Thomas Murray Digital

Digital Asset Risk for Institutional Investors

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Last week saw bitcoin rebound strongly, closing 12% higher than the week open and up 29% from the January low. This may be driven by institutional investment, which after 5 weeks of outflows over the end of last year and the beginning of 2022 has turned positive for the second week, totalling USD 19 million of inflows last week.

There have been key developments regarding the taxation of cryptocurrencies in several countries, with regulators taking widely differing approaches. The UK's HMRC has updated its tax guidance to focus on the use of digital assets in decentralised finance. The result is a confusing, sometimes contradictory and potentially burdensome set of requirements that could see returns from staking and lending of cryptoassets taxed variously as income or as capital gains. In contrast, the US IRS has suggested that staking rewards are not subject to income tax, offering to refund taxes paid by a US couple on staking rewards. Interestingly, similar to the developments in the UK, this is a result of treating the assets as property, although clearly the implications are completely different. The US has also seen the introduction of a new bill that would exempt low value cryptocurrency transactions from capital gains tax, making tax compliance much easier when using cryptocurrencies for everyday transactions.

Elsewhere, India's Finance Minister is set to introduce a new 30% tax on any income generated from the transfer of digital assets, with investors not able to use losses to offset the new tax on profits. The minister has further proposed the implementation of a tax deduction at source (TDS) of 1% above a threshold that is yet to be determined. In comparison, the Thai Revenue Department has cancelled plans to implement a 15% withholding tax on cryptocurrency transactions after opposition on the grounds that it would stifle innovation and development and would be difficult to implement. In Russia, the Chairman of the State Duma Industry Committee has proposed a 15% tax on the sale of tokens generated by mining, with no less than a 6% levy on turnover imposed on individual entrepreneurs subject to simplified (flat-rate) taxation.

Digital Asset Developments

Her Majesty's Revenue and Customs (HMRC) has published updated tax guidance, with changes focusing on the treatment of digital assets used for lending and staking in the UK, for example through decentralised finance (DeFi). The most notable part of the changes states that HMRC considers digital assets to be property for tax purposes, and therefore returns via staking and lending may not be treated as interest payments subject to income tax but – where the level of return and/or frequency of payments is uncertain – may be subject to capital gains tax. The guidance further suggests that in such cases "beneficial ownership of those tokens" may be passed onto the lending or DeFi platform. This would crystallise a disposal for tax purposes and therefore capital gains tax. CryptoUK, a self-regulatory trade association for the UK digital asset industry, has released a statement arguing against the guidance. CryptoUK highlights that HMRC's approach is inconsistent with the Treasury and other regulatory bodies such as the Financial Conduct Authority that regard digital assets as financial instruments and not property. It states that this inconsistent approach creates an unnecessary burden for investors by adding undue reporting requirements, which creates friction and tax compliance confusion. Additionally, the treatment of cryptocurrency lending is inconsistent with that of securities lending.

In contrast to the new guidance published by their UK counterparts, the US Internal Revenue Service (IRS) has offered to refund taxes paid on staking rewards gained but not redeemed by a US couple. The couple, who filed a legal complaint against the IRS in May 2021, claimed that tokens generated through staking are taxpayer-created property, meaning they should only be taxed once sold or exchanged, i.e. as a capital transaction. They argued there is no statute in US law or the IRS code and regulations that allows for taxpayer-created property to be taxed as income. The couple has rejected the offer of a refund and is instead pursuing a court ruling, citing that accepting the settlement would not prevent the IRS from taxing staking rewards as income in the future. Consequently, a court ruling on whether staking rewards are classified as either taxpayer-created property or taxable income, set for March 2023, has potentially large tax implications for investors participating in proof-of-stake mining and staking.

An agreement has been struck to remove a provision in a US House bill that would have provided the Treasury Secretary with unchecked and unilateral power to block crypto transactions. The controversial provision was part of the America Competes Act, a bill designed to stimulate economic competition with China. Industry leaders have welcomed the changes after warning the original bill would have been disastrous for not just cryptocurrency, but also more generally privacy and due process.

Following the recent release of its paper on Central Bank Digital Currencies, the Board of Governors of the Federal Reserve System has published a further paper discussing stablecoins. Like the CBDC publication, this paper largely limits itself to an overview of the theoretical background, current ecosystem, and risk and potential considerations for various designs of stablecoin. It advocates for a model in which commercial banks back stablecoins using the fractional reserve principal, including some central bank backing in addition to loans and commercial deposits, rather than insisting on full dollar backing of tokens. The Fed notes that stablecoins are seen by investors as safe assets during times of cryptocurrency volatility, but they must be subject to full audits and liquidity requirements.

The Federal Reserve Bank of Boston and Massachusetts Institute of Technology have released the findings of their technological research into a Central Bank Digital Currency (CBDC). The research, known as Project Hamilton, does not advocate for or against a US CBDC at a policy level, but is instead a technical study testing a "hypothetical general purpose CBDC" using two potential methods. The first architecture processes transactions using distributed-ledger technology (DLT), which completed 99% of transactions in under two seconds and the majority in under 0.7 seconds. However, the researchers highlight that this architecture has its downsides, citing the need for the central transaction processor to maintain complete transaction history, creating performance bottlenecks. These issues were the result of the ordering server being run under the control of a single actor; however, the researchers claimed a distributed ledger operating under the authority of different actors was not needed for a CBDC. The second architecture did not use DLT, instead processing transactions in parallel on multiple computers. This architecture was able to process 1.7 million transactions per second, with 99% completed in under a second and the majority in under 0.5 seconds. However, the researchers highlighted that although this architecture resulted in superior scalability, it did not create an ordered history of all transactions. These findings conclude Phase 1 of Project Hamilton, with Phase 2 set to explore new functionality and alternative technical designs, including the implementation of smart contracts, offline payments, and secure issuance and redemption, among many others. The researchers do not believe a US CBDC will launch until 2025 at the earliest.

News Links

	Thailand Scraps 15% Crypto Capital Gains Tax Following Public Backlash (Cointelegraph)
	Russian Lawmaker Proposes 15% Tax on Crypto Miners (Cryptoslate)
	Congress Takes a Step Toward a de Minimis Exemption for Everyday Cryptocurrency Transactions Coin Center)
	India to Introduce 30% Crypto Tax, Digital Rupee CBDC by 2022-23 (CoinDesk)
	Anchorage Closes in on FDIC Crypto Custodian Deal, Documents Show (CoinDesk)
	The CSSF Published a White Paper on DLT and Blockchain (CSSF)
	Central Bank of Jordan Reveals CBDC Plans (Cointelegraph)
	Crypto Insurance Firm Evertas Wins Lloyd's of London Approval (CoinDesk)
	Russian Central Bank Registers Nation's First Digital Asset Manager (Cointelegraph)
	SEC Again Delays Decision on Grayscale's Bitcoin ETF Conversion Proposal (The Block)
	Grayscale Debuts ETF to Track Digital Asset-based Equities Index (The Block)

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