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31 August 2022

Financial Products and Services BAI
Lead Official: Alex Bosinceanu, HM Revenue and Customs (HMRC)
3rd Floor, Mail Station E
100 Parliament Street
London SW1A 2BQ
UK

Submitted by email: financialproductsbai@hmrc.gov.uk.

Ladies and Gentlemen;

Coinbase welcomes the opportunity to submit comments and provide its views on the HM Revenue & Customs Call for Evidence with respect to the "The Taxation of Decentralised Finance Involving the Lending and Staking of Cryptoassets".

The attached document presents our recommendations regarding the tax treatment of DeFi transactions and staking by proposing newly tailored rules regarding these activities. These proposals would provide clarity to taxpayers and businesses and assist the UK in reaching its goal of becoming a global crypto hub.

We appreciate your consideration of our comments and recommendations. And, we would be delighted to discuss these and other tax policy issues with you at your convenience. We view our mission to include proactive engagement on tax policy initiatives around the world, the UK in particular.

Very truly yours,

Lawrence Zlatkin
Vice President, Tax

Coinbase Global, Inc.

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Comments on the
HM Revenue & Customs
Call for Evidence
"The Taxation of Decentralised Finance Involving the Lending and Staking of Cryptoassets"

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ABOUT COINBASE

Coinbase Global, Inc. and its affiliates ("Coinbase") is one of the largest global platforms for customers to buy, sell, hold and trade crypto-assets. Our mission is to increase economic freedom in the world. We build safe, trusted, easy-to-use technology and financial infrastructure products and services that enable any person or business with an internet connection to discover, transact, and engage with crypto-assets and decentralized applications. Our products provide access to the crypto economy in more than 100 countries and serve as a critical infrastructure layer to Web3. Customers that start with us grow with us as they experience the benefits of crypto-based products for investing, staking, spending, borrowing and transacting in crypto in a growing number of use cases. Today, our platform enables approximately 103 million retail users, 14,500 institutions, and 245,000 ecosystem partners to engage with crypto-assets.

EXECUTIVE SUMMARY

HMRC has acknowledged the need for further feedback regarding its crypto-asset manual guidance ("2021 Guidance") (drafted in March 2021 and updated in February 2022), which may lead to taxpayers having to recognize disposal events and pay tax even when their economic ownership has been retained. We believe this outcome for taxpayers will inhibit growth of the crypto industry within the United Kingdom. Our comments are centered on the need for the development of effective, efficient and pragmatic tax policy that provides for:

1. Not treating transfers of assets to DeFi protocols for the purposes of lending or staking as disposals;
2. Not treating lending of assets to or through centralized exchanges as disposals;
3. Nonrecognition of gain or loss on the daily/periodic accrual of rewards within a DeFi protocol or staking pool;
4. Implementing rules of convenience for calculating gain or loss when a taxpayer receives assets from a DeFi protocol or staking pool;
5. Treating the withholding tax source of staking rewards as the the location of the

recipient; and
6. Developing specific DeFi tax information reporting rules by mandating the development of and use of smart contracts, public ledgers and tax identity tokens.

The Challenge of Crypto

Coinbase welcomes the UK government's April 2022 plan to make the UK a global crypto-asset technology hub and its efforts to enhance the competitiveness of the UK tax system in the crypto-asset ecosystem. We believe that updating tax policy to address the most recent innovations in the crypto market is important to support the growth of the crypto industry in the UK.

The tax regime in the UK, like that in many countries around the world, was largely drafted when digitally native assets ("DNA") and distributed ledger technology ("DLT") did not exist. As such, the UK tax regime is built on certain premises that may be ill-suited to crypto from a policy perspective.

Decentralized Finance ("DeFi") and staking, the topics on which comments have been requested, are two common use cases for DNA and DLT in the current crypto economy, leveraging the unique aspects of that technology to facilitate the trading, lending and lending of assets through automated, programmatic protocols that can eliminate the need for intermediaries.

HMRC's 2021 Guidance is an important acknowledgement that it is not clear how the existing tax rules in the UK should be applied in the context of DNAs and DLT. The 2021 Guidance provides certain factors that may be relevant to the analysis of the tax treatment of DeFi transactions, including interpretations that may cause consumers or businesses to recognize capital gain in transactions where they still retain economic ownership of the DNAs and thus have not "disposed" of an asset in the most common sense use of the word.

