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Accounting | Tax | Corporate Services

Position Paper

CRYPTOASSETS

Regulatory and Tax treatment
in Hong Kong

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1 BACKGROUND AND DEFINITIONS

Scope of the document

To provide an overview of the regulatory and tax framework for Cryptoassets in HK. Although the document is based on the official sources available at the date of writing, it has a pure informative purpose.

Definitions and Classification

There is no universal definition for Cryptoassets, but there is often some overlap between the commonly used terms, such as "crypto-asset", "digital assets", "crypto token", "crypto currency", "Non-Fungible Tokens or NFTs" and "virtual currency".

Definitions by Hong Kong Institute of Certified Public Accountants (HKIPCA)

One of the most contextualized definition we found is from HKIPCA: "Crypto-assets are digital assets that are stored on distributed ledgers that utilize cryptography for security.

One of the most commonly known subsets of crypto-assets is cryptocurrencies. The market for crypto-assets is fast evolving. Over the past few years, Hong Kong has seen a growing amount of activity related to crypto-assets, including funds, initial coin offerings, exchanges and custodian services".

Definitions by European Central Bank (ECB)

Another appropriate definition of Cryptoassets we found is from The European Central Bank (ECB): "a new type of asset recorded in digital form and enabled by the use of cryptography that is not and does not represent a financial claim on, or a liability of, any identifiable entity".

Definitions by Inland Revenue Department in Hong Kong (IRD)

The IRD defined more broadly the concept of Digital Assets as "digital representations of value that can be transferred, stored or traded electronically. They may be backed by physical assets or guaranteed by government, and they may have no intrinsic value depending on the exact nature of the token".

Fungible and Non-Fungible Tokens

In our view, considering the recent evolution and the exciting potential of blockchain technology and in particular the tokenization of ownership and property, it's important to classify Cryptoassets in relation to their fungibility. In detail:

FUNGIBLE TOKENS (Bitcoins and other payment, security and utility tokens)	NON-FUNGIBLE TOKENS (NFTs) (digital art, gaming, collectibles)
Uniform	Uniform
Interchangeable	Non-Interchangeable
Divisible	Indivisible

The IRD classification of Digital Assets

The regulatory, accounting and tax framework in Hong Kong is still very limited and it has been focusing on fungible tokens only that have been qualified as "Virtual Commodities". In particular, the IRD classifies "Digital Assets" in three categories of Tokens:

(a) Payment Tokens

Means of payment for goods or services and encompass cryptocurrencies like Bitcoin. Such tokens are not legal tender in Hong Kong but are regarded as virtual commodities.

(b) Security Tokens

Tokens that represent ownership interests, a debt or entitlement of share of profits in a business. They are regulated in Hong Kong by the Securities and Futures Ordinance (SFO).

(c) Utility Tokens

Tokens that provide the holder with access to goods or services.

2 REGULATORY FRAMEWORK

Hong Kong does not have any targeted regulatory framework on Cryptoassets. However, a fragmented patchwork regulation has been developed since 2017 with particular reference to those digital tokens falling within the definition of "securities" under the Securities and Futures Ordinance (SFO). In fact, the Securities and Futures Commission (SFC) starting from 2017 has been regulating the ecosystem around the "security" tokens and imposing licensing requiring for crypto players such as trading platforms and "virtual asset" portfolio managers and funds.

Additionally as in "indirect" regulatory framework as stated by the Secretary of Financial Services and the Treasury in 2017 "existing laws provide sanctions against money laundering, terrorist financing, fraud and cyber-crimes, whether or not "virtual commodities" are involved".

In order to provide a summary of the key regulatory circulars we report below an abstract from the "Timeline of virtual assets regulation in Hong Kong" from HKICPA.

