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SM Treasury Exchange

A CRYPTOASSETS PRIMER FOR CORPORATE TREASURERS

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Jargon busting: as easy as C-B-D-C

Cryptoasset / a digital representation of value or contractual rights that can be transferred, stored or traded electronically, and which makes use of cryptography and distributed ledger technology. A broad church, cryptoassets can be put to a number of different uses including acting as a means of payment or investment, a means of obtaining access to a product or service, or a means of imparting rights and obligations on holders (much like shares or debt instruments).

Cryptocurrency / a colloquial term used to refer to cryptoassets that are intended to be used as a method of payment, like bitcoin or ether.

Stablecoin / cryptocurrencies that seek to peg their value to a currency or asset. Typically, this is done by reference to fiat currency.

Central Bank Digital Currency (CBDC) / a digital form of central bank money which could make use of distributed ledger technology.

Non-Fungible Token (NFT) / a unique, tradeable, immutable cryptoasset commonly linked to a specified physical or, more frequently, digital asset. They are often used to record ownership, and/or validate authenticity, of the relevant associated asset.

Smart Contracts / computer code deployed on a distributed ledger (or other type of network) which is self-executing. This means that the code will provide outputs and effect outcomes in accordance with pre-specified functions, without the need for human intervention.

Distributed ledger technology (DLT) enables a distributed network of participants to share and synchronise a database which can be trusted and relied upon, without the need for one or more central administrators.

Blockchain is a type of distributed ledger.

Cryptoassets and the treasury

Cryptoassets have been touted as a way of hedging against inflation and boosting yield, offering a means of diversifying corporate investments in a challenging economic environment. There have been some widely publicised examples of corporates around the world investing in or purchasing cryptoassets, but they remain relatively few. The recent collapse in cryptoasset valuations (a so-called 'crypto winter') may have dampened enthusiasm for the topic. To a longer timetable, however, debate is ongoing as to whether cryptocurrencies could debase, or even replace, fiat currencies.

Beyond discussion of strategic treasury policies, corporate treasury teams may need to have a basic understanding of the possible uses of cryptoassets, the market environment and the regulatory framework, as well as how cryptoassets are treated for tax purposes. The key points are outlined below.

Founded in 1989, MicroStrategy Inc is a business intelligence software company. MicroStrategy has invested heavily in bitcoin since 2020, adopting bitcoin as its **primary treasury reserve asset** in order to **hedge against monetary inflation**. With bitcoin acquisition now forming an integral part of its corporate strategy, it has been **reported** that the value of MicroStrategy's bitcoin holdings is equal to more than half of its market capitalisation.

Hot on the heels of a 'crypto winter' in 2022, MicroStrategy reported a near **$1bn impairment charge** this year on account of its bitcoin strategy. In spite of this, MicroStrategy **remains focused** on buying bitcoin.

How might cryptoassets cross a treasurer's desk?

Possible scenarios include the following:

- **Payments**: the business may be considering whether to accept payment for goods or services in cryptocurrency.
- **Payments again, but faster**: DLT could contribute to faster, cheaper and more efficient payments, with implications for working capital and credit risk.
- **Ransomware attacks**: ransomware payment demands may be made in cryptocurrency.
- **NFT issuance**: the business may be considering whether to issue NFTs. A number of corporates have done so, although typically only for marketing purposes.
- **Digital security issuance**: there is a possibility, driven by the twin forces of automation and disintermediation, that securities could be issued and transferred on the blockchain to benefit from reduced settlement times, lower transaction costs and enhanced transparency. The UK Jurisdiction Taskforce has recently consulted on the ways in which English law can support the issue and transfer of equity or debt securities on blockchain and other DLT-based systems.
- **Syndicated loans**: efficiencies could be introduced into the syndicated lending process by DLT and smart contracts, particularly in the areas of settlement, loan servicing and trading participations. Cost savings arising from these efficiencies could be passed on to borrowers.

Market environment and the long term picture

2022 ushered in a so-called 'crypto-winter', a widespread collapse of cryptoasset valuations. Popular stablecoin TerraUSD (which had a market capitalisation of around $18bn) crumbled, bitcoin lost 70% of its value as compared with November 2021, and several high-profile cryptoasset companies were pushed into bankruptcy. In August 2022, it was **reported** that the crypto market's value had fallen by more than $1.2tn so far this year.

Regulators responded by **underscoring** the importance of regulation where cryptoasset technologies are used in finance. Emphasis has been placed on the need to ensure that technological innovation can flourish, but not at the expense of financial stability and consumer protection. Reflecting an increasingly proactive regulatory approach, stablecoins and cryptoasset promotions have already been brought within UK regulation, and further proposals regarding the expansion of the regulatory perimeter are expected later in 2022 and in 2023. A recent Treasury Select Committee **inquiry** into cryptoassets signals that, in spite of the crypto winter, cryptoassets will continue to be a topic for discussion.

Casting further into the future, the Bank of England has produced some **commentary** on how new forms of digital money (stablecoins and CBDC) could affect the cost and availability of borrowing from banks. It suggests that should customer deposits with banks migrate to these new forms of digital money, banks may attempt to restore their liquidity positions (and their ability to continue lending) by issuing long-term wholesale debt. As this is more costly than deposit funding, the Bank of England observes that overall funding costs for banks could rise, resulting in an increase in interest rates on new bank lending. This may be some time into the future, but is an interesting angle that may ultimately affect corporate treasury operations.