Specifically, the 2021 Guidance requires taxpayers to recognize a capital gain transaction when they transfer control of a token to someone other than themselves or their spouse. DeFi transactions necessarily require holders to transfer their assets to the DeFi protocol itself. While the owner has transferred control of the tokens to a DeFI platform, the owner retains economic ownership of the tokens and can request their return on demand or within a specified period of time.

Similarly, staking often involves transfers of assets to "staking pools," where holders are able to aggregate their assets and benefit from participating in the validation model of the protocol (by running a validator node). Holders thereby enjoy economies of scale, even when the holders are unfamiliar with the technological (including security) requirements needed to properly run a validator node.

A participant's intent when transferring their assets to a DeFI protocol or to a staking pool generally is to earn a return on their DNAs in the form of additional DNAs. In both contexts, the amount of the return is directly proportional to the amount of DNAs transferred to the relevant protocol.

Because of the unique aspects of DNAs and DLTs, we believe the 2021 Guidance accelerates taxable gain or loss in cases where such income recognition is premature. As a consequence, we believe the current UK tax regime both disincentivizes UK taxpayers from taking part in DeFi and staking and presents a disadvantage to crypto holders and businesses in locating their operations in the UK.

We offer below suggestions on revisions to the UK's tax rules that could help it to achieve its objectives of clarifying the UK tax treatment of common DeFi transactions and, therefore, making the UK a global crypto-asset technology hub.

Proposed Solutions:

We encourage the UK to be forward thinking regarding the tax treatment of DeFi transactions and staking by proposing newly tailored rules regarding these activities. We have provided recommendations below that would provide taxpayers (individuals and businesses alike) with the clarity needed to confidently make investment decisions. We believe this would turn a "disadvantage" into an "advantage" for businesses in deciding whether to locate their operations or deploy capital in the UK.

- We recommend that the UK not treat transfers of assets to DeFi protocols and staking pools as dispositions. There is precedent for such treatment under the existing UK rules regarding securities lending, which also involves transfers of assets to third parties in exchange for consideration based on the amount of assets lent and the time elapsed until the assets are returned.

  As was recognized to be the case in the context of securities lending, requiring crypto holders to recognize gain or loss at the time they transfer their assets to a DeFi protocol or staking pool, disincentivizes users from participating in these markets and thereby reduces liquidity and overall economic activity. The current rules recognize these dynamics and provide for nonrecognition treatment to support securities lending activities. However, the 2021 Guidance does not provide the same level of comfort with respect to transfers of assets to DeFi protocols and staking pools.

  The UK should publish clear, unequivocal guidance (not "factors" to be analyzed on a "case-by-case" basis) that transfers of DNAs to decentralized protocols do not trigger gain or loss to the transferor, so long as the transferor retains the right to withdraw their asset from the protocol at any time (subject to a protocol's lock-up period).

- The UK also should apply non-recognition treatment to lending assets on Centralized Exchanges. The same transaction may be treated as a disposal, even when the same asset lending transaction on a DeFi protocol may not be subject to the same treatment. This would favor DeFI protocols over Centralized exchanges and also would inhibit the UK's growth as a crypto technology hub by firms utilizing an intermediary model.

- We recommend that the UK provide for nonrecognition of gain or loss on accrual of rewards within a DeFi protocol or staking pool, and that gain or loss only be recognized when such rewards are transferred to the control of the taxpayer. Under the 2021 Guidance (and existing rules in the UK), it is not clear whether holders who contribute assets to a DeFi protocol or staking pool are required to recognize taxable income on a daily (or perhaps hourly, or even more frequent) basis as rewards accrue within those protocols. Requiring current inclusion of rewards that accrue within a DeFi protocol or staking pool would present an enormous administrative burden for taxpayers. Taxpayers may be required to check the value of all the crypto assets contributed to all DeFi protocols and all staking pools on a daily (or perhaps hourly, or even more frequent) basis in order to properly calculate their gains for UK tax purposes. And this burden exists, even if a taxpayer has no control over the rewards that are accruing "on paper" (or technically, gains with respect to assets on the distributed ledger). This would be a tremendous disincentive to participate in these activities.

