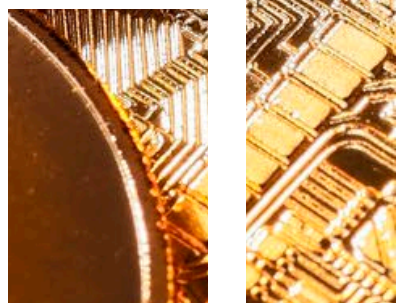





Hong Kong IRD issues guidance on cryptocurrency taxation



The background of the entire page is a collage of various cryptocurrencies. In the top left, there's a close-up of a Bitcoin. The top right shows a portion of an Ethereum coin with its characteristic four-lobed logo. The bottom half of the page is dominated by a close-up of several coins, including a Litecoin with its 'L' logo, an Ethereum with its four-lobed logo, and a Bitcoin with its 'B' logo. The coins are arranged in a way that they overlap, creating a sense of depth and abundance.

On 27 March 2020, the Inland Revenue Department (“IRD”) issued the revised Departmental Interpretation and Practice Notes (“DIPN”) No. 39 covering digital economy, electronic commerce and digital assets. The focus of this article is on the last of the three items.



Hong Kong has long since been a popular choice for doing business for its robust regulatory framework, abundance of capital and wealth of human capital. From a business perspective, its position as a global financial hub also grants it unrivalled advantages for fundraising and ammunition to incubate innovation. Hong Kong's low, simple and competitive tax regime complements these advantages, fostering the free flow of capital in every sense.

Within the market, it is encouraging to see that many substantial blockchain / digital asset projects have taken root in Hong Kong. While the absence of an indirect tax regime such as VAT or GST makes it easier for these companies to operate service platforms and exchanges without having to worry about transactional tax burden, there remains uncertainties on the corporate income tax rules (e.g. profits tax in Hong Kong) on the treatment of these business activities. The broad guidance set out by the DIPN¹ is welcomed as a step on the regulatory front to bolster Hong Kong's position in this industry. However, we also discuss some areas where more needs to be done in order to ensure that Hong Kong's existing tax laws do not tax digital assets unfavourably.

We now look at some of the key areas of clarity provided by the DIPN:

1. Categorisation of digital assets for Hong Kong tax purposes

According to the IRD, the profits tax treatment of digital tokens would depend on their nature and use. To this extent, the IRD provides three categories of digital asset and sets out how these would be classified for tax purposes.

- a. **Payment tokens** are used as a means of payment for goods or services and encompass cryptocurrencies (e.g. Bitcoin). They do not provide the holder with any rights or access to goods or services. Such tokens are not legal tender in Hong Kong but **are regarded as virtual commodities**.
- b. **Security tokens** provide the holder with particular interests and rights in a business. They represent **ownership interests in the business, a debt due by the business or entitlement to a share of profits in the business**. Where digital tokens constitute "securities" as defined in the Securities and Futures Ordinance, then the IRD confirms that the existing provisions in the Inland Revenue Ordinance that relate to securities and collective investment schemes would also be applied to the taxation of such digital tokens where relevant.
- c. **Utility tokens** provide the holder with access to particular goods or services which are typically provided using a blockchain platform. The token issuer would normally commit to accepting the tokens as **payment for the particular goods or services**.

¹ DIPNs set out the IRD's views and assessing practice and have no legal binding force.

2. Initial coin offerings (“ICOs”)

Whilst ICOs have all but vanished after reaching their peak in 2018, in Hong Kong new companies normally do not file tax returns until 18 months after commencement of business (or earlier if they derive taxable profits in their first accounting period), and hence it is about time when the IRD starts reviewing the tax returns filed by companies having done ICOs. The guidance clearly states that the IRD will review the white paper or any other underlying documents of an ICO and examine what **rights and benefits** are attached to the digital tokens. From the perspective of the issuer, the tax treatment of the proceeds from an ICO generally follows from the attributes of the tokens that are issued. It is the nature of the rights and obligations of the tokens, not the form in which the tokens are issued, that determine the tax treatment. For example:

- a. Proceeds from the offering of **securities tokens** which give token holders shareholders' rights would be **capital in nature** (and accordingly should not be taxable).
- b. Proceeds from the offering of **utility tokens** which give token holders a right to future benefits would be viewed as a prepayment for future goods or services and would be **taxable if sourced in Hong Kong**. The **timing of revenue recognition** would depend on the details of the issuer's performance obligations, determined in line with generally accepted accounting principles.

3. Digital assets held for investment

If digital assets are bought (e.g. through an ICO or exchange platform) for long-term investment purposes, any profits from disposal would be capital in nature and not be chargeable to profits tax. In determining whether the digital assets are **capital assets or trading stock**, the usual approach would be adopted – i.e. regard would be had to the facts and circumstances, applying well-established tax principles like the “badges of trade”.

4. Cryptocurrency business

The DIPN sets out the common business activities involving cryptocurrency to include the trading of cryptocurrency, exchange of cryptocurrency and mining. The extent to which these activities amount to the carrying on of a trade or business is a matter of fact and degree to be determined upon a consideration of all the circumstances. Factors such as the degree and frequency of the activity, the level of system or organisation (i.e. whether the activity is undertaken in a business-like manner) and whether the activity is done for the purpose of making a profit are relevant considerations.

