22 June 2023

Alex Bosinceanu
HM Revenue and Customs ("**HMRC**")

Re: Open Consultation: The Taxation of Decentralised Finance (DeFi) Involving the Lending and Staking of Cryptoassets (the "Consultation")

Dear Alex:

The DeFi Education Fund (DEF) thanks you for the opportunity to provide our response and submission on the Consultation. There clearly has been significant thought put into your consultation process, and we applaud your openness to prior market commentary. We also greatly appreciate HMRC's efforts to create a new framework that is tailored to digital assets, rather than forcing new technology into old (and ill-fitting) laws.

By way of background, DEF is a non-partisan research and advocacy group, and our mission is to educate lawmakers about the benefits of decentralized finance (DeFi), achieve regulatory clarity for the future of the global digital economy, and advocate for individual users and developers in the DeFi space. DEF is not a trade association and does not represent the interests of any specific parties.

DeFi has immense potential to advance innovation in the world economy, but that potential can only be realised with a foundation of smart policy. We assist regulators and policymakers with technical understanding and advocate for smart approaches that allow society to enjoy the benefits of innovation in DeFi.

We are of the view that any changes to the tax regime that implicate digital assets must:

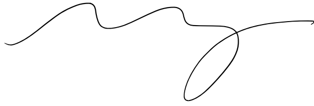
(i) align with the underlying economic substance of a typical DeFi transaction; and
(ii) exhibit utmost clarity and simplicity to promote tax compliance by minimising administrative burden on taxpayers; and
(iii) be flexible and comprehensive in its application to account for future innovation; and
(iv) describe arrangements and associated tax obligations using standard market terminology.

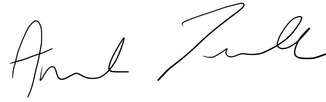
We have noted with appreciation HMRC's progress in developing a tax regime tailored for DeFi transactions, in pursuit of the above objectives. In particular, we are in support of Option 2.

We partnered with Skadden, Arps, Slate, Meagher & Flom (UK) LLP to produce our responses to the Consultation. These responses are set out in Appendix 1. All terms not expressly defined in Appendix 1 have the meanings ascribed to them in the Consultation.

Should you wish to discuss, please do not hesitate to contact us at miller@defieducationfund.org.

Sincerely,





Miller Whitehouse-Levine
Chief Executive Officer

Amanda Tuminelli
Chief Legal Officer

Appendix 1

Question 1: Do you consider that the rules above are sufficiently wide to cover most DeFi lending and staking models available in the market? If not, please provide details of the models that would not be covered.

1. We have provided our comments on the scope of the proposed DeFi tax regime below by addressing limbs (a) to (d) below.

Limb (a) - there is an initial transfer of cryptoassets from one party (the lender) to another party (the borrower) and/or there is a transfer of cryptoassets through the use of a smart contract.

2. The use of the term "transfer" in the context of DeFi lending and liquidity providing does not fully encompass the scope of the activities the Consultation seeks to capture. We suggest expanding limb (a) to cover liquidity-providing arrangements where a liquidity provider makes tokens available (i.e., not a "transfer") via a smart contract.

3. Furthermore, the use of the terms "borrower" and "lender" is restrictive and does not capture the following arrangements:
   a. the "borrower" might be a smart contract, and therefore, limb (a) should also describe an arrangement in which cryptoassets are provided *to (i.e., incorporated within) a smart contract*; and
   b. the "borrower" may also simultaneously be the original lender. As demonstrated in paragraph 4 below, the use of the term "another party" may inadvertently exclude DeFi transactions involving collateralised debt positions ("**CDP**") from being within the scope of the proposed DeFi tax regime, even though they should be included.

4. For example, Maker protocol users can "loan" cryptoassets to a dedicated smart contract and simultaneously borrow another asset (e.g., DAI) against the "lent" cryptoassets on an over-collateralised basis.[1] Unless HMRC considers the dedicated smart contract to be "another party" for the purposes of limb (a), then a significant majority of DeFi transactions wopuld fall outside of the proposed DeFi tax regime. We recommend including smart contracts in the definition of "another party."

