

UNDERSTANDING DIGITAL TOKENS

# Legal Landscapes Governing Digital Tokens in the United Kingdom



*Prepared by the Token Alliance – an industry initiative of the Chamber of Digital Commerce*

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## CHAMBER OF DIGITAL COMMERCE

The Chamber of Digital Commerce is the world's largest trade association representing the blockchain industry. Our mission is to promote the acceptance and use of digital assets and blockchain technology. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop a pro-growth legal environment that fosters innovation, jobs, and investment.

## TOKEN ALLIANCE

The Token Alliance is an industry-led initiative of the Chamber of Digital Commerce, developed to be a key resource for the emerging industry surrounding the generation and distribution of tokens using blockchain technology. Comprised of more than 400 industry participants, the Alliance includes blockchain and token and legal experts, technologists, economists, former regulators, and practitioners from around the globe. The Token Alliance develops community-driven guidelines for the responsible development of tokens.

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# II. REGULATORY OVERVIEW OF DIGITAL TOKEN MARKETS



## I. INTRODUCTION

The regulation of digital tokens is a developing area as the current United Kingdom (“U.K.”) financial services law was not developed with the use of digital tokens in mind. Over time new legislation may well be introduced (and interpretations of current legislation may change) to take account of the expected increase in the use of digital tokens, sharp and frequent price volatility of digital tokens and to safeguard the economy against the use of digital tokens (such as virtual currencies) for criminal purposes and intent. It also is important to bear in mind that subtle differences in the legal structure and commercial function of a digital asset can have significant regulatory consequences. It is not a “one size fits all” regime.

## II. POTENTIAL LEGAL CLASSIFICATION AND RELATED REGULATORY CONSIDERATIONS

### A. OVERVIEW

Broadly, there are several generic approaches to the regulation of digital tokens in the U.K. One is to treat them as a commodity or other form of physical property. Where this is the case, the marketing, purchase and sale of the digital token will largely be unregulated from a U.K. financial services law perspective, save if the contracts for the trading of the digital tokens fall within the scope of the U.K. law definitions of a derivative. Another is to treat them as a financial instrument (principally a security) but also possibly a unit in a fund (including a collective investment scheme, which is broadly defined

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## GENERIC REGULATORY APPROACHES TO TOKENS IN THE U.K.

**1** | A COMMODITY  
OR OTHER FORM  
OF PHYSICAL  
PROPERTY

**2** | A FINANCIAL  
INSTRUMENT

**3** | MONEY OR FORM  
OF CURRENCY

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and capable of capturing arrangements involving digital tokens or an alternative investment fund), the third approach is to treat them as money or a currency (potentially e-money or entailing the provision of a payment service). In this regard, whether the digital token will be subject to regulation will depend on whether it is designed as a medium of exchange or whether it has more narrow functions such as solely enabling for the payment for services provided within the particular digital token's closed infrastructure.

The regulatory categorisation of the digital token is important as it will determine the extent to which (if at all) any U.K. authorisation, prospectus, marketing restrictions, systems, controls, procedural, conduct of business, anti-money laundering and anti-terrorist financing requirements apply.

### B. U.K. COLLECTIVE INVESTMENT SCHEME ANALYSIS

The term "Collective Investment Scheme" ("CIS") is deliberately broad and vague and so it is capable of capturing a wide range of arrangements even if the parties to the arrangements do not intend to create or establish a 'fund' or a collective investment.

Section 235 of the Financial Services and Markets Act 2000 (as amended from time to time) ("FSMA") defines a CIS as "any arrangements with respect to property of any description . . . the purposes or effect of which is to enable persons taking part in the arrangements . . . to participate in or receive profits or income arising from the acquisition, holding, management, or disposal of the property or sums paid out of such profits or income."<sup>1</sup>

Further elements of the definition are that the participants do not have day-to-day control over the management of the property.<sup>2</sup>

In addition, the arrangements must have either of the following characteristics:<sup>3</sup>

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1 Section 235 of FSMA.  
2 *Id.*  
3 *Id.*



- » pooling of contributions and profits or income of the participants in the scheme (which would include the holders of the digital tokens); and
- » the property is managed as a whole on behalf of the operator of the scheme.

