled allowable costs would be deducted.

Similarly to shares, where an individual acquires tokens within thirty days of disposing of tokens of the same cryptoasset, no gain or loss arises until the disposal of the replacement tokens. This prevents individuals from benefitting from the sale and immediate re-purchase of tokens for the sake of crystallising a loss or a gain ('bed-and-breakfasting').

### **POOLING: A FORK IN THE CHAIN**

Sometimes the blockchain of a cryptoasset will split, in what is known as a 'hard fork'. In such a case, there will be a new type of cryptoasset created and this will be in a separate pool to the previous cryptoasset. Allowable costs for the original cryptoassets will be split between the new and old assets.

Soft forks will not create a new type of cryptoasset and therefore will not require a separate pool.

### **AIRDROPS**

Similarly, cryptoassets given by an 'airdrop' will need to go into a new pool.

### **GIFTS**

Where crypto-owners wish to make a gift of their cryptoassets, this will be a deemed disposal for CGT purposes. The gift will be deemed to be made at the cryptoassets' sterling market value.

### **CLAIMING FOR LOSSES**

Crypto-owners will be able to crystallise the losses they sustain on cryptoassets, and use these losses to reduce their overall gains, provided they have reported the loss to HMRC first.

Where cryptoassets become worthless or of 'negligible value', an owner will also be able to make a 'negligible value claim', which will crystallise the loss without disposing of the assets.

Individuals that lose their private keys and are therefore unable to access the cryptoassets will also be able to bring a negligible value claim if there is no

prospect of recovering the key or accessing the assets. However, a victim of theft or fraud will not be able to make a similar claim as they still have the right to recover the assets, though they may never do so.

### **DEATH**

On a crypto-owner's death, cryptoassets, like other assets, benefit from an uplift to date of death value.

#### **4.3. CGT: Lifetime planning for cryptoassets**

UK resident and domiciled crypto-owners are taxed on gains made on their worldwide assets and therefore will be liable to pay CGT at their relevant rate (10% or 20%) on any gains made on the disposal of cryptoassets.

Individuals who are not UK tax resident will not be liable to CGT on gains even on UK assets (but note there are anti-avoidance rules for short-term non-residents).

Those who are UK resident but not UK domiciled or deemed domiciled may elect to be taxed on the 'remittance basis', meaning they will only pay CGT on their UK gains or on foreign gains which they remit to the UK.

For remittance basis crypto-owners, advice should be sought as to the location of their cryptoassets. In line with the above comments on the situs of cryptoassets, and subject to future guidance from HMRC, some advice at this stage would be to encourage crypto-owners to:

- use 'cold-storage' for their cryptocurrency private keys, delete any mobile wallets, and keep these keys in a tax-friendly jurisdiction; and
- use wallet providers and exchanges that are based in tax-friendly jurisdictions.

#### **4.4. Inheritance Tax ("IHT")**

On death, UK domiciled or deemed domiciled individuals will be liable to pay IHT at 40% on their worldwide estate over the tax free threshold of £325,000.

## TAX AND ESTATE **PLANNING**

HMRC have confirmed that, for IHT purposes, cryptoassets will be 'property', and therefore they will also be taxed at 40% on the death of the owner.

Non-UK domiciled individuals are only liable to IHT on their UK situs assets (subject to any tax treaty relief), hence the question of situs is important once more.

### 4.5. IHT: lifetime gifts of cryptoassets

Outright gifts of cryptoassets made during an individual's lifetime will only be liable to IHT if the donor dies within 7 years of making the gift.

Certain lifetime transfers such as gifts to companies and into certain trusts will be immediately taxable at a rate of 20% but gifts into trust within a cumulative £325,000 tax free threshold will not incur IHT.

Since non UK domiciled or deemed domiciled individuals will only pay IHT on their UK assets, they should take simple steps to avoid being liable to IHT during their lifetime, or on death, by placing their private keys outside the UK and using non-UK based wallet providers. They should consider lifetime trusts to put their cryptoassets outside the IHT net forever, even if they subsequently become deemed domiciled in the UK.

