We refer to the HM Revenue & Customs request for consultation responses "The taxation of decentralised finance (DeFi) involving the lending and staking of cryptoassets". We appreciate the opportunity to contribute to this consultation.

Summary of consultation questions and preamble

Bitcoin Policy UK Ltd (BPUK) is a not-for-profit organisation. Our aim is to help the United Kingdom keep pace with developments in the Bitcoin space and to maximise the potential benefits arising from the adoption both of Bitcoin and its attendant industry. Bitcoin itself - whether as a neutral protocol, akin to TCP/IP, as an asset, or as an industry - can help drive economic opportunity, provide increased energy security and help the UK achieve its net-zero commitments. The principle of self-custody, namely the ability of a Bitcoin user fully to own and control their bitcoin without needing a third party intermediary, is core to the ethos of Bitcoin. However, we do appreciate and acknowledge that some market participants will seek to lend out their assets in search of yield and we respect their right to do so as the absolute owners of their bitcoin. As such, we would like to provide comments in general terms with regards to the 'Defi' taxation consultation.

In the wider debate, BPUK are keen to stress the importance of separating a) Bitcoin from b) all other digital assets or 'currencies'/'alt coins'. Bitcoin is not 'crypto' other than in the very broadest sense and has certain key elements and characteristics that set it apart from all other digital assets.

Inasmuch as it applies to purchasing digital assets other than Bitcoin, we broadly agree with the Treasury Committee Report dated 17th May 2023, which categorised crypto investing as 'gambling'.

Whilst we do not dispute there are a number of well-intentioned developers and participants in the non-Bitcoin space, it is apparent that a significant proportion of the circa 24,000 alt coins currently on the market have little or no apparent tie to economic reality, and have a cost of production that is at or close to zero. We note that it is entirely possible to create a new proof-of-stake token in 15 minutes with a simple explainer widely available on YouTube.

Such new 'alt coins' have neither the enormous network effect of Bitcoin (with its circa 45,000 globally distributed nodes and millions of users), nor do they tend to use the 'proof of work' algorithm to release new coins and to ensure that energy is expended by miners/validators in order to maintain and sequence the transactions in the distributed ledger. It is in many ways this 'proof of work' that gives Bitcoin its 'unforgeable costliness' and ensures that its ledger cannot be tampered with or amended, or new coins created from thin air. New bitcoins can only be released through the expenditure of energy - it is this invention that ties the digital Bitcoin to the physical world and imparts a cost to their production that is not shared by the vast majority of alt coins (or indeed, any government-issued money either, which like alt coins is also created at will and with no cost to the issuer).

Given the apparent ease of creating new alt coins, and the ease of subsequently selling newly created tokens to retail investors, it is little wonder then that many market participants do exactly this.

We cite the recent journey of a developer called Rhett Mankind (Twitter handle @Rhett) utilising an AI bot and twitter follower surveys to create the next 'memecoin'. In this public journey of 'memecoin' creation, we witnessed a developer create TURBOTOAD (TURBO) and release it on May 8th 2023. By the following day the market cap had exceeded $100,000,000. Following the initial hype, TURBO has since collapsed in price. Without question, some buyers of this token understood that they were buying a 'pump and dump' scheme, but others attracted by the hype, will have been less aware. **We reiterate our general policy position regarding regulation in this area, which is that the overarching aim of any regulation should be to avoid customer harm**. Sales of unregulated assets such as TURBO, and the subsequent financial losses suffered by retail buyers, are the very kind of harm that good regulation should aim to prevent.

As an aside, we note that if the findings and recommendations of the Treasury Committee Report dated 17th May are followed, the analysis of the transactions set out in this consultation, may be entirely irrelevant if the Government seeks to regulate and tax these activities as gambling, since any potential gains accrued by retail investors would be considered gambling winnings and not taxed therefore as capital gains.

The APPG for Crypto & Digital Assets Inquiry report highlights that "In April 2022, the UK Government set out its landmark vision to make the UK the global hub for cryptocurrency investment, committing to create the right conditions for cryptocurrency and digital asset businesses to set up and to scale up in the UK".