5. Based on the above, we propose the following changes (in red) to limb (a) to align it with the market's understanding of DeFi lending and staking:

   there is an initial transfer, provision or deposit of cryptoassets from one party ~~(the lender)~~ to another party ~~(the borrower)~~ and/or there is a transfer, provision or deposit of cryptoassets through the use of or to a smart contract.

   For the purposes of this limb (a),
   (i) "an initial transfer, provision or deposit" may also include the collaterisation of cryptoassets
   (ii) "another party" may include smart contracts.

[1] For example, a user can "lend" $150 worth of ETH and simultaneously "borrow" or "receive" $100 worth of DAI.

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Limb (b) - the borrower has an obligation to return to the lender the borrowed tokens and/or the smart contract allows the lender to withdraw the tokens.

6. In some circumstances, the “borrower“ may not be obliged to return the “borrowed“ tokens, nor might a smart contract allow the “lender“ to withdraw their tokens. For example, in relation to a CDP where the value of the collateral falls below a certain threshold, the smart contract triggers a liquidation process, and the collateral is subsequently auctioned (see paragraph 42.c below). In these circumstances, the smart contract would not allow the “lender” to withdraw their tokens (the collateral).

7. Although discussed further in relation to limb (d), it is also unlikely that the “borrower” in liquidity providing arrangements will return to the “lender” the exact quantity of the same type of token.

Limb (c) - the tokens can be returned at the instigation of the lender, at the request of the borrower, or automatically at the end of a predetermined period.

8. We have no comments on limb (c).

Limb (d) the lender has the right to withdraw at least the same quantity of the same type of tokens that were originally lent or staked

9. As HMRC is already aware, limb (d) will likely exclude a number of “staking” (liquidity providing) arrangements that the market would expect to be treated as a DeFi transaction. This is discussed further in our response to Question 8.

10. We also discuss in our response to Question 4 that the “right” described here is not characterised as a legal right by the market.

11. Furthermore, additionally, we would like to provide clarification regarding the liquidity pool tokens (“**LP tokens**”) received when a user provides liquidity. It is important to note that these LP tokens generally do not directly represent a “provisioner’s“ economic interest in the tokens provided. Instead, they represent the “provisioner‘s“ proportionate share of the pool to which they initially provisioned tokens. Holders of LP tokens have exposure to the overall performance and value of the liquidity pool as a whole rather than having a direct claim on the underlying tokens.

Question 2: Do you consider that the rules above would give rise to any unintended consequences or significantly restrict the development of the DeFi lending and staking market? If so, please provide details.

12. Some DeFi transactions will be out of scope of limb (d) based on the proposed drafting because the “borrower“ or smart contract often does not return the same quantity of tokens that were originally “staked“ (i.e., provisioned) and therefore transactions involving multi-token “staking“ (i.e., provisioning) are likely to be out of scope. Because DeFi users often conduct these types of transactions, without amendments to limb (d), a large portion of DeFi transactions will not be within the Consultation’s proposed solution.

Question 3: Do you consider that the rules would be open to abuse?

13. We are unaware of specific circumstances where the proposed DeFi tax regime would be open to "abuse", but HMRC should clarify how they perceive such abuse could arise in order for us and other market participants to comment productively.

Question 4: Are the rights of the lender to receive the lent or staked tokens of a legal nature? Please respond to this question with reference to any specific DeFi models you have an involvement in, highlighting any legal uncertainties.

