COLLYER BRISTOW

CRYPTO & DIGITAL ASSETS

PLANNING WITH CRYPTO ASSETS

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PLANNING WITH CRYPTO ASSETS

The rise and fall of cryptocurrencies is something regularly publicised in today's media. Alternative coins, such as Ether, Litecoin or Ripple, are very real rivals to the reign of Bitcoin and it is estimated that there are now over 10,000 types of cryptocurrencies on the market. Of course, the crypto market[1] is not simply limited to cryptocurrencies. The past decade has seen considerable growth in the availability and diversification of blockchain technology, with the real estate and automobile industries using blockchain technology to track and record transactions. With 68 billion users holding blockchain wallets in 2021,[2] it is increasingly important for individuals to understand how crypto assets are taxed, both in life and on death, and ensure the consideration of crypto assets in succession planning.

WHAT ARE CRYPTO ASSETS?

Crypto assets, known also as "tokens" or "cryptocurrency", are cryptographically secured digital representations of value or contractual rights that can be transferred, stored or traded electronically using a Distributed Ledger Technology ("DLT").[3] The use of DLT means there are no physical assets being traded, nor are there physical registers recording transactions or asset holders; users remain anonymous and retain total privacy.

Crypto assets are traded on exchange platforms using a "private key"; a cryptographically generated list of numbers and letters which is known only to the owner and contains no personal data. Private keys are stored using a "wallet". This can either be through electronic software or in a physical form.

Each trade is recorded as a "block" added to the chain, or collection of transactions, made within that particular cryptocurrency. There are a variety of tokens available, namely: exchange tokens (a popular form of currency), utility tokens (tradeable tokens providing access to goods and/or services on a platform) or security tokens (holding rights or interests in a business – for example shares in future profits or repayment of a sum of money).

Developments in blockchain technology have led to the creation of asset-backed tokens or tokenised commercial real estate, modernising the ownership of property. It is clear to see that blockchain technology is consistently being utilised in new ways; something the law must grapple with to ensure appropriate taxation of these new assets.
On the basis that an individual is UK resident and domiciled, the following summarises the lifetime tax position, the taxation of these assets on death, and what happens if the crypto owner loses capacity. However, with reference in particular to their taxation, it is fundamental first to identify the location of the crypto assets.

THE SITUS OF A CRYPTO ASSET

As crypto assets are a digital asset, they do not, by their very nature, have a location. For the purpose of calculating applicable Capital Gains Tax ("CGT") and Inheritance Tax ("IHT"), establishing a location is important. A crypto trade made via an exchange platform may be difficult to tie to a specific location. HMRC has taken the view that the situs for crypto assets, where there is an underlying asset, is the location of the asset. Where there is no underlying asset, the situs will be determined by the residency of the beneficial owner.[4]

This is significant for individuals residing in the UK but not yet domiciled here. Typically, individuals resident but not domiciled, or deemed domiciled, will only pay tax on their UK assets; their worldwide estate would pass outside of the UK tax regime. However, under HMRC's analysis, an individual resident but not domiciled or deemed domiciled will pay both CGT and IHT on their crypto assets, regardless of the location of the exchange or payment transaction. Consequently, individuals should carefully consider their tax liability/risk when reviewing their crypto assets.

Interestingly, the Society for Trust and Estate Practitioners ("STEP") disagree with HMRC's approach, arguing it imposes an artificial location.[5] The alternative by forward by STEP is that the situs should be the location of the residence the transaction is most closely connected with.
It remains to be seen whether HMRC will change their approach in light of such criticism.

LIFETIME TAX

Individuals holding crypto assets should be aware that the buying and selling of those crypto assets will incur a CGT liability upon the realisation of a gain on disposal of the asset. CGT will be charged at 20% for higher rate taxpayers.

