STEP Guidance Note: Location of Cryptocurrencies – an alternative view

Purpose of this note

HMRC has recently published its crypto-assets manual. The term cryptoasset covers a number of different types of digital asset. This note is concerned with one particular type of digital asset, commonly referred to as cryptocurrency, but also sometimes known as exchange tokens. The best known is, of course, Bitcoin but there are many other examples of cryptocurrency.

The cryptoassets manual confirms (at CRYPTO22600) that, in HMRC’s view, exchange tokens (i.e. cryptocurrency) are located where the beneficial owner is resident. For this purpose, HMRC consider an individual to be UK resident if they are tax resident under the statutory residence test.

As far as tax is concerned, the location of cryptocurrency is principally relevant in relation to non-domiciliaries in order to determine whether any gains are foreign gains (and therefore capable of benefitting from the remittance basis of taxation) and, for inheritance tax (IHT) in relation to the question as to whether cryptocurrency is excluded property. However, as HMRC mentions in its manual, the location of cryptocurrency can be relevant for other tax purposes, for example whether the rate at which any penalties might be charged is the rate that applies to offshore assets.

It is important to note, however, that the location of cryptocurrency will be relevant not only for tax purposes but also for other purposes. For example, it is common for a foreigner who is resident in the UK to make an English will, which is limited to assets that are situated in the UK.

Ultimately, in the absence of any statutory rules,¹ the location of cryptocurrency is a matter for the courts. Although HMRC has put forward one view, STEP members should be aware that there are alternative views. In particular, it is worth noting that HMRC’s view does not appear to be based on any legal principle. Rather it seems to be a pragmatic conclusion that:

‘Using the residency of the beneficial owner of the exchange tokens to determine the location gives a clear, logical, predictable and objective rule which can be easily applied.’

A consensus is emerging in the common-law world that cryptocurrency is a form of intangible property. For example, the legal statement on crypto-assets and smart contracts put together by the UK jurisdiction task force,² AA v Persons unknown [2019] EWHC 3556 (Comm) (England), Ruscoe v Cryptopia Limited [2020] NZHC 728 (New Zealand), Shair.com Global Digital Services v Arnold [2018] BCSC 1512 (Canada).

We accept that, as cryptocurrency is property, it must be allocated a location, despite the fact that (as acknowledged in the legal statement – see paragraph 97) cryptocurrency is specifically located outside the UK. If, however, it is not located in the UK, it may be located in some other jurisdiction (e.g. the country of residence of the beneficial owner).

¹ HMRC notes that there are statutory rules which apply for capital gains tax purposes in sections 275-275B TCGA 1992. However, they take the view that these rules do not apply to crypto-assets which are not linked to some other asset (crypto-assets linked to other assets are sometimes called stablecoins – for example the cryptocurrency proposed by Facebook known as Libra or Diem). This note deals only with cryptocurrency which is not linked to another asset. Contrary to HMRC’s view, it might perhaps be possible in some circumstances that such cryptocurrency is ‘subject to UK law’ (or indeed is subject to some other law) for the purposes of s275A(3). This is however an issue which is beyond the scope of this note.

² Legal statement on cryptoassets and smart contracts (netdna-ssl.com)
designed not to have a location (see, for example, IRC v Muller and Co’s Margarine Limited [1901] A.C. 217; English, Scottish and Australian Bank Limited v IRC [1932] A.C. 238). In the absence of any statutory rules, it is therefore necessary for the courts to develop the law to allocate an artificial location to cryptocurrency.

In formulating principles to allocate a location to cryptocurrency, we would expect a court’s starting point to be the principles that have been applied in allocating an artificial location to other types of intangible property. These include matters such as enforceability, recoverability, transferability, location of any physical assets to which the intangible is attached and the place where ownership is recorded or registered. It is notable that the residence of the beneficial owner is not a principle that has previously been applied in allocating a location to intangible property.

The problem, of course, is that many of the principles that have previously been applied are irrelevant to cryptocurrency due to the nature of the asset. It exists only as a computerised entry on a digital database that has no single location. The token is represented by a public address or public key that is freely accessible. That public address or public key is linked to a private key that must be used to implement any transaction relating to the token.