14. In relation to the proper characterisation of a "lender's" rights, it is essential to note that describing the "lender's" rights to receive the "lent" or "staked" tokens as being of a legal nature is not accurate. There are two key reasons for this:
    a. In a DeFi transaction, a user's "counterparty" is typically a smart contract, making it challenging to determine the legal relationship and identify parties who could defend against the "lender's" rights. Therefore, establishing a traditional legal framework for these relationships becomes complex and less straightforward as there is no "counterparty" with legal personality; and
    b. DeFi's foundational concept aims to create a financial infrastructure in which trust is established through software protocols rather than traditional legal relationships and mechanisms. A legal relationship is only required when trust in human discretion is required for the relationship to function—in traditional finance, consumers must trust intermediaries to issue transactions and, in the case of loans, borrowers to repay. On the other hand, DeFi is built on autonomous code (smart contracts) that functions without intermediation. Suggesting that such trust is established through legal means in DeFi would run counter to its fundamental innovation.

15. While we understand HMRC's interest in determining whether transactions in the DeFi space should have a condition or requirement of being legally binding, we believe that should not be their primary focus or demand. Although there is an argument against taxing transactions where no legal transfer of assets or creation/disposal of legal rights/obligations occurs, we expect that the desire to tax economic activity in DeFi should take precedence over technical concerns about legal characterisation. The nature of DeFi, both presently and as it evolves in the future, is centred around removing dependence on legal constructs to establish trust between parties. If HMRC only seeks to provide certainty in tax treatment when clearly enforceable legal rights are established, it would leave a significant portion of the market in a state of uncertainty and HMRC may risk hindering their ability for revenue collection from what would otherwise be recognised as revenue-generating activity.

16. In the majority of cases, the nature of rights arising from DeFi lending and staking arrangements may not align with traditional legal frameworks, and the rights involved, if any, are more nuanced and not easily categorised within established legal concepts. Therefore, HMRC should adopt a comprehensive approach that recognises the unique characteristics of DeFi transactions. This would ensure a fair and accurate assessment of the tax implications and treatment of wealth creation derived from DeFi transactions.

Question 5: Other than (i) the sale of rights during staking or lending and (ii) the borrower not being able to return staked or lent tokens, are there any other situations in which the lender may cease to hold the right to receive back the lent/staked tokens?

17. It may not always be clear when a “borrower“ becomes unable to return the “lent“ or “staked“ token and therefore, we recommend HMRC provide clear guidance to allow “lenders“ to identify, with certainty, when a disposal will arise under the new DeFi tax regime. If helpful, a user might perceive that the “borrower“ (or smart contract) is unable to return the “lent“ or “staked“ tokens when a public announcement is made that the funds in a liquidity pool are at risk due to a hack or bug.

Question 6: Do you favour a change in the rules to always treat the DeFi return as being of a revenue nature? What are the pros and cons?

18. Overall, we favour a change in the rules to treat the DeFi returns as being of a revenue nature by default.

Pros

19. Previous HMRC guidance placed the burden on taxpayers to determine whether DeFi returns should be treated as capital or revenue. By defaulting to treating DeFi returns as revenue, it would provide individual taxpayers with clarity regarding the tax classification of their DeFi returns.

20. A corporate taxpayer will generally be neutral on the revenue vs capital treatment of DeFi returns.

Cons

21. Treating DeFi returns as miscellaneous income may prevent individual taxpayers from offsetting their tax liabilities on DeFi returns using allowances available for dividends and interest income. However, we acknowledge the challenges of characterising DeFi returns as interest, dividends, or royalties due to the complexities related to ascertaining source and determining withholding tax obligations given the decentralised nature of DeFi “lending“ and “staking“.

22. Under the proposed DeFi tax regime, non-trading individual taxpayers who might otherwise receive a capital DeFi return will not benefit from the currently lower CGT rate.

Possible solutions

23. The legislation could specify that DeFi returns are treated as miscellaneous income by default. However, if certain requirements are met, such returns could be treated as capital for individuals and deferred for all taxpayers until the end of the contract or a return otherwise arises. These requirements could align with the principles outlined in HMRC guidance in CRYPTO61214.

24. HMRC should consider introducing a separate allowance similar to the personal allowance regime for interest income. This approach would alleviate the administrative burden for users engaging in low-volume transactions, equalise tax incentives (via allowances) between DeFi returns, interest, and dividends, and demonstrate the UK government’s commitment to maintaining its global position as a leading financial centre.