Authority	Regulation	Date
Hong Kong Monetary Authority (HKMA)	Bitcoin is not a legal tender but virtual commodity and it does not qualify as means of payment. Not regulated by HKMA.	**Feb 2015**
HKSAR Government Financial Services and the Treasury	Digital Tokens are not currencies. Digital Tokens are Virtual Commodities. Security Tokens to be regulated by SFO Existing laws on money laundering, terrorist financing, fraud and cyber-crime apply.	**Nov 2017**
Securities and Futures Commission (SFC)	Digital Tokens/ICO offered or sold as "securities" may be subject to SFO and parties engaged in related activities subject to SFC Licenses	**Sep 2017**
	New regulatory approach for (1) Virtual Asset Portfolio Managers and Distributors of virtual assets funds and (2) Virtual Assets Trading Platforms.	**Nov 2018**

Mainland China

China does not recognize cryptocurrencies as legal tender and the banking system does not accept cryptocurrencies or provide relevant services.
In 2013, the government defined Bitcoin as a virtual commodity and initially allowed individuals to freely participate in its online trade. However, later that year, financial regulators, including the PBOC, banned banks and payment companies from providing Bitcoin-related services.

In September 2017, China banned Initial Coin Offerings (ICOs) and cryptocurrency trading platforms from converting legal tender into cryptocurrencies and vice versa. The ICO rules also barred financial firms and payment companies from providing services for ICOs and cryptocurrencies, including account openings, registration, trading, clearing or liquidation services.

Recent events

Following the very recent turmoil of cryptocurrencies on 19 May 2021, Chinese regulators have tightened restrictions and new rules greatly expanded the scope of prohibited services. In particular:

- Institutions were prohibited from providing cryptocurrency saving, trust or pledging services and issuing crypto-related financial products.

- Virtual currencies not to be used as investment targets by trusts and funds.

- Banks and payment to monitoring money flows involved in cryptocurrency trading and coordinate more closely in identifying such risks.

The directives were made in a joint statement from the National Internet Finance Association of China, the China Banking Association and the Payment and Clearing Association of China.

Our view

We believe that the incredible potential of blockchain and distributed ledger have not been fully exploited yet and most importantly not fully understood by regulators, financial institutions, banks, traditional players and ultimately individuals.

Despite its name, the crypto ecosystem is capable of providing in addition to security and digital efficiency, an extreme level of immediate and instant transparency.

As an example, a transaction in the Blockchain like an exchange of cryptoassets needs to be "validated" by the community and it is visible almost real-time by anyone.

The recent booming of the digital art and the other applications on the Blockchain are in our view just the initial milestone of the definitive digital revolution.

On the other side, the decentralized system put an unprecedented amount of responsibilities on the single individuals (the community) exposing them to risks that until "yesterday" were mitigated by the above financial institutions like banks.

In addition, the rules of the game despite the "dreamy" intentions, are currently set with a high degree of information asymmetry with the paradox that influential power is polarized on few key opinion leaders in a strong volatility context.

To conclude, we don't believe that bans and restrictions represent a constructive approach to foster the unstoppable digital revolution. We rather see (and we hope) an unavoidable and imminent engagement of authorities and requalification of the traditional players like banks and financial institutions.

3 TAX TREATMENT IN HONG KONG

The tax treatment of " Digital Assets" is regulated by the Hong Kong's Departmental Interpretation and Practice Notes NO. 39 (Revised) issued in March 2020 by the Inland Revenue Department (IRD) on a document called "Profit's tax - Digital Economy, Electronic Commerce and Digital Assets".

The general principle of the DIPN 39 is that the tax treatment of digital tokens would depend on their nature and use.

The DIPN 39 provides a definition of Nature of Digital Assets as:

- digital representation of value
- transferred, stored or traded electronically
- may not be backed by physical assets or guaranteed by Government
- may have no intrinsic value
- short-term and volatile by nature

The DIPN 39 also provides a Classification of Digital Tokens in the three categories (payment, security and utility) mentioned in the first chapter of this document.

In light of the short-term nature and classification of Tokens, we can deduce that Non□ Fungible Tokens or NFTs are excluded from the DIPN 39 and therefore ordinary tax framework will apply to NFTs and related businesses.

Initial Coin Offering (ICO)

The ICO involves the issuance of new digital tokens by an issuer in exchange of cryptocurrencies or fiat currency from a subscriber.

The process is equivalent to an Initial Public Offering (IPO) and it is typically related to companies seeking to raise money for the development of projects in the blockchain ecosystem.

The investors can receive a new token issued either as a utility token for using product or service from the company or as a stake or interests in the company or in a specific project.

The difference between utility and security token is crucial to determine the nature of the token and its tax treatment.

The ICO is typically accompanied by a White Paper and/or other documents which set out the details of the business proposal and the terms including the rights to be conferred on the token holders.