Typically, a CIS takes in money from investors and invests it in some other type of property. It is that other property, plus any uninvested contributions and undisbursed profits and income, which would normally be regarded as the underlying property of the CIS.

In the context of digital tokens, arrangements are capable of being treated as a CIS in circumstances where participants pay cash to an 'issuer' in exchange for a certificate or token which gives the participants/investors an entitlement to underlying property (e.g., gold, silver, wine, art, etc.) if the underlying property is managed by a third party (the term managed could entail administrative functions such as arranging for the property to be stored and/or insured) or if the contributions or profits of the participants/investors are pooled. Therefore arrangements relating to digital tokens need to be carefully scrutinised to determine whether they are within the U.K. CIS regime even if the intention is not to create a fund or collective investment.

Even if the arrangements fall within the basic definition of a CIS, they will not be caught if an exemption in the Schedule to the FSMA Collective Investment Scheme Order 2001 (the Order) applies. There are exemptions for arrangements relating to debt instruments, joint venture arrangements and those structured as bodies corporates.

The regulatory consequences of an arrangement relating to a digital token being a CIS are twofold:

- » A CIS arrangement triggers authorisation requirements and compliance with certain rules for certain parties.

For example, establishing, operating or winding up a CIS is a regulated activity under section 19 of FSMA and no exemption applies. This may be relevant to the person who is charged with establishing the arrangements, or arranging for the issuance of the certificates or tokens relating to digital tokens or arranging for the tokens to be stored and/or insured). Therefore, if this is done in the U.K., the operator will require authorisation from the U.K. Financial Conduct Authority (FCA). Other activities that may require authorisation, in relation to arrangements that amount to a CIS include managing investments, advising, dealing as principal or agent and arranging. It is an offence to carry on a regulated activity without authorisation under section 23 FSMA. Any contracts made by an unauthorised person (with participants/investors) in carrying on a regulated activity are unenforceable unless the court is satisfied that it is just and equitable to allow them to be enforced pursuant to section 28 of FSMA.

» A CIS arrangement will have an impact on the ability to market the CIS to investors in the U.K.

For example, it may only be possible to market the CIS to certain professional investors, high net worth individuals or certified sophisticated investors as units in a CIS are “controlled investments” under FSMA, and so section 21 and section 238 of FSMA will apply to their marketing.<sup>4,5</sup>

### C. U.K. ALTERNATIVE INVESTMENT FUND ANALYSIS

An Alternative Investment Fund (“AIF”) is defined in Article 4(1)(a) of the Alternative Investment Fund Managers Directive (“AIFMD”) as any “collective undertaking including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy and which is not required to be authorised under Article 5 of Directive 2009/65/EU” (the EU Directive dealing with authorisation of open ended retail funds). All elements of the AIF definition must be present in order for the digital token arrangements to be treated as an AIF.

An AIF is a particular type of fund or collective investment vehicle, which overlaps in certain respects with the definition of a CIS, but they are not exactly the same. For example, an arrangement structured as a closed ended body corporate is capable of being categorised as an AIF whereas such an entity would not be a CIS.

Arrangements that relate to body corporates, partnerships, unincorporated associations and a fund set up as a trust, which pool together capital raised from participants/investors for the purposes of investment (e.g., the pooled capital is used to purchase gold or silver) with a view to generating a pooled return for those investors from investments (e.g., the arrangements are capable of generating a return for the participants) may amount to an AIF.

An arrangement relating to digital tokens that meets the basic definition of an AIF under the AIFMD will not constitute an AIF if it falls within an exemption under Article 2 of the AIFMD. There are exemptions for holding companies, certain joint ventures and securitisation special purpose vehicles.