Question 7:

a) Do you agree that the proposed treatment of DeFi transactions has been applied correctly in each of Examples 1 to 5?

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25. While we generally endorse the proposed tax approach for DeFi transactions as outlined in Examples 1 to 5, we believe there is room for additional clarity.

26. Furthermore, it is crucial for HMRC to provide clarification on whether the proposed DeFi tax regime will apply to users who conduct a trade involving cryptoassets for UK tax purposes (distinct from individuals engaging in DeFi transactions as a form of investment). Specifically, it would be helpful to understand the following points:
    a. whether the initial "transfer" of tokens and the subsequent "return" of the tokens would continue to be disregarded transactions under the proposed DeFi tax regime; and
    b. whether the proceeds from a sale of the LP token or the "right" to the underlying tokens would still be taxable as income in the hands of a trader.

27. For clarity and any avoidance of doubt, it would be useful if HMRC could confirm that the following transactions will not attract any UK Value Added Tax, whether through the application of the financial services exemption or by other means:
    a. The initial supply of tokens to the borrower/liquidity pool;
    b. The supply of tokens as a DeFi return; and
    c. The sale of any LP tokens or "right" to the "lent" or "staked" tokens; and
    d. The subsequent "return" of tokens to the borrower or liquidity provider.

Example 1 – Transfer of a token to another party for a fixed return

28. With regards to the timing of when User A becomes liable for tax on the DeFi return, the Consultation provides guidance in Example 1, stating:

    The additional 0.3 T1 will be subject to tax as miscellaneous income at the market value at the time when it is paid.

    The above suggests that DeFi returns will be taxed on a cash basis and we seek HMRC's confirmation that the same approach will also apply to corporate taxpayers.

29. HMRC defines DeFi returns as "financial returns received by users of lending and staking services." In Example 1, the DeFi return is described as a "fixed return of 30% per annum," representing one type of financial return. However, it is important to note that DeFi returns are often variable in nature and rarely fixed.

Example 2: Transfer of a token to another party for a fixed DeFi return and receipt of a liquidity token

30. HMRC should make clear that the receipt of the LP tokens by User B will not be a taxable event.

31. HMRC should confirm that User B will be subject to tax on the DeFi return in this Example when the user takes possession of the DeFi return (as seen in Example 1). This will ensure that "lenders" participating in a DeFi "staking" or "lending" arrangement will not be at a disadvantage if the users do not or cannot take possession of the DeFi returns until a certain period has lapsed.

32. If the DeFi returns will be treated as miscellaneous income, HMRC should confirm that they will not look to apply any withholding tax regime that is typical for payments of interest, dividends, and royalties.

33. Our comments in paragraphs 28 to 29 also apply to this Example 2.

Example 3 – Sale of rights related to the lent or staked tokens

34. HMRC should confirm if the base cost of the aT3 tokens will be calculated by reference to the base cost of the underlying T3 token. In particular, we note that when User C sells the aT3 token, HMRC states in this Example 3 that "*the buyer is treated as having bought the corresponding T3 token*." Therefore, in our view, User C should also be treated as having disposed of the underlying T3 token.

35. On the basis that User C will be subject to tax on the DeFi returns received prior to the sale of the aT3 tokens, HMRC should also clarify whether the received DeFi return amount will be added to User C's T3 pool.

36. Similarly, HMRC should also confirm whether the DeFi returns received by the buyer during their period of ownership of the aT3 token will also be added to the buyer's T3 pool.

37. Our comments in paragraphs 28 to 33 also apply this Example 3.

Example 4 – Sale of rights related to the lent or staked tokens and accrued return

38. Similarly, HMRC should confirm whether the additional DeFi returns received by the buyer at the end of the staking term will also be added to the buyer's T4 pool.