We suggest that the UK publish clear, unequivocal guidance (not "factors" to be analyzed on a "case-by-case" basis) that the accrual of rewards within DeFi protocols and staking pools does not result in current income inclusions until such rewards are transferred back to the control of a taxpayer (or the taxpayer sells his/her interest in the DeFi protocol or staking pool).

- We generally agree with the UK guidance that calls for recognition of gain or loss as a capital asset at the time assets (other than those initially lent) are withdrawn from DeFi protocols, or when rewards are transferred to the control of a taxpayer.

- In order to minimize the administrative burden for taxpayers that participate in DeFi and/or staking, we recommend the UK implement rules of convenience for calculating gain or loss when a taxpayer receives assets from a DeFi protocol or staking pool. Specifically, we recommend that transfers of digitally native asset from decentralized protocols should be treated as a return of capital until the amount received by a taxpayer equals the amount transferred by that taxpayer to the decentralized protocol, and thereafter any additional amounts received by the taxpayer would be treated as gain on a capital asset.

  Alternatively, the UK could adopt a "pro rata" basis recovery rule, where the receipt of assets from a decentralized protocol or staking pool would result in gain or loss to the extent the value of such assets does or does not exceed the pro rata amount of the taxpayers' basis in all assets transferred to the decentralized protocol. This alternative would be significantly more burdensome for taxpayers, and we do not believe the "timing" benefit for the government (resulting from taxpayers recognizing gains sooner, assuming asset prices have increased since the assets were transferred by the taxpayer) justifies the significant additional administrative burden on the taxpayer. It would not make the UK "user friendly" for crypto should this timing rule be adopted.

- We recommend that the UK publish clear guidance that the source of rewards earned from participating in DeFi and staking is based on the location of the recipient of such rewards. We believe this recommendation is consistent with the objective of making the UK a global crypto-asset hub. Without this guidance, individual taxpayers participating in DeFi have no way of knowing whether they may be subject to significant penalties for failure to withhold on payments made to potential non-UK participants in DeFi protocols, since borrowers would have no way of knowing the tax residence of all of the different contributors to any given pool of assets available for borrowing from a DeFi protocol.

Moreover, businesses that facilitate DeFi or staking could face uncertainty and significant adverse tax liability if the UK were to assert that payments made on DeFi protocols or from staking were UK source and subject to UK withholding tax. The UK should consider whether businesses in the DeFi and staking industries would minimize their connection to and presence in the UK if they were faced with the prospect of withholding liability on all transactions they facilitate.

We believe the lack of guidance in this area currently is affecting business decisions on where to locate operations and deploy capital. We are aware that certain businesses active in DeFi and staking have chosen to locate operations and deploy capital in jurisdictions that have confirmed the absence of withholding tax to these transactions.

- In DeFi transactions, such as trading or lending of cryptocurrency, there is no central, authoritative, intermediary entity facilitating the transactions or payments among participants. Traditional tax information reporting rules rely on an intermediary for reporting purposes and, as such, it would be difficult to simply bolt DeFi onto the existing UK tax reporting regime. This is an enormous opportunity for the UK to be forward looking in its application of reporting rules to DeFi and staking. For example, the UK could develop specific DeFi tax information reporting rules by mandating the development of and use of smart contracts, public ledgers and tax identity tokens. Participants in a DeFi transaction using smart contracts could insert their tax relevant information through a tax identity token. Tax relevant information would encompass, for example, full legal name, country of tax residence, and taxpayer identification number. When the participant engages in a transaction, as set by parameters within the smart contract, the smart contract could then send encrypted relevant tax token information and transaction information to HMRC. The smart contract can be viewed and audited any time by HMRC. The combination of identifying information with DeFi would be the point of reference when the participant files an income tax return with HMRC or any corresponding taxing jurisdiction.

We understand that writing an entirely new set of rules specifically for DeFI may take considerable time and resources. We would welcome the opportunity to work with HMRC on the development of a balanced and modernized tax policy regime for crypto that preserves tax revenue, while encouraging participants to invest and develop their infrastructure and operations in the UK.