### 4.6. IHT: Will planning

There is a variety of tax planning which a client could consider in order to mitigate their IHT liabilities for their cryptoassets. For example, a UK domiciled crypto-owner should consider leaving cryptoassets to their spouse to make use of the 100% spousal exemption (although this exemption is limited if the surviving spouse is neither UK domiciled nor deemed domiciled).

For non UK domiciled and non-deemed domiciled individuals they should seek to hold non-UK situs assets, see 4.5 above.

## 5. SUCCESSION

### THE LAW GOVERNING SUCCESSION

Under UK law, moveable property (which includes cryptoassets) passes in accordance with the law of the jurisdiction of the deceased's common law domicile (lex domicilii) as opposed to deemed domicile, which is purely a UK tax status.

This means that English domiciled crypto-owners are entitled to leave their cryptoassets to whomever they please, in accordance with the longstanding English principle of testamentary freedom (notwithstanding the scope for overlooked dependents to claim after death).

On the other hand, the succession of cryptoassets owned by non UK domiciled individuals will be governed by the law of the country in which the owner is domiciled. For EU citizens outside the UK, Ireland and Denmark, succession will be governed by the rules in Brussels IV.

### DISPUTES OVER SUCCESSION

For the most part, the succession of cryptoassets is likely to occur in the same way as other assets. However, one question which must be considered is how any disputes over the succession of cryptoassets will be dealt with.

If a UK domiciled testator were to leave all of their cryptoassets to a UK individual or charity, the forum in which any dispute would be heard would most likely be the UK courts.

But what if one heir had access to the private key and the executors did not? Whilst the executors of an estate could freeze a bank account to protect its contents, it is unlikely that you would get an injunction against the thousands of nodes on the bitcoin blockchain to protect the cryptocurrency. Where would you enforce such an order? You may be able to sue the heir in the UK for return of the cryptoassets but enforcement against the assets themselves will be another matter.

## TAX AND ESTATE PLANNING

It may, however, be easier to sue an exchange, such as Coinbase. Either way, even greater care needs to be taken during a testator's lifetime when dealing with cryptoassets to ensure they reach the desired beneficiaries.

### 6. PRACTICAL TIPS AND TRICKS

The mechanics of cryptoassets can make planning for succession tricky. One only has to read the headlines to see stories of crypto-billionaires failing to successfully pass on their cryptocurrency.

Advisors should therefore encourage crypto-owners to be proactive in their planning. The following are a few useful hints and tips:

#### 1) Encourage clients to identify, locate and record their cryptoassets at an early stage

Due to the anonymous nature of crypto-ownership, it can be extremely difficult to discover if somebody owned cryptoassets once they have died. Clients should therefore be encouraged to write down the cryptoassets that they own and/or keep their advisors informed of any cryptoassets that they own.

At its first stage this may be as simple as including an additional question on an asset schedule questionnaire.

#### 2) Make specific provision for cryptoassets in a will

Careful attention must be paid to the drafting of a will where the testator is a crypto-owner. Testators

should make provision not only for the gifts of the assets themselves, but also for the gifts of the phone, hardware or paper on which the private keys are contained – and if the intention is for these to go to separate individuals, this must be properly accounted for.

A will should also contain the administrative powers that an executor may need to manage a gift of cryptoassets, including the power to use a private key to effect such a gift.

#### 3) Consider the use of digital executors, managers or trustees

Many individuals, including trust corporations, may not feel comfortable administering crypto-assets, especially where investment may be needed. Clients may wish to appoint digital managers or executors for this purpose, or make provision for executors to consult expert advice where needed.

#### 4) Ensure that beneficiaries and executors have access to cryptoassets

In addition to providing for the gift of both cryptoasset and storage in a will, a testator or settlor will need to take practical steps to ensure that their executors or trustees can access and transfer the cryptoassets.

This will include making sure that private keys, laptop passwords and phone codes are passed on to the relevant individuals, stored securely and kept updated.

---

**For more information on our Private wealth and fintech services, please visit [collyerbristow.com](https://collyerbristow.com) or e-mail [info@collyerbristow.com](mailto:info@collyerbristow.com)**