Example 5 – Staking a token in exchange for a non-fungible token (NFT) — the NFT is fractionalised and part of the fractionalised NFT is sold

39. Given HMRC has stated that the taxation of the DeFi returns in this Example follows the same principles set out in Examples 4 and 5, please see our comments in paragraphs 34 to 38 above.

b) Do you foresee any practical difficulties applying the proposed treatment to situations similar to those in these examples?

40. Please see our response to Question 7.

c) Please provide any further examples of DeFi transactions that you think would be helpful, including an explanation of how the proposed tax treatment would apply.

41. As discussed in paragraph 29 above, DeFi returns are rarely fixed. The returns fluctuate based on supply and demand dynamics. Nonetheless, we propose that DeFi returns with varying rates should still be taxed as miscellaneous income.

42. Some protocols allow users to "borrow" against collateralised cryptoassets. As described in paragraph 6 above, where the value of the collateral falls below a specific threshold, a liquidation event is automatically triggered and the protocol liquidates the collateral (often through a collateral

auction) to cover the outstanding "debt". In our view, the new DeFi tax regime could apply to this type of transactions:

a. The act of collateralising cryptoassets should not be treated as a taxable event on the basis that there is no change in the economic ownership of the cryptoassets;
b. Any loan proceeds received as a result of the collateralised cryptoassets should not be taxable in the hands of the recipient; and
c. In the event that the value of the collateral falls below the collateralised ratio and the protocol or smart contract triggers the liquidation process through a collateral auction:[2]
    i. If the collateral is sold to another party during the auction, it is likely to be considered a disposal of the owner's economic ownership. As a result, any gains made from such a sale would be subject to capital gains tax.
    ii. Where the owner "purchases" their own collateral in the auction process, there are two possible arguments to suggest that the event should be treated tax neutral:
        1. The simplest argument suggests that since there is no change in economic ownership, no taxable event occurs; or
        2. Alternatively, the share matching rules outlined in Part 4, Chapter 1 of the Taxation of Chargeable Gains Act 1992 could apply. According to these rules, no gain would crystallise because the collateral is disposed of and acquired by the same person on the same day and in the same capacity.[3]

43. As an extension to Examples 3 and 4, it is common for users to continuously "stake" their LP tokens. Using Example 3, User C might choose to provide their four aT3 tokens (i.e., the LP tokens) to another liquidity pool and in exchange, the liquidity pool may issue LP tokens (say four bT3 tokens) and so on. We expect that the provision of the aT3 tokens to another liquidity pool would not alter User C's economic ownership of original T3 tokens and therefore, under the proposed DeFi tax regime, the provision of the aT3 token to the liquidity pool should be disregarded from CGT and should also be distinguished from a sale of the LP token.

44. Additionally, digital asset market participants can utilise protocols or, alternatively, businesses to "wrap" tokens, allowing assets to be used on various blockchains to which they are not native. For example, WBTC is a "wrapped" version of Bitcoin, meaning that WBTC is a token issued on the Ethereum blockchain that is backed one-to-one with BTC on the Bitcoin blockchain.[4] In our view, the "wrapping" of the Bitcoin described in this paragraph should also be within the scope of the proposed DeFi tax regime.

d) Please provide examples of any DeFi transactions where you consider it would be problematic to apply the proposed new rules, with an explanation. If you think a different treatment would be easier to apply while retaining broadly the same level and timing of tax charges, please set this out.

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[2] A collateral auction is a mechanism employed by protocols to handle liquidations of collateral

[3] See section 105, TCGA92 and HMRC's guidance in CRYPTO22200.

[4] Please note that the WBTC system leverages centralised custodial relationships: https://wbtc.network/dashboard/order-book.

45. Please see paragraph 42 above which demonstrates the complexities of applying the proposed DeFi tax regime to a collateral auction.

Question 8:

a) Do you think that the transaction in Example 6 should be within the scope of the proposed tax rules for DeFi? On what principles have you based your response?