Hong Kong sourced profits from a cryptocurrency business carried on in Hong Kong are chargeable to profits tax. The broad guiding principle (i.e. what were the person's operations which produced the relevant profits and where those operations took place) will be applied to determine the source of the profits. (Similar comments were made in the 2018 Annual Meeting between the IRD and the Hong Kong Institute of Certified Public Accountants, but unfortunately no further guidance is provided beyond these general comments in the DIPN.)

New cryptocurrencies received through certain events such as airdrops and blockchain forks in the course of a cryptocurrency business are to be regarded as business receipts of the business and assessed accordingly.

5. Cryptocurrency used for business transactions

Transactions involving cryptocurrencies should be accrued based on the prevailing market value as of the date of transaction.

6. Cryptocurrency received as employment income

The same salaries tax treatment would apply to remuneration in cryptocurrency received by employees, and the amount to be reported should be the market value of the cryptocurrency at the time of accrual. (Readers are reminded that both employers and employees have reporting obligations.)



Areas requiring further guidance

Whilst the DIPN has covered many common issues encountered by cryptocurrency industry players and the IRD's views are largely in line with our views, there are some issues where uncertainty remains. Furthermore, there are a number of areas of Hong Kong tax law where special concessions, or specific tax treatments, are available to certain kinds of businesses, but only when those businesses are entering into transactions in securities. In many cases these concessions have been provided to ensure that Hong Kong's financial services sector remains competitive from a tax perspective. However, even though many digital assets are marketable and can be traded on exchanges, they often do not meet the definition of a security. If the same concessions are not available to businesses performing fundamentally similar activities, but trading in digital assets, then Hong Kong risks seeing these businesses move to other jurisdictions.

We highlight a number of areas where we feel that further guidance, or if necessary legislative change, is needed to ensure that businesses trading digital assets are taxed in ways that are consistent with currently established practice relating to the trading of more traditional financial assets:

1. Treatment of unrealised gains/losses

The DIPN has not touched on the treatment of fair value gains and losses that may arise from the year-end revaluation of the digital assets used for the purposes of carrying on a cryptocurrency business.

Our view is that the treatment should depend on the nature of the digital assets (whether capital or revenue), and to the extent that they are revenue in nature, it would appear that the principles in the *Nice Cheer* case² should generally be followed unless the provisions under the Inland Revenue (Amendment) (No. 2) Ordinance 2019, which allow taxpayers to elect to be taxed on a fair value basis in respect of financial instruments accounted for in accordance with Hong Kong Financial Reporting Standard ("HKFRS") 9 / International Financial Reporting Standard ("IFRS") 9, apply. However, since not all digital assets are accounted for in accordance with HKFRS 9 / IFRS 9, the IRD may consider providing a concession or making legislative changes to allow for such an election in the case of digital assets that are trading stock.

² The judgment of the Court of Final Appeal in *Nice Cheer Investment Limited v CIR* established that unrealised gains from the increase in value of trading stock – marketable securities in this particular case – are not chargeable to tax at the time they are accounted for, but should instead be taxed at the time of realisation. Whilst it is not clear whether the principle has wider application to other types of trading stock beyond marketable securities, there does not appear to be such a restriction.

2. Availability of profits tax exemption for qualifying investment funds

The Unified Fund Exemption regime, enacted in 2019, provides that all privately offered onshore and offshore investment funds operating in Hong Kong, regardless of their structure, size or the purpose that they serve, can enjoy a profits tax exemption for their transactions in qualifying assets subject to meeting certain conditions. Qualifying assets broadly cover securities and other types of financial products. As digital assets that are not securities would not be qualifying assets, crypto funds investing in such digital assets will not be able to enjoy the tax exemption.

The government may wish to consider whether from a policy perspective the regime can be extended to allow crypto investment funds to benefit from it, especially given that the SFC recently introduced a new regulatory regime covering crypto fund managers.

3. Potential adverse tax implication associated with crypto borrowing and lending transactions

Similar to traditional financial institutions which may engage in regular securities borrowing and lending transactions, players in the cryptocurrency industry may engage in the borrowing and lending of digital assets, or commonly referred to as “crypto borrowing and lending”.

In a separate DIPN, the IRD has indicated that it will look at the legal form rather than the underlying economic substance or accounting treatment as a starting point to determine the nature of a given financial instrument. Given that a crypto lending transaction may constitute a change in legal title, there is a risk that it would be regarded as a disposal by the lender and acquisition by the borrower of the coin, in which case the realised gain / loss could be included as the lender’s taxable profits.

While the Inland Revenue Ordinance contains specific provisions to provide relief for securities borrowing and lending transactions, such relief may not be applicable to crypto borrowing and lending transactions that do not fall within the ambit of the provisions. The IRD may consider extending the relief to cover these transactions.

As blockchain and the associated business models are still relatively new arenas, there will certainly be more tax questions arising from different scenarios – for instance, how should the source of profits be determined in cryptocurrency mining through proof of work vs. proof of stake, or more broadly in the context of smart contracts that are executed autonomously on a blockchain? How can permanent establishment risks be managed? How to determine the value of digital assets that are not widely traded for tax purposes? Would the transfer of certain types of digital assets give rise to stamp duty? What actions are needed from a Common Reporting Standard perspective?

All these and many other issues will need to be addressed by companies operating in this sector, as the industry evolves.

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