Before that future can arrive, the environmental and climate footprint of cryptoassets will need to be reckoned with. The high energy consumption of the proof-of-work (PoW) consensus mechanism that currently underpins some blockchain ledgers (including Bitcoin) has drawn increasing attention from governments, regulators and stakeholders, particularly against a backdrop of rising energy prices. The proof-of-stake (PoS) consensus mechanism presents an energy efficient alternative, and Ethereum (a preeminent blockchain platform) recently transitioned from PoW to PoS in in an upgrade referred to as '**The Merge**'. Ethereum has announced that The Merge will reduce its energy consumption by ~99.95%.

Are cryptoassets regulated?

Cryptoassets have attracted regulatory attention around the world, with the US, UK, EU, Japan and Singapore, among others, developing regulatory frameworks to encourage innovation and bring cryptoassets 'out of the shadows'. These regulatory frameworks also seek to mitigate the potential risks that cryptoassets pose to financial stability and consumers. Here in the UK there are a number of touchpoints at which cryptoassets could come within the regulatory perimeter and, crucially, these rely on different definitions of 'cryptoasset'.

Holding, transferring and issuing cryptoassets may constitute a regulated activity depending on how the cryptoasset is classified—that is, whether it is a security, e-money, a 'digital settlement asset' (a new regulated category which will capture certain kinds of stablecoin), or other kind of cryptoasset. In addition, the promotion of qualifying cryptoassets is to be prohibited in the absence of authorisation or approval of the promotion from an authorised person.

The fifth Money Laundering Directive, which came into force in January 2020 and has been implemented in the UK, brought virtual currency exchange platforms and custodian wallet providers (which provide services to safeguard customers' private cryptographic keys) within the scope of anti-money laundering regulation. Notably, this expansion hauls along with it an FCA registration requirement. Corporate treasury functions could be captured if, for example, they exchange money for cryptoassets, or one type of cryptoasset for another. Treasurers may also need to take account of the so-called 'travel rule', which from September 2023 places information sharing requirements on certain cryptoasset transfers.

Finally, ransomware payments made in cryptocurrency could engage regulations made under the Sanctions and Anti-Money Laundering Act 2018 and other UK sanctions legislation, as well as the Terrorism Act 2000.

How are cryptoassets taxed?

For direct taxation purposes, cryptoassets (including cryptocurrencies) are generally regarded by HMRC as capital assets that are subject to the capital gains tax regime. Therefore, subject to various exemptions and deductions, when a cryptoasset is disposed of (including where it is used to purchase something, where it is sold for a fiat currency or where it is exchanged for another cryptoasset), any increase in value (by reference to Pounds Sterling) over the period that the asset was held, will be a capital gain on which the person or entity disposing of the cryptoasset will be chargeable to tax. Any loss of value over that period will be a capital loss which may be capable of being used to off-set other taxable capital gains the person or entity may have.

For VAT, the position adopted by HMRC is that the exchange of a cryptocurrency for a fiat currency is a transaction that is exempt from VAT (as are financial services provided by a cryptocurrency exchange in facilitating the exchange of a cryptocurrency for a fiat currency or another cryptocurrency). Where a cryptocurrency is used to pay for goods and services, VAT will still be chargeable in the normal way on the supply of those goods or services, but will not be due on the supply of the cryptocurrency itself. Where cryptoassets which are not a cryptocurrency are used to pay for goods and services, the VAT treatment will depend on the nature of the cryptoasset concerned.

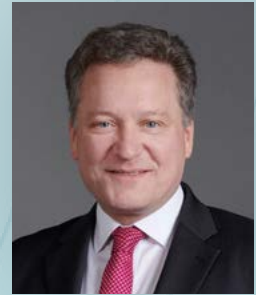
If the cryptoasset activities of a person or business amount to taxable trading, any trading profits will be taxable as income. Transactions involving cryptocurrencies that are undertaken by businesses may, depending on the activity being undertaken, attract further taxes such as PAYE, National Insurance contributions and Stamp Taxes (for example, if an employee is paid in exchange tokens, this will normally give rise to the same PAYE/national insurance obligations as a cash payment).

The international perspective

The ability to use cryptoassets varies widely by jurisdiction, meaning that the geographical reach of a business and its customer base will have a bearing on pressures to engage with cryptoassets.

For example, in China all activities related to cryptocurrencies are illegal, and this ban includes offshore exchanges providing services to Chinese citizens. In Russia, cryptocurrencies and other cryptoassets like NFTs cannot be used as a means of payment for goods and services. Meanwhile, the Reserve Bank of India has signalled that it would like to see cryptocurrencies prohibited in India. At the other end of the spectrum, bitcoin has been legal tender in El Salvador for the past year, although reports suggest that adoption has been slow. Between these two poles, jurisdictions including the US, Japan and Singapore, as well as the EU, are developing robust regulatory frameworks which may affect the proliferation of cryptoasset activities in those territories.

Contacts



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