The regulatory consequences of an arrangement being an AIF may trigger a requirement for the manager to be authorised (known as the AIFM), the appointment of a depositary, and compliance with various procedures, controls, capital and conduct requirements. There are restrictions in relation to the marketing of AIFs, including the type of investors who can be marketed to, prior notifications to EU regulators and reliance on private placement rules.

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4 Section 238(1) of FSMA restricts the marketing by authorized persons of an unregulated CIS unless it falls within one of the exemptions to this restriction (under FSMA (Promotion of Collective Investment Schemes) (Exemptions) Order 2001) (as amended) (the “CIS Promotion Exemptions Order”) or under Chapter 4 of the Conduct of Business Sourcebook of the FCA Handbook.

5 Authorized persons may market unregulated CISs to certain categories of persons in the U.K. under the CIS Promotions Order, including, investment professionals (Article 14), certified high net worth individuals (Article 21), high net worth companies (Article 22), sophisticated investors (Article 23), self-certified sophisticated investors (Article 23a), associations of high net worth or sophisticated investors (Article 24).

## D. U.K. E-MONEY ANALYSIS

E-money is defined in the Directive 2009/110/EC as electronically (including magnetically) stored monetary value represented by a claim on the electronic money issuer which: (i) is issued on receipt of funds for the purposes of making payment transactions; (ii) is accepted by a person other than the electronic money issuer; and (iii) is not otherwise excluded. The E-money directive is implemented in the U.K. through the Electronic Money Regulations 2011.

There is an explicit exclusion for monetary value stored in instruments that can be used to acquire goods or services only in the issuer's premises or under a commercial agreement with the electronic money issuer, either within a limited network of service providers or for a limited range of goods and services (the limited network exclusion) which may be relevant for arrangements involving digital tokens. The Payment Services Regulations 2017 introduced a notification obligation on firms relying on this exclusion where the total value of the payment transactions executed by the firm under the limited network exclusion exceeds € 1 million over a 12-month period.

In many instances, the digital token will not be treated as e-money because:<sup>6</sup>

- » there is no claim against the issuer of the digital token for the value of the digital token acquired (indeed, in many instances, there will not even be an issuer);
- » it does not have 'monetary value' (as it is not a currency); and
- » the digital token is not issued on receipt of funds (e.g., assuming that the term "funds" means fiat currency, which is a term used to differentiate between "real currency" – meaning traditional currency such as USD, GBP, Euro, and Yen – from virtual currency).

However, the success of the digital token over time could alter how it is categorised from a regulatory perspective (e.g., it is accepted as a medium of exchange – i.e., currency – and therefore has monetary value).

If the digital token is e-money, this may require the issuer of e-money to be registered with the FCA, though there is a lighter touch regime for small e-money issuers. E-money issuers are subject to certain capital requirements, systems and controls, reporting and operational requirements.

## E. U.K. PAYMENT SERVICES ANALYSIS

The Payment Services Directive ("PSD") regulates a broad range of services including those that enable: (i) cash to be placed on a payment account, (ii) cash withdrawals to be made from a payment account, (iii) the transfer of E-money; (iv) the execution of payment transactions where the funds are covered by a line of credit (e.g., direct debits, credit transfers), (v) customers to purchase goods and

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<sup>6</sup> Article 2(1) of the Electronic Money Regulations 2011, Article 2(1) of the Payment Services Regulations 2017 and Glossary of the UK FCA Handbook.

services through their online banking facilities or by e-money, and (vi) money remittance that does not involve the creation of payment accounts .

In many cases, the issuance as well as the purchase and sale of the digital token will not amount to the provision of a payment service subject to regulation under PSD, on the basis that the arrangements do not:

- » enable cash to be placed on a payment account or cash withdrawals to be made;
- » enable direct debits or credit transfers (e.g., standing orders) to be made;
- » facilitate payment transactions where the funds are covered by a credit line since the digital token holders have to pay for the digital token upfront (i.e., they are pre-paid); and
- » there are no money remittance services as funds are not received from a payer for the sole purpose of transferring a corresponding amount to a payee or to another payment service provider acting on behalf of the payee, and the funds are not received on behalf of, and made available to, the payee.