46. Yes, the transaction set out in Example 6 should be within the scope of the new DeFi tax regime. This is on the basis that DeFi "staking" arrangements will *very* rarely return the exact same quantity of tokens that were originally " staked". Therefore, limb (d), as currently drafted, significantly reduces the applicability of the new DeFi tax regime.

b) If you think that this transaction should be within the scope of the proposed DeFi rules, how should they treat the economic conversion between the 2 types of token while the tokens are staked as a pair, given that crypto to crypto transactions are taxable?

47. We have reservations about characterising the conversion of 0.5 T7 into 6 T6 as an economic conversion. This oversimplification fails to represent the actual functionality of liquidity pools and inaccurately implies that there is a crypto-to-crypto "conversion" undertaken by the liquidity pool.

48. In our view, the return of the different number of tokens in Example 6 is explained by (i) the shifting ratio of tokens in a liquidity pool that is caused by more buying (or selling) on one side of the liquidity pool; and (ii) the broader supply and demand dynamics of each token in the pool. Accordingly, when a user wishes to withdraw from the liquidity pool, they will receive the number of tokens proportionate to their ownership of the pool.

49. For example:
    a. A user adds 1 T8 and 100 T9 to a liquidity pool. Assuming the liquidity pool contains 10 T8 and 1,000 T9, the user receives 1 LP token which represents a right to 10% of the total liquidity pool.
    b. Traders sell T8 for T9 using the pool, therefore increasing the supply of T8s and reducing the supply of T9s in the pool. The pool now has 20 T8 and 500 T9.
    c. The user redeems their LP token and is entitled to withdraw 10% of the liquidity pool. The liquidity pool returns 2 T8 and 50 T9.[5]

50. For the reasons above, we do not agree that the "economic conversion" described in Example 6 is a "crypto-to-crypto" transaction that would be taxable. Rather, Example 6 should fall within the proposed DeFi tax regime. Please see our response to Question 8c below for suggested amendments to limb (d).

c) Noting that this transaction does not meet all the conditions for the proposed rules, how could those rules be modified to provide a fair outcome for this transaction?

[5] Please note that there is no "DeFi return" earned in this example.

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51. We propose the following revisions to limb (d) (in red) to include DeFi transactions contemplated in Example 6:

    d) the user ~~lender~~ has the right to withdraw or the smart contract or liquidity pool is designed to return at least ~~the same quantity of~~ the same types of tokens that were originally lent or staked;

d) Do you foresee any difficulties for users who engage in these and similar transactions to establish the value of the DeFi return? If so, please provide examples where this may be an issue.

52. As a starting point, we expect that users will refer to HMRC published guidelines on valuing cryptoassets for UK tax purposes in CRYPTO23000. For reference, we set out the extract below:

    Many cryptoassets (such as bitcoin) are traded on exchanges which do not use pound sterling, so the value of any gain or loss must be converted into pound sterling on the Self-Assessment tax return.

    If the transaction does not have a pound sterling value (for example, if bitcoin is exchanged for Ether) an appropriate exchange rate must be established in order to convert the transaction to pound sterling.

    Reasonable care should be taken to arrive at an appropriate valuation for the transaction using a consistent methodology. Details of the valuation methodology should be kept.

53. However, establishing an appropriate exchange rate for converting a DeFi return or cryptoassets generally into fiat currency, as outlined in CRYPTO23000, presents a challenge due to the existence of several markets for the same fiat-crypto pairs (each with differing prices) or the lack of fiat-priced markets for a cryptoasset. This divergence in prices for the same trading pairs or unavailability of a fiat market for a cryptoasset could complicate the conversion process. See below an example which illustrates the challenges of valuing a tokens involved in a typical DeFi liquidity pool transaction:

Example		
	WETH	MATIC
Deposited to pool	0.02000000000	55.614500494
Withdrew from pool	0.02000922774	55.588852510
Fees earned for providing liquidity	0.00000200786	0.005639538
Total Received*	0.02001123561	55.594492049
*assets withdrawn + fees earned		

The taxpayer would then need to determine total assets received vs. deposited and determine which portion of assets returned is attributable to the reweighting of “staked” (LPed) assets and which of the tokens are attributable to the fees (the DeFi returns) earned.