Looking at the principles that have been applied in the past to allocate a location to intangible property, a case could be made for allocating the location of cryptocurrency to the place where it can effectively be dealt with. This is, for example, the principle that has been applied to shares (and is normally where the share register is located).

In the case of cryptocurrency, it can only be dealt with by the use of the private key and, arguably, its location should therefore be linked to the location of the private key or of the person who has control of the private key (who may or may not be the beneficial owner).

It appears that the question of the location of cryptocurrency has been touched on recently by the English courts in Ion Science Limited v Persons Unknown (2020, unreported). The court apparently considered that it was arguable that the location of the cryptocurrency was the place where the participant in the cryptocurrency system is domiciled. This conclusion is said to be based on the arguments put forward by Professor Andrew Dickinson in chapter 5 of the book Cryptocurrencies in Public and Private Law.

In fact, in that chapter, Professor Dickinson is dealing with the question as to which law governs the proprietary aspects of any rights relating to cryptocurrency. The reason this is connected with the location of cryptocurrency is that, normally, the law that governs property rights in relation to an asset is the law of the jurisdiction in which the asset is located. In the absence of any location for cryptocurrency, Professor Dickinson suggests in paragraph 109 in chapter 5, that the law of the place of residence of the participant is the appropriate law to govern any proprietary questions relating to the cryptocurrency.

The important point to note from this analysis is that the governing law is based not on the residence of the beneficial owner but on the residence of the participant in the relevant cryptocurrency system. The reason for this is that Professor Dickinson’s conclusion that the value of cryptocurrency derives from a claim or legitimate expectation to be associated with and have the power to engage in transactions in relation to particular units of cryptocurrency within the system. In practice, this means controlling the public address to which the cryptocurrency

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3 This is recorded by the solicitors who acted for the claimant in that case – Ion Science Ltd v Persons Unknown Explained. Cryptocurrency Fraud & Asset Recovery (rahmanravelli.co.uk).

4 Edited by David Fox and Sarah Green, Oxford University Press (2019).
has been allocated and holding the private key which is needed to authorise transactions in relation to that cryptocurrency.

Although Professor Dickinson’s focus is on determining the law governing proprietary aspects relating to cryptocurrency. It might be expected that a UK court would consider similar principles in relation to the location of cryptocurrency. Indeed, that is what the court in Ion Science appears to have done.⁵

In our view, the approach taken by Professor Dickinson and adopted by the court in Ion Science seems a more likely approach for the courts to take in relation to the question of location than that suggested by HMRC as it builds on existing principles (control, ability to deal and, by extension, enforceability) rather than introducing a completely new principle which has no precedent in determining the artificial location of an intangible asset.

It is worth noting that the UK jurisdiction taskforce agrees that the law governing any proprietary aspects in relation to cryptocurrency is not to be determined by looking at the location of the cryptocurrency (as it has none) but by reference to other factors. The only factor they identify which is relevant to cryptocurrency (at paragraph 99(c)) is ‘whether a particular cryptoasset is controlled by a particular participant in England and Wales (because, for example, a private key is stored here)’. Although expressed in slightly different terms, this leads to the same conclusion as that reached by Professor Dickinson, which is that the applicable law is linked not to the beneficial owner but to the participant in the relevant cryptocurrency system who will be the person who has control over the private key.

Of course, the beneficial owner may also be a direct participant in the cryptocurrency system and, in that capacity, may hold the private key. In those circumstances, the cryptocurrency will be located where the beneficial owner is resident.

However, there will be situations where cryptocurrency is not held directly by the beneficial owner but, instead, is held on behalf of the beneficial owner by a third party such as a cryptocurrency exchange, trading platform, nominee, trustee or custodian.

In these circumstances, it will be the residence of the third party, being the participant in the cryptocurrency system and the holder of the private key that will determine the location of the cryptocurrency. The residence of the beneficial owner will be irrelevant assuming the beneficial owner is not the holder of the public address with which the relevant units of the cryptocurrency are associated and is not the holder of the private key that allows transactions in respect of those units to be authorised.