There is an exclusion for services based on specific payment instruments that can be used only in a limited way, which may be relevant in the context of digital tokens provided that they meet one of the following conditions:<sup>7</sup>

- » they allow the holder to acquire goods or services only in the issuer's premises;
- » they are issued by a professional issuer and allow the holder to acquire goods or services only within a limited network of service providers which have direct commercial agreements with the issuer;
- » they may be used only to acquire a very limited range of goods or services; or
- » they are valid only in a single EEA State, are provided at the request of an undertaking or a public sector entity, and are regulated by a national or regional public authority for specific social or tax purposes to acquire specific goods or services from suppliers, which have a commercial agreement with the issuer.

Those who provide payment services may be required to be authorised by the FCA and must comply with certain systems, controls and conduct requirements.

## **F. OTHER U.K. REGULATED ACTIVITIES ANALYSIS**

Arrangements relating to digital tokens may entail the carrying on of a regulated activity. Section 19 of FSMA states that a person must not carry on a regulated activity in the U.K., or purport to do so, unless he is an authorised person or exempt person or an exclusion applies. This is referred to as the

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<sup>7</sup> Schedule 1, Part 2, 2(k) of the Payment Services Regulations 2017.

“general prohibition.” Carrying on a regulated activity in breach of the general prohibition is a criminal offence and may result in certain agreements being unenforceable.

A regulated activity is described in FSMA as a specified activity that relates to a specified investment or property of any kind and is carried on by way of business (section 22, FSMA). Specified activities include dealing as principal or agent in a specified investment, making arrangements “with a view” to persons buying and selling certain specified investment, bringing about transactions in specified investments as well as safeguarding and administering tokens. Specified investments include shares, debt instruments, collective investment schemes, e-money and derivatives as defined in the FSMA (“Regulated Activities”) Order 2001 (“RAO”). Whilst digital tokens are not specifically identified as a specified investment, the characteristics of the digital token would have to be assessed against the criteria of each specified investment to determine whether it is within scope.

In addition, any platform on which the digital tokens are traded or exchanged may be considered to be a regulated market, a multilateral trading facility or an organised trading facility if the digital token is categorised as a specified investment.

Even if a regulated activity is being performed, authorisation under FSMA may not be required if an exclusion is available. There are various exclusions in the RAO that may be relevant in the context of digital tokens including for overseas persons or whether the activity is carried out in connection with the sale of goods or the supply of services or there is an absence of holding out.

In the event of a regulated activity being performed and there is no available exclusion, there are three consequences to the digital token being categorised as a specified investment under the FSMA and the RAO as follows:

- » the marketing of the digital token may be restricted under section 21 and/or section 238 of FSMA or subject to compliance with certain conduct rules;
- » accessing the platform or exchange and its use by participants may be restricted; and
- » the operator of the platform, the custodian of the digital tokens, the issuer of the digital token and those who make arrangements for others to acquire the digital tokens may be required to be authorised. This in turn would trigger the requirement to comply with certain capital, systems, controls and conduct requirements.

Even if the digital token is not categorised as a specified investment under FSMA and the RAO, the platform or exchange on which the digital token is bought or sold may be considered to be a commodity trading platform. It should be noted that there is no EU-wide regime for commodity trading platforms and so the analysis of whether a commodity trading platform needs to be regulated in a particular EU Member State will have to be considered on a country by country basis. A pure commodity platform would not currently be required to be regulated in the U.K. under FSMA.

## **G. REGISTRY, SETTLEMENT AND CLEARING**

Many digital token systems will operate on a distributed ledger technology basis to register transfers of digital tokens between parties. As such, it is not considered likely that such a system will fall within the current boundaries of regulation in the U.K. However, systems which involve the transfer of digital tokens against value are being reviewed by a number of regulators including in the U.K. because of their resemblance to payment systems.