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MATIC/USD(T) + GBP Markets[6]			
	At deposit	At withdrawal	
Coinbase (MATIC/GBP)	$0.4713	$0.4606	*Minute-level data
Kraken (MATIC/GBP)	$0.4601	$0.4731	*Minute-level data
Coinbase (MATIC/USD)	$0.5883	$0.6017	*Minute-level data
Binance (MATIC/USDT)	$0.0603	$0.5876	*Second-level data
Kraken (MATIC/USD)	$0.5886	$0.5898	*Minute-level data
On-chain	*Unable to determine the price source for fiat value		
Deposit: Jun-15-2023 03:20:15 PM +UTC			
Withdrawal: Jun-15-2023 09:11:26 PM +UTC			

ETH*/GBP Markets			
	At deposit	At withdrawal	
Bitfinex (ETH/GBP)	$1,290.70	$1,310.20	*Minute-level data
Bitstamp (ETH/GBP)	$1,310	$1,303.30	*Minute-level data
Kraken (ETH/GBP)	$1,289.41	$1,308.76	*Minute-level data

54. The taxpayer would need to determine the fiat value of the assets at the time of deposit and the time of withdrawal. This will present difficulties and HMRC will need to clarify which sources of fiat-pricing data will be acceptable for taxpayers to use as they calculate their tax obligations.

55. For administrative ease and clarity, we recommend HMRC consider establishing a list of official exchange rates that users may refer to when valuing their cryptoassets.

[6] Exchange rates are sourced from https://www.coingecko.com/

Appendix 1

Question 9: Do you have any general comments regarding the proposed tax framework for DeFi that you have not included in the previous questions?

Align DeFi terminology with broader market use

56. Although HMRC has made it clear that "staking" for the purposes of this Consultation will not include "staking tokens as part of a proof-of-stake transaction verification process," the market predominantly uses the term "staking" to refer to that activity. The use of this term to refer to a different category of transactions will undoubtedly lead to public confusion on the applicability of the new tax regime.

57. We disagree with the use of the terms "borrower" and "lender", as they are restrictive and do not accurately characterise the participants involved in a typical DeFi transaction. This is demonstrated in Example 5 where it is unlikely for the market to refer to User E as a "lender". Similarly, users who "wrap" their tokens (as explained in paragraph 44 above) would not be described as "lenders" by the market. We would suggest more inclusive terms such as "user" and "party".

Align the timing of the tax charge in relation to DeFi returns for (i) individual taxpayers and (ii) corporate taxpayers

58. HMRC has provided clear guidance stating that DeFi returns "received by the lender during the term of the lending or stake" should be taxed at the time when the user takes possession of the DeFi return. We believe this principle is suitable for individual taxpayers, and we wish to confirm with HMRC if the same principle will be applicable to corporate taxpayers in circumstances where DeFi returns accrue during the term of lending or staking but are not payable until the end of the term.

Taxpayers should be able to retrospectively elect for Option 2 to apply

59. HMRC has specified the new DeFi tax regime will not be applied retrospectively. However, we recommend that HMRC reconsiders this approach and introduces an election regime that allows taxpayers to voluntarily apply the new DeFi tax regime to historical transactions. Implementing such an election regime would provide taxpayers with the necessary flexibility and fairness in applying the updated rules to historical transactions.

Negligible loss claims

60. In the event that the "lent" or "staked" tokens become worthless during the "lending" or "staking" period, the "lender" should retain the option to claim a negligible loss on the underlying tokens in accordance with HMRC's guidance in CRYPTO22500.