We broadly welcome that the government is seeking to explore and expand its knowledge in the space. It should also seek to provide the most simple and easily understood tax regime in the world. If the rules are overly complicated, the most talented participants will inevitably operate their businesses from other jurisdictions, or structure their operations so as to take advantage of complexity and minimise their tax burden. The UK must seek to become competitive, but moreover ensure that its rules are simple to understand and to apply.

Responses 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.

Yes, although we do not rule out the further complexity that could be encountered in the future. As the markets mature, we believe it is reasonable to believe that the more complex financial instruments will also find their way into such ecosystems.

We are particularly concerned about the notion of taxation on the proceeds of lending any digital asset, including Bitcoin. In this context we are broadly in agreement with that element of the intended legislation. We agree that the use of any tax framework that treats the lending of an asset as a disposal is not reflective of the underlying economic activity or reality. We must also highlight the dangers of lending (or seeking yield) on digital assets in general - not least because of the way in which title to these assets is transferred. These are digital bearer assets, where title and control is transferred to the person who holds the 'private keys' that enable the assets to be 'spent' or transferred. As we saw in the Celcius, Blockfi, FTX sagas, it is important to ask. "Where is the yield coming from?'. We do not advocate for the UK to become a safe haven for market makers who trade against their own customers.

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.

The question is one of a sensible approach to taxation. We do not see that the lending of any digital asset should give rise to a CGT charge, at least at the point in time when the loan is made. In such we are broadly in agreement with that element of the intended legislation. We agree that the use of any tax framework that treats the lending of an asset as a disposal is not reflective of the underlying economic activity or reality. If Participant A lends a painting to an art gallery for display, in return for an economic benefit derived from admission charges to see the painting, they have not disposed of it and retain beneficial title to it (even though, as a bearer asset, the gallery may ostensibly hold the painting for the duration of the display). However, it is essential to distinguish between what the participants believed they were doing (lending their liquid assets for a rate of return) from the description of the legal transfer of assets to the borrower. When fiat currency is deposited in a bank, the title of that currency transfers to the bank and the depositing party becomes a creditor. However, a bank depositor in reality always assumes that their money will be available to withdraw either upon demand or following any agreed period of withdrawal notice or lock up. It is easy to see why those cryptocurrency market participants in the Celsius or other examples believed that their deposits were not disposals.

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

We do not consider that there is any immediately increased threat of abuse. We would encourage simplicity of taxation to encourage market participants to evaluate their tax liability simply and with relative clarity. We would advocate any tax treatment be based on a 'sale to fiat' model. Whilst we do not advocate for the use or adoption of non-Bitcoin tokens, it is clear that the business of 'Defi' is unlikely to be consigned to the history books any time soon. We advocate for clear user-advisory warnings akin to that used to regulate the Tobacco Industry.

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.

Yes, we believe they are of a legal nature in principle. Lending tokens is akin to a split of the legal and beneficial interest, where the legal interest may sit with the holder of the relevant private keys, but the beneficial interest remains always with the ultimate depositor. However, as we have seen from Cefi exchanges such as Celsius, Blockfi and Voyager, the retail user is often baffled with lengthy terms and conditions allowing the borrower (Celsius, for example) to appear to be 'a bank paying interest'. The question of enforcement becomes almost impossible due to global permissionless rails. However, one could argue that an exchange or broker could benefit from the 'kite-mark' type of badge that could be awarded to those businesses who have brought themselves into regulatory alignment with appropriate disclosures/evidence. Whilst there is clear need to reflect on how best to protect the innocent from fraud, concerted action against the space is also more likely to drive legitimate business offshore and motivate those left outside the system to find a way in. Within the traditional investment world, there is already division between those who can access the capital markets and those who cannot. We must strive to ensure those same walled gardens are not erected in this industry.

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?