Digital token arrangements may also require a settlement system in order to transfer the digital token from one account or e-wallet to another and record the transaction pursuant to which the digital token is transferred and the movement of the corresponding “consideration.” Indeed, if over time, the digital token becomes accepted as a medium of exchange for goods and services, then it may be necessary either to expand its registry system into a payment system or settlement system or to develop interoperability between the digital token settlement system and other virtual currency and/or fiat currency payment systems, which may result in it developing into a clearing system.

An entity which interposes itself between “counterparties” to certain types of contracts, thereby becoming the buyer to every seller and the seller to every buyer may be required to be authorised or registered as a central clearing party (“CCP”). This may be applicable to certain infrastructure arrangements involving digital tokens, depending on how they are categorised under the financial system. In the U.K., CCPs are supervised by the Bank of England and are subject to various capital, systems and controls, margin, and procedural requirements.

## **H. FUTURE U.K. REGULATORY DEVELOPMENTS (DATED AUGUST 2018)**

European regulators, including the FCA, have recently issued warnings regarding the risks associated with investing in digital tokens such as bitcoin and ether. This has principally been driven by the recent volatility in the price of these virtual currencies. The FCA has warned investors that: (a) virtual currencies are not issued or guaranteed by a central bank or public authority; (b) virtual currencies do not have any legal status as a “fiat currency”; and (c) the purchase and sale of virtual currencies are not subject to safeguards and protections as they are unregulated in the U.K.<sup>8</sup>

The U.K. Government has signalled its intention to extend certain anti-money laundering and counter terrorist financing rules to virtual currency exchange platforms and certain custodial e-wallet providers through proposed changes to the EU Fourth Anti-Money Laundering Directive in the Fifth EU Anti-Money Laundering Directive.

If adopted, the Fifth EU Anti-Money Laundering Directive, which is expected to be agreed at the EU level this year, will require virtual currency exchange platforms and custodial e-wallet providers to

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<sup>8</sup> FCAWebsite: Consumer Warning about the risks in investing in cryptocurrency CFDs (dated 14/11/2017). FCA Website: Consumer warning about the risks of Initial Coin Offerings (dated 12/09/2017).

conduct KYC due diligence checks on traders and users to determine their source of wealth and their source of income. Additional checks would be required if the trader or user is located in a “high risk” jurisdiction. In essence this will require virtual currency traders/users to disclose their identities and exchange platforms and e-wallet providers will be required to report any suspicious activity to the national crime agency.

Whether this will ultimately lead to virtual currencies and other digital tokens being subject to bespoke general regulatory rules which introduce authorisation requirements, prospectus-like disclosures, marketing restrictions, systems, controls, procedural, and conduct of business requirements remains to be seen. In a recent statement the FCA announced that it will be issuing joint guidelines (expected in late 2018) with the Bank of England on the possible future regulatory treatment of virtual currencies.

The FCA also recently stated that:

- » “cryptocurrency derivatives are . . . capable of being treated as financial instruments under [MiFID II], although [the FCA] does not consider cryptocurrencies to be currencies or commodities for regulatory purposes . . . Firms conducting regulated activities in cryptocurrency derivatives must, therefore, comply with all applicable rules . . . and regulations;”<sup>9</sup> and
- » it is “likely” that firms engaging in certain activities (e.g., dealing, arranging and advising) “in relation to derivatives that reference either cryptocurrencies or tokens issued through an initial coin offering (ICO), will require authorisation by the FCA.”<sup>10</sup>

### III. U.K. TAX ANALYSIS (UPDATED NOVEMBER 2019)

In this section, we explore key U.K. tax considerations that may arise on a distribution of utility tokens. This section does not explore tax issues attaching to the subscribers or acquirers of the tokens (other than in limited circumstances for certain employees).

