5-2022

New assets, (largely) same old rules: The taxation of digital tokens

Vincent OOI
Singapore Management University, vincentooi@smu.edu.sg

New Assets, (Largely) Same Old Rules: The Taxation of Digital Tokens

Digital tokens have become increasingly important as an asset class in recent years. They are digital financial assets based on distributed ledger technology, with the most prominent example being cryptocurrencies. Various tax authorities are gradually seeing their potential as a source of tax revenue, with numerous jurisdictions stepping up tax enforcement activities. Despite this, few statutes specifically address the taxation of digital tokens. The overwhelming majority of tax rules which govern the taxation of these relatively new asset classes are entirely orthodox. Tax practitioners largely start off by looking at the characteristics of the digital token in question, such as the nature of the asset and its use cases. They then look at the surrounding circumstances of a tax event, which are the circumstances in which tax liability may arise (such as the creation of asset), before applying existing tax principles to determine the relevant tax treatment.

However, digital tokens can have a very wide range of characteristics and can also be subject to a multitude of tax events, many of which might be unfamiliar to someone new to the area. In my recent paper 'A Framework for Understanding the Taxation of Digital Tokens' , I propose a framework mapping out the common tax events relating to digital tokens, based on the 'life-cycle' of a digital token, from creation, to transfer, to disposal. The paper focuses on Income Tax and Value Added Tax, since these are core taxes in most jurisdictions, but digital tokens may be subject to a whole range of other taxes as well, with Capital Gains Tax and Inheritance Tax being prominent examples in the UK.

The paper notes that the novelty of digital tokens, coupled with insufficient tax knowledge and some extent of wishful thinking on the part of the taxpayer, may lead to some misconceptions on the part of taxpayers. It seeks to address these misconceptions by laying out five propositions for the taxation of digital tokens. Firstly, digital tokens are not a monolithic asset class attracting uniform tax treatment. The wide variety of ways in which digital tokens may be commercially used makes it untenable to assume that the classification of an asset as a digital token will in itself tell us anything about how it might be taxed. Secondly, the common trichotomous division of digital tokens into payment, utility and security tokens is a classification largely based on the law of securities regulation and should not be blindly adopted into tax law. Thirdly, even under this classification scheme, the three classes of digital tokens are not mutually exclusive (or exhaustive) and hybrid tokens may exist.

Fourthly, the fact that an asset is a digital token does not generally change its tax treatment in and of itself. One cannot say with certainty that just because a digital token falls into one of the three classes, it must necessarily be subject to a particular kind of tax treatment. This will still have to be determined through the application of orthodox tax principles, based on the surrounding circumstances of the relevant taxable event. In general, tax law primarily focuses on the circumstances surrounding the taxable event, and only secondarily on the asset in question (if at all). There are certain exceptions to the proposition that the nature of the asset does not generally affect its tax treatment. However, until more legislation specifically dealing with digital tokens comes into force, these exceptions remain relatively rare across jurisdictions.

Fifthly, digital tokens of the same class are generally taxed in broadly similar ways as they tend to have similar surrounding circumstances. There is utility in spotting patterns in tax treatment across various classes of digital tokens, though one must remember that the focus must always be on the circumstances surrounding the relevant taxable event. A rough framework of potential tax treatments might be mapped out based on the class of digital token, the type of tax in question and the common taxable events that might occur.

These common taxable events can be divided into three main stages of the ‘life cycle’ of digital tokens: creation, transfer and disposal. These broad categories can be further subdivided into common tax events. Digital tokens are commonly created through mining, forging, and issue and purchase. Transfers typically occur where a token is exchanged for goods and services, other tokens, or fiat currency. Finally, digital tokens are commonly disposed of through redemption, token burning and loss. Some of the events involve relatively new concepts. For example, mining refers to the process in some distributed-ledger protocols by which transactions of digital tokens are verified and are added to the blockchain-based ledger recording the transactions. Token burning involves the permanent removal of a token from circulation in a manner akin to a share-buyback. Each of these events and the common Income Tax and VAT implications are addressed at length in the paper.

Across jurisdictions, until more legislation specifically dealing with digital tokens comes into force, the taxation of digital tokens will be determined by existing (general) tax provisions. Where existing tax provisions are broadly drafted to generally catch most transactions of a particular nature, the tax treatment of digital tokens is likely to follow the existing orthodox tax treatment and there are likely to be clear patterns. On the other hand, the more specific existing tax provisions are with respect to the types of assets and asset classes that trigger the application of these provisions, the less easy it will be to predict the tax treatment of digital tokens. Taxpayers should be cautious about ‘reasoning by analogy’ without carefully looking at the specific tax provisions in question. No matter how much a digital payment token looks like money and no matter how closely it can serve as such a substitute, one should not assume that a provision specifically referring to ‘money’ will necessarily apply to digital payment tokens as well.

Vincent Ooi is a Lecturer at Yong Pung How School of Law, Singapore Management University