It is important to understand that applications, wallets and protocols can all be susceptible to hacking. It is possible to conceive of a situation where the staked coins have been returned to an end user's own custody, perhaps in a hot-wallet, which is then subsequently hacked. The user will have never realised a fiat-gain, but still carry a theoretical tax liability under the rules being proposed. Unless the UK adopts a 'on return to fiat' or 'tax as gambling' approach, it is conceivable that the losses claimed via tax returns will be significant, harming the overall tax-take. If a 'return to fiat' approach were taken, we envisage increased preparedness from participants to spend those gains into the 'real economy' whilst ensuring those talented participants do not seek to play jurisdictional arbitrage, which is a by-product of high and complex tax treatments.

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?

Pros of Treating DeFi Returns as Revenue:

Clear Tax Treatment: Treating DeFi returns as revenue provides clarity in tax categorisation, ensuring that income generated from DeFi activities is accounted for and subject to appropriate taxation.

Simplified Reporting: Revenue treatment may simplify tax reporting for individuals engaging in DeFi, as the income generated would be treated similarly to other traditional forms of revenue. This can streamline the reporting process and reduce ambiguity.

Potential for Deductible Expenses: Treating DeFi returns as revenue may allow individuals to deduct certain expenses related to their DeFi activities, such as transaction fees, gas fees, or operational costs. This could help offset the tax liability and incentivize participation.

Alignment with Traditional Finance: Treating DeFi returns as revenue brings consistency between traditional financial activities and decentralised finance. This can ensure a level playing field and prevent potential tax loopholes or discrepancies between different forms of investment or income generation

Cons of Treating DeFi Returns as Revenue:

Complex Determination: Determining the exact nature of DeFi returns as revenue can be challenging. DeFi platforms often involve various mechanisms such as lending, staking, liquidity provision, or yield farming, which may have different tax implications. Defining the revenue nature of each DeFi activity accurately can be complex and require detailed analysis.

Regulatory Challenges: The rapidly evolving nature of DeFi makes it challenging for tax authorities to keep up with the emerging complexities and novel financial instruments involved. Developing comprehensive regulations that address all aspects of DeFi activities and revenue generation can be a significant regulatory challenge.

Tax Burden on Users: Treating DeFi returns as revenue may impose an additional tax burden on individuals engaging in DeFi. This can potentially reduce the overall profitability and incentives for participation in DeFi activities.

Lack of Clarity in Jurisdictions: Tax regulations related to DeFi can vary significantly between jurisdictions. The lack of standardised and globally accepted guidelines may lead to confusion and inconsistency in tax treatment across different regions, creating challenges for individuals operating in multiple jurisdictions.

Question 7: Do you agree that the proposed treatment of DeFi transactions has been applied correctly in each of Examples 1 to 5?

Yes. But it is unnecessarily complex and littered with day-to-day complexities for the accountant trying to make sense of their client's activities.

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

See 7a.

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.

Nothing to add.

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.

We do not see how the timing of the tax application is relevant. Since in the guidance to this consultation it is made clear that the outcome of this consultation will have 'ZERO" effect on the tax take or other governmental outcomes, it seems to make little sense to seek to complicate the tax treatment in this way.

Question 8: 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?

Nothing to add.

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?

See Question 10.

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?

See Question 10.

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.

See Question 10.

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

See Question 10.

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?

We expect the administrative burden to be extremely time consuming. Any serious participant in this space, from enthusiastic hobbyist to professional traders, will have a mountain of regulatory and reporting requirements from these rules and timings of ‘on-chain tax’. The gains cannot be spent into the real economy, driving GDP growth, if they are marooned in cyber-space due to fear of the over-complicated tax system. Revert to a gambling approach, or ‘return to fiat’ tax, or the jurisdictions with far simpler tax treatments, such as Portugal, will benefit from a wave of talented and historically British participants.

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

None that have not already been articulated above.

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

It is impossible to know from analysing the on-chain records, the terms on which a transaction takes place. The nature of a distributed ledger simply tells you that a transaction was made, but it does not tell you the terms or conditions upon which it was made. Our best guess is that this is extremely rare, however where this does occur, it is likely to be hedge funds and market-makers engaging in this activity in order to open sell positions against their own customers. It is extremely rare in our experience for a retail client to lend their assets to another retail participant. A further example of how consumers need protection from the predatory tactics of their own custodians/exchanges.