Like many other jurisdictions, the United Kingdom has not introduced a special regime or specific rules for crypto assets. Therefore, the tax consequences of a token generation and distribution must be considered in light of general U.K. tax principles. The U.K. tax authority, H.M. Revenue and Customs, originally published guidance on 19 December 2018 in relation to the taxation of individuals who hold crypto assets.<sup>11</sup> This guidance was updated on 1 November 2019 to cover how H.M. Revenue and Customs will tax transactions undertaken by companies and other businesses involving crypto asset “exchange tokens”; this updated guidance does not address security or utility tokens.

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9 <https://www.fca.org.uk/news/statements/cryptocurrency-derivatives> The FCA does not provide a definition for “so-called cryptocurrencies.”

10 Ibid.

11 <https://www.gov.uk/government/publications/tax-on-cryptoassets>

When the U.K. launched its “Cryptoassets Taskforce” consisting of H.M. Treasury, the Financial Conduct Authority and the Bank of England in March 2018, it concluded that there are three broad categories of crypto asset:<sup>12</sup>

- 1. Exchange tokens** – which are often referred to as ‘cryptocurrencies’ such as Bitcoin, Litecoin and equivalents. These forms of token are not issued or backed by a central bank or other central body. They do not provide the types of rights or access provided by security or utility tokens, but are used as a means of exchange or for investment.
- 2. Security tokens** – which amount to a ‘specified investment’ (see section F “Other U.K. Regulated Activities Analysis” in the UK regulatory comments above on page 12). These may provide rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits. They may also be transferable securities or financial instruments under MiFID II.
- 3. Utility tokens** – which can be redeemed for access to a specific product or service that is typically provided using a distributed ledger technology platform.

As mentioned above, this section explores how the U.K. rules apply in relation to utility tokens rather than security tokens (or the U.K.’s concept of “exchange tokens”), although there can be a certain degree of overlap between utility tokens and exchange tokens.

The analysis can be complex in relation to utility tokens primarily because of the uncertainty as to what exactly a utility token is (and most utility tokens differ in this respect).

This can be contrasted with the tax analysis of a security token or even an “exchange token” now that the U.K. has published guidance concerning these because generally that analysis should be similar to reasonably well-understood tax analysis of a traditional security issuance.

A U.K. company can distribute utility tokens in a variety of ways. Thus, for the purposes of this section, the discussion assumes that the token sponsor is a U.K. company. Further, some U.K. businesses prefer to use an offshore vehicle to distribute utility tokens (rather than a U.K. company) because that can add a degree of simplicity to the numerous complications an onshore vehicle may bring. However, offshore vehicles have their own tax complications that need to be considered carefully (for example, ensuring that the tax residency of the offshore vehicle is not brought onshore, otherwise any perceived offshore benefits could be lost).

U.K. companies have four broad U.K. tax areas to consider when distributing utility tokens:

1. whether the distribution proceeds fall within the scope of corporation tax;
2. whether the distribution of the utility tokens triggers a value added tax (“VAT”) charge;

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<sup>12</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/752070/cryptoassets\\_taskforce\\_final\\_report\\_final\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf)



3. whether employment taxes (being income tax, national insurance (or social security) contributions, and the apprenticeship levy) are triggered by any tokens awarded to or acquired by employees; and
4. whether the utility tokens are subject to stamp duty or stamp duty reserve tax.

Each of these areas can create an absolute cost for a U.K. company or create a cash flow or funding cost to manage.

Although this section largely focuses on the tax implications of a token distribution, each of these taxes could arise at other points in the life cycle of a project (e.g., set-up, token pre-sale, token sale, the operational phase, and any exit). Therefore, the best practice is to consider and plan for each phase at the outset.

Addressing some of the high-level aspects of each of these in turn:

### 1. CORPORATION TAX - TOKEN DISTRIBUTION PROCEEDS

In the United Kingdom, the profits of a company are currently (as of November 2019) subject to corporation tax at 19% (reducing to 17% in April 2020).<sup>13</sup>

As a broad starting point, the profit of a U.K. company is determined in accordance with accounting principles subject to various specific tax deviations. Therefore, it is important to understand the accounting treatment and how and when the accounts recognize any revenue from the token distribution because that will flow through to the tax analysis.

