Analysis

Tax implications for fintech

Speed read

While P2P lending and crowdfunding are already well established, the full range of blockchain's practical uses have yet to be explored. Blockchain, a decentralised digital ledger technology, will affect the legal, regulatory and tax environment in which fintech players operate. With the exception of certain tax rules affecting IP and R&D, any tax consequences are likely to flow from the actual transaction enabled by blockchain, rather than the technology itself, and these will only come into play once more practical uses have been established. Tax practitioners should therefore monitor practical uses for this technology as they develop.

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What is fintech?

'Fintech' bridges the gap between financial services and technology, and nowadays is generally understood to mean innovation in financial technology. While fintech is a global phenomenon, London is likely to be an important fintech hub in the medium to long term.

Recent fintech developments have led to much speculation about their impact on the business, regulatory and legal environment in which fintech start-ups and established financial institutions operate, with little mention of tax implications. Consequently, this article considers some high level UK tax implications for three important fintech developments, namely P2P lending, crowdfunding and blockchain.

Peer-to-peer loans and crowdfunding

Although peer-to-peer (P2P) lending and crowdfunding have been around for the past ten years or so, they have gained considerable traction in the last five years, to the point where they have now become relatively mainstream forms of financing for small businesses. Crowdfunding allows investors to invest in one or more asset classes (including equities) by placing a series of small 'bets' (investments of, say, £10) on one or more companies. P2P lending platforms are intermediaries that connect investors with one or more individual or small business borrowers, thus enabling them to spread the credit risk. Certain UK taxes have recently begun to recognise and adapt to the needs of P2P lending, notably withholding and income taxes.

Withholding and income taxes

It is common for P2P platforms to allow each lender to receive interest from a number of different borrowers; and each borrower to pay interest to a number of different lenders. This type of 'many-to-many' lending model makes the current withholding tax treatment of P2P loan interest inconsistent and unnecessarily complex, since some P2P loan interest payments may constitute 'yearly interest' within the meaning of ITA 2007 s 874, while others may not. To resolve this issue, draft Finance Bill 2017 Sch 4 contains a new exemption from withholding tax for P2P loan interest paid on or after 6 April 2017. In the meantime, *Revenue & Customs Brief 2/2016*, published on 8 January 2016, sets out HMRC's view that P2P loan interest payments made in the run-up to this new exemption may be made without withholding tax, provided that the P2P platform is authorised by the Financial Conduct Authority.

FA 2016 also introduced a form of 'bad debt' relief for income tax purposes in respect of P2P loans which have become irrecoverable on or after 6 April 2015, the relief being equal to the principal sum originally lent less any principal repayments already received (ITA 2007 s 412A).

Investors in equity-based crowdfunding may benefit from income tax relief under the enterprise investment scheme (EIS) or the seed enterprise investment scheme (SEIS), provided that the requisite criteria are met. These criteria are applied strictly, and should continue to be met throughout the relevant investment period (as referred to in ITA 2007 ss 159 and 257AC) in order to prevent a later withdrawal of relief under ITA 2007 Part 5 Ch 7 (in the case of EIS) or ITA 2007 Part 5A Ch 7 (in the case of SEIS) in certain circumstances.

VAT

Under *Kretztechnik* principles (*Kretztechnik AG v Finanzamt Linz* (Case C-465/03)), issues of new shares, bonds or other financial instruments via a crowdfunding platform (such as Crowdcube) should be treated as non-supplies for VAT purposes where the purpose of the issue is to raise capital for the issuer's business (see *Business Brief 21/2005*). The business should also be able to recover any VAT on related issue costs (such as advisory fees), assuming it is registered for VAT and entitled to recover fully any VAT it incurs. The crowdfunding platform will also be providing its own services to the business, the supply of which will need to be analysed carefully in order to determine the correct VAT treatment.

Reward-based crowdfunding is viewed as a supply of (potentially VATable) services by the company (namely, the supply of the reward or benefit) in exchange for a cash contribution.

Blockchain or distributed ledger technology

Readers will be familiar with bitcoin, a digital currency invented in 2009. The blockchain technology underpinning bitcoin, also known as 'distributed ledger technology' (DLT), may potentially have a wide range of practical uses beyond bitcoin, particularly for the financial services sector.

What is blockchain/DLT and how does it work?