Although tokens are digital and, consequently, intangible, HMRC view them as a chargeable asset if they are both capable of being owned and have a value that can be realised.[6] The sale of tokens, exchange of tokens or payment of goods or services are all instances where a disposal occurs, and a gain may be realised. A disposal does not occur if the individual retains beneficial ownership of the crypto asset.

For CGT, deductions can be made for allowable expenses, for example: transaction fees, some exchange-platform fees, advertising and the cost of making a valuation. Notably, the cost of mining activities (the technical process of solving complex algorithms to generate cryptocurrency) cannot be deducted. Pooling is available for the same types of token.

HMRC have confirmed that Income Tax ("IT") will only be relevant in limited circumstances as the buying and selling of crypto assets by an individual is more akin to investment activity than trade dealing. However, employees receiving crypto assets as a form of payment from employers should be alert to the fact that this will attract IT.

Cryptocurrency owners are advised to keep detailed and accurate records of any transactions, including the initial fiat currency, as HMRC may request evidence of the gains being realised.

TAXATION ON DEATH

Typically, the IHT regime in the UK mandates that individuals will be taxed at 40% on anything above the tax-free allowance, known as the Nil Rate Band, available to everyone. There is currently a minimum of £325,000 available tax-free. Crypto assets are included within an individual's estate and potentially subject to IHT on death. That said, crypto assets will benefit from an uplift to the value as at the date of death for CGT purposes, thereby erasing any unrealised gain.

Personal representatives will be required to submit the value of an individual's estate on death (and any resulting IHT payable) to HMRC. A profound issue arises as some cryptocurrencies cannot be purchased or sold without converting into a token and therefore cannot be purchased with cash. It is therefore not possible to directly convert cryptocurrencies into a fiat currency and it will likely be necessary to obtain a specialist cryptocurrency valuation. Any gifts of crypto assets made in the 7 years leading up to the donor's death, will incur an IHT liability. Gifts made to a spouse will generally pass free of IHT, in light of the spouse exemption. However, personal representatives will still be required to calculate the value of the gifted crypto asset in sterling.

WHAT IF THE CRYPTO OWNER LOSES MENTAL CAPACITY?

The identification of crypto assets and access to an individual's private key is of the upmost importance where a crypto owner loses capacity. Whilst the anonymity afforded to individuals holding crypto assets often proves attractive, it can cause significant difficulties for attorneys or executors trying to manage an individual's crypto assets, or even identify if an individual owns crypto assets.

It is, therefore, advisable for crypto owners to keep a record of the assets held. Information should include the exchanges used, the types and amounts of crypto assets and the location of their private keys. Similarly, access to any electronic or physical wallets is imperative. Whilst it is tempting to hide wallets to ensure utmost security, it is ultimately in the interest of individuals to make their attorneys aware of their crypto assets as misplacement of the private key effectively locks out those managing the crypto asset. This could result in the crypto assets becoming unreachable, despite continuing to exist, with individuals and their successors potentially losing out on significant sums.

1 Statista, • Number of crypto coins 2013-2022 | Statista
2 Finances Online, Number of Blockchain Wallet Users 2022/2023: Breakdowns, Timelines, and Predictions - Financesonline.com
3 HMRC Cryptoassets Manual: CRYPTO10100 CRYPTO10100 - Introduction to cryptoassets: what are cryptoassets - HMRC internal manual - GOV.UK (www.gov.uk)
4 HMRC Cryptoassets Manual: CRYPTO22600 CRYPTO22600 - Cryptoassets for individuals: Capital Gains Tax: determining the location of exchange tokens -HMRC internal manual - GOV.UK (www.gov.uk)
5 STEP UK Technical Committee, 'STEP Guidance Note: Location of Cryptocurrencies – an alternative view' published 3 September 2021
6 HMRC Cryptoassets Manual: CRYPTO22050 CRYPTO22050 - Cryptoassets for individuals: Capital Gains Tax: what is an asset - HMRC internal manual - GOV.UK (www.gov.uk)

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