Once the tax analysis has been overlaid on the accounting treatment, the general proposition is that any token distribution proceeds received by a U.K. company for granting the tokens are likely to fall within the scope of U.K. corporation tax.

This means that 19% of the token distribution proceeds may need to be paid to the U.K. tax authority on account of corporation tax leaving the U.K. company with less cash than originally envisaged. The question then becomes whether a U.K. company has incurred any expenditure that can be used to offset any revenue received from the distribution to reduce any such leakage; this depends on the nature of the expenditure incurred by the U.K. company and also various other tax and accounting timing considerations. This is why it is important to understand any project's projected cash flow and proposed expenditure — these complications are one reason why an offshore entity situated in a low or no tax jurisdiction may afford an element of simplicity in this respect.

Further, it is important to build any anticipated tax leakage into the financial model at the outset so that no surprises manifest themselves at a later stage.

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<sup>13</sup> <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax>.

Other corporation tax issues of which to be mindful include:

- A. disposals of crypto assets:** as many token distributions accept payment by way of other crypto assets, it is possible for an exchange rate gain or loss to be made when the U.K. company eventually disposes of the relevant asset; and
- B. discounts / credits:** additional complications can arise where the token in question has an inbuilt discount for a future service or if it provides a service credit which can be used as a payment in kind — such complications are often linked to when revenue is recognized for accounting purposes.

## 2. VAT – TOKEN DISTRIBUTION PROCEEDS

VAT is an exceptionally broad tax and it captures effectively anything done (or granted) by a U.K. company in return for consideration. The distribution of utility tokens falls squarely within this scope because a U.K. company is distributing “tokens” in return for cash (or cryptocurrency) and, unlike the issuance of security tokens, there is no immediately obvious exemption from a VAT charge.

If VAT is chargeable, it can lead to an erosion of 20% of the token distribution proceeds; 20% is the current U.K. main rate of VAT.<sup>14</sup>

Even if there is no U.K. entity involved, VAT still needs to be considered where a non-U.K. entity distributes tokens to U.K. persons; this can be missed by overseas token sponsors who may assume that they do not need to be concerned with VAT.

U.K. VAT is based on European Union VAT law, so there should be similar issues arising in relation to every E.U. country. In addition, as many other jurisdictions have similar VAT systems, these (or equivalent) issues may arise elsewhere.

In relation to the application of VAT itself, there is limited guidance from the U.K. tax authority which provides very broadly that if the token is effectively like bitcoin, it should be treated as cash or currency (so the distribution or exchange of it ought to be exempt from VAT).<sup>15</sup>

Unfortunately, a significant proportion of utility tokens are not sufficiently comparable to bitcoin because various other rights attach to those tokens such as having the ability to claim a special discount, having an entitlement to other rights, or having a certain cash credit attached to them which can be applied against buying certain products or services.

Additional complexity may be caused depending on whether the tokens are distributed to consumers or businesses and whether the nature of the arrangements falls within specific

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<sup>14</sup> <https://www.gov.uk/vat-rates>.

<sup>15</sup> See <https://www.gov.uk/hmrc-internal-manuals/vat-finance-manual/vatfin2330> and <https://www.gov.uk/government/publications/tax-on-cryptoassets/cryptoassets-tax-for-businesses>.

identified categories of service, such as those relating to “electronically” supplied services which can engage other rules.

All of these factors could give rise to a token sponsor needing to register and account for VAT on any token distribution.

In light of this, companies can incorporate specific checks and balances in the token distribution process to ensure that the token sponsor has the necessary information required to undertake the VAT analysis.

Some of these complications may be eased by using an offshore structure. In addition, restricting the distribution of tokens to overseas business entities may help to shift the liability for any VAT to those entities.

Other VAT matters to consider include where a U.K. company pays for services with tokens (instead of with fiat) which is likely to give rise to VAT implications for both the U.K. company and the person providing services to the U.K. company (whether that person is an individual or a company).

