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HMRC update cryptocurrency guidance to include decentralised finance

HMRC have recently updated their guidance on Decentralised Finance (DeFi) and the tax implications surrounding this area of cryptocurrency.

What is DeFi?

DeFi is an umbrella term used to provide products akin to traditional financial services through Distributed Ledger Technology. DeFi platforms can provide services such as Decentralised exchanges (DEXs), savings, lending and derivatives.

DeFi lending platforms facilitate lending between unconnected lenders and borrowers. A lender could then be provided with a return on their loan, allowing cryptoassets to provide a source of income in addition to any increase in the capital value of the cryptoassets.

DeFi Income

HMRC does not consider any return received by a lender to be interest for tax purposes. HMRC deem that interest is the return or compensation paid/received for the use or retention by one person of a sum of money belonging to another. As HMRC does not consider cryptoassets to be currency or money and as such, the rate of return is not considered interest.

Any return does not get the benefit of the personal savings allowance for an individual and is deemed to be miscellaneous income. This is charged under sections 687-689 Income Tax (Trading and Other Income) Act 2005 for individuals and section 979 Corporation Tax Act 2009 for companies.

There are two key methods individuals and companies can utilise to obtain income from DeFi: lending and staking.

1. Lending is where a person transfers the control of tokens to another person. At the time that transfer occurs, the lender acquires a right to demand that the borrower transfer to the lender the control of an equivalent quantity of tokens at a time in the future to satisfy the loan.

Example: I lend 100 ETH. After 1 year the terms of the contract are that a balance of 105 ETH will be repayable to me.

The date that the balance becomes payable, the value of the additional ETH received (in this case, 5 ETH) would need to be transferred to GBP and this would be deemed to be income. If the interest amounts are paid incrementally (i.e. on a monthly basis), the GBP value would need to be realised at each point payment is received. Amounts would then appear in the applicable Tax Return.

2. Staking is where a person (liquidity provider) transfers control of their tokens to a DeFi lending platform. At the time when the transfer occurs, the DeFi lending platform transfers control of one or more different tokens to the liquidity provider.

Example: I stake 100 ETH in Binance. The Return rate is 10% per annum payable monthly in USDT.

Each time I receive USDT, the GBP value would need to be realised and this is classified as income.

It is possible that the activity of lending tokens may amount to a trade however the expectation is that this will only apply in exceptional circumstances.

DeFi Capital Gains

If the company or individual transfers the beneficial ownership of their tokens that they have lent/staked to a borrower or DeFi lending platform, this would be a chargeable disposal for Capital Gains Tax purposes and a gain/loss is worked out at this point in relation to the base cost of the asset. This also occurs if collateral is provided and the terms and conditions specify that the lending platform takes beneficial ownership of the tokens.

HMRC see staking/lending as disposing of tokens for a right to receive a future quantity of tokens; this represents deferred consideration. The taxation treatment of this depends on whether the future quantity of tokens to be received is ascertainable or unascertainable.

If a borrower's position needs to be liquidated by the DeFi lending platform, then this will be a disposal.

If tokens are taken away as a penalty, these tokens will not be allowed as a deduction in calculating gains or losses for Capital Gains Tax purposes.

HMRC's full guidance on DeFi can be found here:

https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto61400