*Application of the proposed DeFi tax regime to the investment manager exemption ("**IME**") rules*

61. We understand that the scope of IME was recently amended to include investment transactions in relation to designated cryptoassets. It is our understanding that a non-UK resident company conducting trade activities through a permanent establishment ("**PE**") in the UK would generally not be liable for UK tax on profits attributable to that PE. In light of this, we kindly request HMRC to confirm whether the DeFi transactions contemplated in the proposed DeFi tax regime would indeed fall under the category of "transactions in relation to designated cryptoassets". If this is the case, we

seek clarification on whether the following transactions would be exempt from UK tax, subject to meeting the other conditions of the IME:

a. The receipt of DeFi returns pertaining to “lending“ and “staking“ activity; and
b. The sale of the LP tokens or the “right” to the “lent“ or “staked“ tokens.

Question 10: What impact do you expect the proposals in this document, if implemented, to have on administrative burdens and costs for users of DeFi?

62. Overall, the proposals are a positive step towards alleviating administrative burdens and costs for users of DeFi and will promote compliance. Removing the CGT consequences on certain steps on the lifecycle of a typical DeFi transaction (e.g., the initial lending and staking of cryptoassets; and the withdrawal or return of the lent or staked tokens at the end of the term) reflects the underlying economic ownership of a liquidity provider.

63. Assuming a DeFi transaction falls within the scope of the new DeFi tax rules, there are 3 “tax events” that a “lender“ would be concerned with:
    a. DeFi returns that are received during the term of the “lending“ or “staking“;
    b. When a “borrower“ becomes insolvent as this could give rise to a taxable event as a result of lost “staked“ or “lent” tokens; and
    c. If the “lender“ sells their “rights“ to the “lent” or “staked” tokens to another person.

64. Each of the above events occurs regularly. Without accurate and automated means through which transactions can be reviewed to show gains/losses or revenue earned in accordance with the proposed DeFi tax rules, the new rules remain a significant administrative burden for users.

Question 11: Are there any other impacts, benefits or costs arising from the proposals in this document, if implemented?

65. The proposals in the document simplify tax reporting and establish a degree of clarity for tax purposes by setting out a clear framework for how and when a taxable event will occur. However, the burden of record-keeping on users may leave some challenges, as alluded to in our responses to Question 8.

Question 12: How common is direct lending of tokens between 2 parties compared to the use of staking?

66. Because the “lending” and “staking” transactions covered by the Consultation serve different economic functions, comparing their commonality does not appear to serve a purpose to the tax discussion; however, these types of transactions are among the most common DeFi transactions today. For HMRC’s reference, we include two charts below which demonstrate that “lending” and “staking” transactions still occur at very high volumes.

Appendix 1

Rank	DEX	Total Value Locked (TVL)	Trading Volume (6/17 - 30d)
1	Curve	$3.75b	$129m
2	Uniswap V3	$2.35b	$17.18b
3	Sushiswap	$339m	$7.75m
4	PancakeSwap AMM V3	$284m	$3.13b
5	Platypus Finance	$224m	$25.70m
6	Velodrome	$223m	$243m
7	Bancor V3	$80.34m	$5.70m
8	Trader Joe	$31.88m	$53.35m
9	Pangolin	$23.61m	$24.44m
10	Apeswap	$21.54m	$33.85m
Source		https://messari.io/protocol-explorer/decentralized-exchange	

Chart 1: This chart illustrates the amount of capital (TVL) placed within the top 10 protocols that operate using liquidity pools and the amount of trading occurring in a 30 day period (trading volume).

Rank	Lending Protocol	Active Deposits (6/17)	Active Borrows (6/17)
1	MakerDAO	$7.96b	$4.54b
2	Aave V2	$5.16b	$1.73b
3	Aave V3	$2.58b	$918m
4	Compound V2	$1.79b	$546m
5	Venus	$1.16b	$506m
6	Liquity	$831m	$276m
7	Radiant V2	$524m	$303m
8	UWU Lend	$241m	$163m
9	Abracadabra	$189m	$70.25m
10	Euler	$188m	$176m
Source		https://messari.io/protocol-explorer/lending	

Chart 2: This chart illustrates the amount of capital deposited and borrowed of the top 10 lending protocols at the time the data was acquired.