### **3. EMPLOYMENT TAXES - DISTRIBUTION TO OR ACQUISITION BY EMPLOYEES**

Employment tax implications arise in relation to utility token distributions, primarily where those tokens are distributed to or acquired by employees of a U.K. company.

Again, this is an area where, if the token is a security, the tax issues have a relatively clear analysis and there are available protections which can provide certainty and clarity.

Unfortunately, in the context of utility tokens, the position is much more opaque. The U.K. tax authority has now published guidance which addresses crypto assets received as earnings, but the guidance is vague in places and expressly states that different tax treatments may need to be adopted for utility and security tokens. The updated November 2019 guidance now addresses some of these issues but only in the context of “exchange tokens”.<sup>16</sup>

Applying general U.K. tax principles typically leads to analysing whether the employee (or director) in question derives a benefit from their employment by virtue of the distribution or acquisition of the utility tokens.

If the answer is yes, the high-level analysis is that if the employee pays below market value for the tokens or is given them for free, there is likely to be an employment tax charge. Furthermore, given potential cash flow constraints of a U.K. company, this cash flow cost needs to be managed, modelled, and funded; for example, neither the U.K. company nor the employee may have excess cash available to pay this tax.

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16 <https://www.gov.uk/government/publications/tax-on-cryptoassets/cryptoassets-tax-for-businesses>

To elaborate on this further, where an employee receives tokens as part of their employment, these rules will be engaged. This leads importantly to establishing whether the tokens can be considered to be “money’s worth” which broadly means something that is of direct monetary value to the employee or something that is capable of being converted into money. In the guidance published by the U.K. tax authority, crypto assets received as employment income count as money’s worth, suggesting that the U.K. tax authority will always consider this to be the case. It is still important to establish, however, whether the tokens can be considered to be money’s worth.

What is or is not “money’s worth” is an area guided by complex U.K. case law. The U.K. tax authority approaches this test by looking at what the arm’s length market value of the tokens would be if they were sold to a third party at the time immediately after the employee acquired the asset.<sup>17</sup>

Therefore, sponsors may wish to consider obtaining a valuation from a professional valuation expert in relation to market value because it is inevitable that this will be an area of challenge from the U.K. tax authority in the years to come. Having professional advice in place regarding such valuations assists in minimising any risk. Complications also may arise in respect of valuations where pre-sales take place before the tokens are distributed or acquired. Any such pre-sale may give rise to an identifiable benchmark for the token valuation; if the employee has paid an amount below this benchmark, a tax charge could potentially arise.

This does not necessarily mean that it is correct to value any award or sale of tokens to employees in the same way as third-party benchmarks because various restrictions attaching to employee tokens could have an impact on their value. For example, indicators suggesting lower valuations potentially include distributing tokens to employees before any token sale begins, having restrictions preventing employees from disposing of the tokens for a number of years (lock-ups), and/or having tokens with forfeiture rights which apply if the employee leaves the business within a number of years or on bad terms.

If these rules are engaged, it is also important to establish whether the tokens are “readily convertible assets” or not; the importance of this goes to whether it is the employer and/or the employee that has various employment tax liabilities. Broadly, this turns on whether trading arrangements exist or are likely to come into existence at the point the crypto assets are distributed (which may often be the case). If the tokens are readily convertible assets, the responsibility for U.K. national insurance contributions and for withholding U.K. income tax on behalf of the employee falls on the employer.

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17 <https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim00540>.

As with the other tax aspects, the critical point is to consider and plan for these issues at the outset.

#### **4. STAMP DUTY/STAMP DUTY RESERVE TAX**

The United Kingdom imposes stamp duty and stamp duty reserve tax on certain transactions. Generally speaking these duties apply in respect of shares, loans, and various other securities and are levied at 0.5% of any consideration.

The positive news is that these duties are not typically relevant on a distribution or transfer of utility tokens. Where these taxes are more likely to arise in practice is where the token is a security token.



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UNDERSTANDING DIGITAL TOKENS  
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