HONG KONG TAX ALERT

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Taxation of digital assets in Hong Kong

Summary

The Inland Revenue Department (IRD) has revised its Departmental Interpretation & Practice Notes No. 39 (DIPN 39) to update its views on the taxation of the digital economy, electronic commerce and digital assets - see Hong Kong Tax Alert Issue 5 (link here).

For digital assets, whilst the guidance in DIPN 39 is helpful and consistent with the general tax principles, taxpayers will need to carefully consider how they practically apply these principles to their respective businesses.

Fluctuations in the value of many digital assets such as Bitcoin and other cryptocurrencies ("crypto" or "tokens") in the digital asset economy has not only attracted Crypto miners and technology start-ups, but increasingly serves as an alternative asset class for traditional asset managers.

To date there has been no guidance how crypto should be taxed which has led to divergent approaches as to how the general charging provisions in the Inland Revenue Ordinance (IRO) should apply to the various forms of crypto. The issuance of the DIPN 39 is therefore welcomed and a positive sign for the digital asset service industry in Hong Kong generally as this coincides with further regulatory guidance of digital assets by the Securities and Futures Commission in Hong Kong.

However, the guidance in DIPN 39 provides only very broad brushed principles, and having regard to the breadth of the digital asset economy falls short in articulating many practical issues crypto businesses will need to consider in order to determine how their profits should be taxed. Taxpayers who make simplistic interpretations on how to determine location and character of income from their business activities may be setting themselves up for detailed enquiry or possibly challenge from the IRD.

IRD views

The taxation of gains (and losses) arising from digital assets will depend both on the type of digital assets and how the assets are used in a taxpayer's business. In this respect, the IRD classifies crypto assets into three categories:

- **Payment tokens** such as Bitcoin which are used as a means of payment for goods and services.
- **Security tokens** which provide the holder with ownership interests in the business, such as a debt or a right to a share in the profits of the business. Where the digital tokens constitute "securities" as defined in the Securities and Futures Ordinance (link here), the tokens and activities involving such tokens would be subject to the regulation by the Securities and Futures Commission.
- **Utility tokens** which provide the holder with access to goods or services, and whereby the issuer of the utility tokens normally commits in the future to accepting the tokens as payment for goods and services.

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In the case of initial coin offerings (ICOs) involving the issuance of digital tokens in exchange for crypto or fiat currency to fund the development of a digital platform, it will be the nature of the tokens issued itself which in the first instance will determine how the tokens should be treated from a tax perspective, rather than the purpose to which token issuance proceeds are put.

If the tokens represent a security token offering such as equity or ownership interests in the company, proceeds received from the issuance will be treated as capital in nature and non-taxable. If on the other hand the tokens only give the holders the right to goods or services without any equity or ownership interests (utility tokens), the issuance proceeds will be treated as a prepayment for goods or services, and the timing of the revenue recognition should generally follow how the token proceeds are reflected in the P&L in accordance with applicable generally accepted accounting principles.

For investors who hold digital assets for long term investment purposes, the proceeds will not be taxable. Whether the assets should be regarded as capital assets or trading stock of a business is carried on is a question of fact, having regard to degree, frequency of activity and level of system and organisation, and whether the purpose of the activity is in fact to make a profit.

If a business is considered to be carried on, say by trading, exchanging or mining assets, it will only be Hong Kong sourced profits that are subject to profits tax. Again, this is a question of fact and will require an analysis of where the profit generating activities have been undertaken. Events such as airdrops and blockchain forks are to be treated as Hong Kong sourced profits in the course of a crypto currency business for such taxpayers.

For taxpayers using crypto as consideration for ordinary business transactions, for example receipt of crypto to purchase goods or services, the market value of the crypto at the date of transaction should reflect the amount of sales and purchases.

Finally, employees who receive crypto as remuneration will be taxed under the salaries tax provisions. The amount to be reported in the employee's return should be the market value of the crypto at the time of accrual.

KPMG observations

Whilst the IRD's approach above is consistent with the general profits tax and salaries tax charging provisions, there are many issues which Hong Kong based taxpayers will need to consider in order to form a tax filing basis in respect of their profits. We highlight some of the more salient issues for persons who are carrying on a crypto business.

ICOs

Hong Kong based technology firms who have issued utility tokens by way of ICO through offshore structures will not be able to treat token issuance proceeds as non-taxable simply because the token issuing company is established outside of Hong Kong.

If Hong Kong based teams have a general authority to enter into contracts on behalf of the offshore token issuing company, that company should generally be regarded as carrying on business in Hong Kong for profits tax purposes, and as such a profits tax return should be filed.

If the provision of goods or services which attach to the utility tokens are done in Hong Kong, the profits from the ICO will be Hong Kong sourced and taxable in Hong Kong. On the other hand, if services are rendered from outside Hong Kong, or contracts for the purchase and sale of good are affected from outside Hong Kong, a portion or all profits may be treated as non-Hong Kong sourced.

Assuming profits from the ICO proceeds are taxable in Hong Kong, the accounting treatment will significantly influence how the proceeds are ultimately brought to tax in Hong Kong. The amount of the taxable profit for each year of income will depend on the period over which the ICO proceeds are brought to the P&L, and to what extent offsetting tax deductions may be claimed for expenditure incurred.

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If tax deductible expenditure (including expenditure on computer hardware and software) is incurred over a similar time period as the revenue is recognised in the P&L, there may ultimately be very little net tax charge in Hong Kong.