DLT is a digital record of transactions that can be updated instantaneously across a network of participating computers with new information each time a new transaction occurs. The record may be over a public or 'permissioned' network. A blockchain is a technical component of a distributed ledger, and refers to a chain

of transactions that reside within a ledger. A transaction, such as a money transfer from A to B, is represented online as a 'block' of encrypted data. Each block is bound together chronologically into a 'chain' using complex algorithms. The block is then broadcast to all computers on the network, which then need to validate the transaction before the 'block' can be added to the 'chain' of previous transactions, thus allowing the money to move from A to B.

Aside from speed, efficiency and transparency, DLT is also said to have a number of other benefits. For example, the fact that multiple copies of the same database are distributed over a network and can be viewed in real time means that any unauthorised tampering or fraud can be easily detected, thus making it more secure and less prone to cyber-attacks. In addition, the in-built digital consensus requirement for all network participants removes the need for a 'middle man', a role traditionally played by banks and central counterparties.

Practical uses for blockchain

Blockchain may be used to record and validate any transaction that involves an exchange of something valuable (including cash, securities, real property or IP) or as a means of sharing data between permissioned network members. Some practical uses for DLT include securities trading and 'smart' contracts (essentially, computer programs supported by DLT that allow automatic execution of a contract once certain pre-programmed conditions are satisfied). The UK Government Office for Science also sees its potential for specific tax-related purposes, such as reducing the EU's VAT shortfall, reducing tax fraud and distributing welfare benefits to those who might otherwise face barriers to financial inclusion (see the report *Distributed ledger technology: beyond blockchain* at www.bit.ly/1WreVPL).

Tax implications

So what tax implications do blockchain and its practical uses entail? At the moment, this is a difficult question to answer, primarily because many practical uses for blockchain are still in the experimental stages. In addition to the technology itself, governance frameworks and other legal and regulatory issues will need to be considered before DLT can be implemented successfully, and it is only after this has occurred that all of the tax issues may become clear. At that point, one would expect any tax consequences to flow from the nature of the actual transaction, rather than the blockchain technology itself that enables it. However, because blockchain may involve a multi-jurisdictional network and the technology itself does not have any physical location, questions may arise as to where the taxable activity is taking place or where the value is being created – a difficulty recognised in particular by the BEPS actions on transfer pricing (Actions 8–10) and permanent establishments (Action 7). Blockchain-based transactions may also challenge other traditional tax constructs such as source and residence.

VAT and IP-related taxes may be relevant for the technology itself in certain circumstances. For example, a fintech start-up provider of blockchain platforms may need to charge VAT on any services it supplies in licensing the technology. Any IP it creates or acquires through developing the technology may also generate royalty income, and any expenditure incurred on such IP will be amortised year on year, both of which may fall to be taxed on an accounts basis under CTA 2009 Part 8. Also, if the blockchain technology is protected by a patent, the patent box rules under CTA 2010 Part 8A (as amended by FA 2016 s 64) will need to be considered. Such providers may also be able to claim enhanced R&D deductions and related R&D tax credits under the SME Scheme in CTA 2009 Part 13 Ch 2 if the start-up incurs R&D expenditure on developing the technology and makes a loss in doing so.

Should a financial institution decide to implement blockchain, it will need to weigh the cost of implementation against the anticipated savings to be made from its use. Any implementation costs will need to factor in any irrecoverable input VAT costs, as well as any royalty payments it makes to a fintech start-up; for example, if a fintech start-up licenses the blockchain technology to the financial institution, which in turn may attract withholding tax. If a withholding tax applies, the financial institution will also need to factor in any gross-up for such withholding tax if the relevant licensing agreement includes a gross-up clause. The withholding tax regime for royalties underwent significant changes in FA 2016, the effect of which was to impose UK withholding tax on nearly all royalty and other similar IP-related payments to overseas persons where the payer is within the charge to UK income tax or corporation tax.

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Other possibilities?

Because DLT is already known to work for securities trading, traditional clearing houses and settlement systems such as CREST could become obsolete if the London Stock Exchange (LSE) decides to use it, meaning that stamp duty reserve tax on LSE transactions would need to be collected by some means other than through CREST. Some reports have suggested that governments could use DLT to collect certain taxes.

What next?

While P2P lending, crowdfunding and their tax treatment are relatively well established, practical uses for blockchain are still in early stages. Consequently, tax practitioners should monitor new developments in practical uses for this technology, particularly since blockchain and smart contracts may have a role to play going forward in the collection and reporting of certain taxes, and possibly also in the transmission of taxpayer data. With the exception of certain tax rules affecting IP and R&D, any tax consequences are likely to flow from the actual transaction enabled by blockchain rather than the technology itself, and these will only come into play once more practical uses have been established. ■

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- HMRC issues guidance on bitcoin (6.3.14)