The DIPN clarifies that the substantive nature of the token itself will determine its classification and not the stated intention of the issuer.

In other terms, the White Paper and the assessment of the rights and benefits of the tokens will determine its nature. In details:

- Security Tokens: the proceeds of the ICO will be treated as capital in nature and therefore not subject to Profit Tax.

- Utility Tokens: since the tokens offer the holders the access to specific goods or services the proceeds of the ICO will be treated as a prepayment for goods or services and the Profits arising will be charged to Profit Tax.

The timing of the revenue recognition should follow the generally applicable accounting principles (GAAP).

Digital Assets: capital assets and trading stock

The DIPN 39 clarifies that for investors who hold digital assets for long term investment purposes, the profits will be non-taxable.

Whether the digital assets are Capital Assets or Trading Stock must be assessed on the basis of the intention at the time of acquisition and on the facts and circumstances.

The DIPN 39 lists three cryptocurrency business (trading, exchange and mining) whose profits are chargeable to Tax.

The criteria to qualify a cryptocurrency business are:

a) frequency of activity
b) level of system and organization (i.e. whether the activity is undertaken in a business-like manner)
c) the purpose of the activity is to make a profit in fact.

Cryptocurrencies used for business transactions and payroll

For taxpayers who use crypto for ordinary business transactions such as a means of payment for selling or purchase goods or services, the market value of the crypto at the date of transaction should reflect the amount of sales and purchases.

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

Considering the extremely high volatility of cryptocurrencies even in a single day, in our view the DIPN 39 and the accounting framework currently leave significant room for discretionary and judgmental representation of business transaction.

Date	Source	Document
Aug 2008	Satoshi Nakamoto	Bitcoin: A Peer-to-Peer Electronic Cash System https://bitcoin.org/bitcoin.pdf
July 2013	Vitalik Buterin	Ethereum Whitepaper https://ethereum.org/en/whitepaper/
Sep 2017	SFC HK	Statements / Circulars published by Fintech unit https://www.sfc.hk/en/Welcome-to-the-Fintech-Contact-Point/Important-links
Nov 2017	HK Financial Services / Treasury	LCQ15: Regulation of offering and trading of digital tokens https://www.info.gov.hk/gia/general/201711/08/P2017110800405.htm
May 2019	HKICPA	Holdings of Cryptocurrencies https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/03_Our-views/PCD/2019/Fred/sub_TAD.pdf
June 2019	IASB / IFRS	Holding of Cryptocurrencies https://cdn.ifrs.org/content/dam/ifrs/supporting-implementation/agenda-decisions/holdings-of-cryptocurrencies-june-2019.pdf
Nov 2019	IASB / IFRS	Project Cryptoassets | Monitoring Activities https://www.ifrs.org/content/dam/ifrs/meetings/2019/november/iasb/ap12j-implementation-matters.pdf
Dec 2019	HKICPA	A Response to the EFRAG's Crypto-Assets – Outreach Questionnaire https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/07_Major-projects/crypto/resp_hkicpa.pdf
Mar 2020	IRD HK	Departmental Interpretation and Practice Notes No. 39 (revised) https://www.ird.gov.hk/eng/pdf/dipn39.pdf
May 2020	PCAOB	Audits Involving Cryptoassets https://pcaobus.org/Documents/Audits-Involving-Cryptoassets-Spotlight.pdf
Jul 2020	EFRAG	Accounting for Cryptoassets (liabilities) – Holder and Issuer Perspective https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/SiteAssets/EFRAG%2520Discussion%2520Paper-Accounting%2520for%2520Crypto-Assets%2520%28Liabilities%29-%2520July%25202020.pdf
Dec 2020	EFRAG	Accounting for Cryptoassets (liabilities) https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F1907221406510717%2F09-02%20-%20asaf-paper%2002%20-%20EFRAG%20presentation%20on%20DP%20crypto-assets-%20EFRAG%20TEG%20CFSS%2020-12-02%20-%20For%20background%20only.pdf
May 2021	REUTERS	Explainer: What Beijing's new crackdown means for crypto in China https://www.reuters.com/world/china/what-beijings-new-crackdown-means-crypto-china-2021-05-19/

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The information is not intended as an offer or solicitation with respect to the purchase or sale of cryptoassets, nor legal/tax advisory on the subject matter.

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