In this context, where the beneficial owner has an account with the cryptocurrency exchange, the nature of the relationship with the exchange must be carefully analysed. In some cases, the wallet that represents the public address and the associated private key will be held by the beneficial owner and the exchange merely facilitates transactions. However, in other cases, the wallet and the private key will be held by the exchange itself on a pooled basis for all of its clients with the rights of the beneficial owner being limited to the holding of an account with the exchange in which the holding of units of cryptocurrency are recorded in the form of book entries made by the exchange itself. This was, for example, the position in relation to the Cryptopia Exchange, which was the subject of the New Zealand case of Ruscoe v Cryptopia mentioned above.

⁵ The decision in Ion Science has been followed in Fetch.ai Limited v Persons Unknown [2021] EWHC 2254 (Comm)
One objection to this conclusion might be that, in the case of other types of intangible property, the location of a custodian does not affect the location of the underlying asset. For example, if shares in an English company are held by a custodian in Switzerland, the beneficial owner would still be treated for UK tax purposes as holding a UK asset, being his beneficial interest in the shares in the English company. However, the position is different as the shares in the English company have an independent location based on the place where the company share register is kept (which has nothing to do with the status of the custodian or the beneficial owner). In the case of cryptocurrency, if the suggested analysis is right, this has no independent location separate from the residence of the actual participant in the relevant cryptocurrency system.

We can see that the position might be different if cryptocurrency is held by a dedicated nominee for the beneficial owner – i.e. the cryptocurrency is not pooled as part of a commercial arrangement. Where there is a dedicated nominee, it would be open to the beneficial owner to require the nominee to give them control of the private key (which would relate only to the cryptocurrency held for the benefit of the beneficial owner). This might be said to give the beneficial owner sufficient control over the cryptocurrency to be treated as if it were directly held by them. This is not however the case where cryptocurrency is held on a pooled basis for multiple participants as none of the participants would be in a position to require the operator of the arrangement to disclose the private key to them.

One important point to note is that, whether the location of the cryptocurrency is based on the residence of the beneficial owner or on the residence of the participant in the cryptocurrency system, residence must surely be tested by reference to relevant common-law principles and not by reference to the tax definition contained in the statutory residence test. The reason for this is that, as explained above, the location of an asset is a general common law concept and is relevant for purposes which go beyond taxation. If the statutory residence test is to be used in order to determine residence for this purpose, this would need to be provided for by statute.

Where a person is resident in more than one jurisdiction, Professor Dickinson suggests that the governing law should be based on the jurisdiction with which the relevant participant has the closest connection. We would suggest that this is also the most sensible approach to apply to determining the location of cryptocurrency.

One particularly difficult issue that arises is what the position is where cryptocurrency is jointly owned. As HMRC points out in its manual, this is provided for in relation to capital gains tax in section 275C TCGA 1992. This provides that the location of an asset should be determined on the basis that the taxpayer in question is the sole owner. The effect of this is that, if a UK resident jointly owns cryptocurrency with a non-UK resident and those individuals are direct participants in the cryptocurrency system (both having access to the wallet containing the public address with which the cryptocurrency is associated and to the private key) the share of the cryptocurrency owned by the UK resident will be located in the UK and the share owned by the non-UK resident will be located outside the UK.

Where there is no statutory provision (for example in relation to IHT), we would again endorse Professor Dickinson’s suggestion that the location of the cryptocurrency should be determined by identifying the place of residence with which the participation in the cryptocurrency system is most closely connected.

Until there is a clear decision from the courts, taxpayers and their agents will need to decide what approach to take. However, if they conclude that cryptocurrency that is beneficially owned by a UK resident is not located in the UK, it will be incumbent upon them to refer to this in the white space on the individual’s tax return given the clear statement setting out HMRC’s view in its cryptoassets manual. It should of course be expected that HMRC may not accept an
alternative analysis and that a referral or appeal to the Tax Tribunal may be required in order to resolve the point.

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