The IRD's comments on security tokens that represent ownership interests in the token issuer are clear, namely, that consideration received for the issuance of such interests should be non-taxable capital receipts. This is consistent with how ordinary share issuances are taxed. However, the DIPN does not address security type tokens which legally do not constitute shares or debt in a company but may be akin, to say, a total return swap. In such cases, the terms and conditions of these tokens and their accounting treatment to the issuer will need to be carefully considered.

Sale of crypto

DIPN 39 does not specifically address how ICO issuers who receive crypto as consideration for issuing tokens under an ICO, or indeed other taxpayers who purchase and resell crypto at a gain, should treat gains and losses on the eventual sale of the crypto received.

If the crypto is said to have been received by the issuer of tokens for the provision of goods or services, case law would suggest that the character of such gains should generally remain 'revenue' in nature if there has not been a separate application of the funds for an investment purpose; although where the crypto is no longer needed in the business and there is no intention to trade the crypto speculatively, there may equally be grounds to treat any gains as non-taxable capital gains. Ultimately the facts and circumstances for each taxpayer will need to be considered on their merits.

If the crypto is not considered to be held on capital account, any gain on eventual sale will only be taxable if the gains are Hong Kong sourced. This is not only relevant for ICO issuers but all taxpayers who purchase and sell crypto, but all owners of crypto who trade for their own account.

For taxpayers carrying on a crypto basis more broadly, the DIPN provides little guidance other than to say the question of whether such profits are Hong Kong sourced is a question of fact.

If the crypto exchange is located outside Hong Kong, a crypto participant may possibly look to treat the gain as non-Hong Kong sourced and therefore non-taxable in Hong Kong – similar to the IRD guidance on source of gains from trading is listed securities. Following the ING Barings and Hang Seng Bank profits tax cases, crypto trades that are effected through overseas brokers would help support a non-Hong Kong source treatment. Although those cases dealt with securities, there should be no reason why the principles in them could not similarly apply to commodities, including crypto such as ETH or even tokens more broadly.

However, the facts surrounding crypto exchanges are unique in so far as they are typically situated in a low tax jurisdiction, albeit increasingly with local regulations governing their operation, but whereby software developers effectively operate the exchange from anywhere in the world through software situated in the "cloud".

Taxpayers should therefore not assume that the IRD will automatically agree to taxpayers taking a similar line for crypto trades. Again, each case will need to be considered on its own facts, and where for instance the assets, risks and functions of a matching crypto exchange platform are situated in a single properly regulated jurisdiction, then location of the exchange may be a supportable basis for determining source.

If the location of the where the exchange is registered cannot be used as a basis for determining source of profit, or where the shares are not traded through a crypto exchange, for instance where purchases and sale of tokenized shares take place bilaterally between buyers and sellers by contracting over a messaging platform, the source of the gain would, in the absence of facts to support otherwise, generally be the place the investor undertakes his business. If a Hong Kong investor undertakes all activities relating to the acquisition and disposal of the shares in Hong Kong, in the absence of additional facts gains in such instances would more likely be Hong Kong sourced.

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Ultimately, it should only be realised profits recognised in the P&L under generally accepted accounting principles. Whilst DIPN 39 does not address this, Hong Kong case law is clear that unrealised profits are not profits for tax purposes.

Asset management

The issues outlined above relating to carrying on business and source of gains on sale of crypto will be equally relevant to crypto funds who may have structured their investments through offshore investment vehicle. Where crypto funds have an investment advisor situated in Hong Kong with a discretion to execute trades, the activities of the investment advisor in Hong Kong will generally cause the offshore funds to be regarded as carrying on business in Hong Kong and taxable in respect of its Hong Kong sourced profits.

For exemption from profits tax under the Unified Fund Exemption (UFE) regime, only qualifying transactions are exempt, and in this respect, transactions in utility tokens or payment tokens are not qualifying transactions. Therefore, the general principles on carrying on business and source of profits in Hong Kong outlined above should equally apply to profits of offshore fund investment vehicles.

Crypto exchanges with trading or investment arms will similarly need to be mindful how they structure their activities, and whether the crypto they deal with is crypto they hold on their own account or for the account of others.

Separate dealings of digital assets may be considered disposals for profits tax purposes, and differences in the market values of such assets on transacting may crystallise unintended gains and losses, depending on the type of transaction. It will therefore be important to properly identify in what capacity the digital assets are held both legally and beneficially (since this will determine who the profits belong to); the nature of the transactions (e.g., trading or lending of digital assets); and that the intended transactions are consistent with contractual arrangements with clients and counter-parties.

Employee remuneration

Crypto may be used an effective salary packaging arrangement. Similar to employee shares, where crypto is granted to employees and they are taxed on the upfront value of the crypto, any further upside in the value of the crypto should generally be tax free in the hands of employees when they eventually sell the crypto in their personal capacity.

A trend observed in Hong Kong

The clarification of the IRD is very welcomed by the growing Digital Asset and FinTech community in Hong Kong, and will help Hong Kong continue to grow as a centre for institutionalised Digital Asset investors and service providers, e.g. Exchanges and custodians.

Since autumn 2019, the SFC in Hong Kong has issued two important guidelines: Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets (link here) and a position paper on the Regulation of virtual asset trading platforms (link here).

As a result of this regulatory clarification there has been a strong interest from major digital asset service providers and exchanges to pursue asset management and automatic trading licenses in Hong Kong. The application processes for these licenses are ongoing and we should see a first batch of regulated service providers in the second half of 2020. It is no surprise that one of the SFCs conditions for licensed corporation is that entities comply with local and international tax laws which makes DIPN 39 timely in its issuance.

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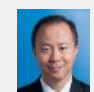

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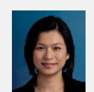

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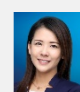

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