VAT focus

Evolving technologies: VAT, cryptoassets and the metaverse

Speed read

Developments in the variety and ingenuity of digital asset transactions have far outpaced the guidance that can be provided by tax authorities or courts on their VAT treatment. However, a number of non-UK rulings provide some insight into the VAT characterisation of transactions concerning digital assets such as cryptocurrencies and non-fungible tokens (NFTs). A decision of the German Federal Tax Court also provides guidance on the VAT treatment of transactions taking place in a virtual world. Each case emphasises the importance for VAT practitioners of digging beneath the technical terminology surrounding the transaction to identify the legal rights arising and real-world economic consequences.

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Ascertaining the correct VAT treatment of a new generation of digital assets and transactions always has the potential to cause difficulty, but presents an even greater challenge given the dearth of guidance and case law. Even HMRC's *Cryptoassets Manual* (originally published in March 2021) still contains only one page relating to VAT, and there are no UK cases concerning the VAT treatment of cryptoassets. However, there have been some non-UK rulings (both judicial and non-judicial) which provide valuable insight of the nature of these transactions and how they should be analysed for VAT purposes.

Dealing in cryptocurrencies

The original case concerning the VAT treatment of cryptoassets is *Hedqvist* (Case C-264/14). Mr Hedqvist planned to operate a website through which users could exchange Bitcoin for Swedish crowns and requested a decision from the Swedish Revenue Law Commission to confirm the relevant VAT treatment.

On reference to the CJEU, both Advocate General Kokott and the court held that the supplies constituted services falling within the exemption in article 135(1)(e), being 'transactions … concerning currency, bank notes and coins used as legal tender'. A key issue was whether the reference to legal tender qualified the term 'currency', or could the exemption also apply to unregulated currency? The various language versions of the Directive had different literal meanings: for example, the German wording referred to 'currencies ... which are legal tender', whereas the Finnish version applied that qualification only to bank notes and coins.

In light of the linguistic differences, the scope of the exemption fell to be applied by reference to its overall purpose, which the court held was to alleviate the difficulties in determining the taxable value of financial transactions. This purpose applied equally to regulated and unregulated currencies, since taxation of either had the potential to impede cross-border transactions.

What is a 'currency'? The court held that a currency is a pure means of payment: 'Transactions involving non-traditional currencies … in so far as those currencies have been accepted by the parties to a transaction as an alternative to legal tender and have no purpose other than to be a means of payment, are financial transactions.' The advocate general reached the same conclusion reasoning that, in accordance with the fiscal neutrality, something which has no other function other than to serve as a means of payment should be treated in the same manner as legal tender (unlike, for example, gold or cigarettes which can be used as a means of payment but have other practical uses). Since Bitcoin had no other purpose than as a means of payment, it constituted a currency.

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Given that Bitcoin has since been recognised as legal tender in El Salvador (since September 2021) and the Central African Republic (since April 2022), a decision today in relation to Bitcoin would be considerably more straightforward. But what about other cryptoassets? If a cryptoasset's only function is as a means of payment, then *Hedqvist* confirms that it will be treated as currency for VAT purposes (as an aside, this is in stark contrast to the position in direct tax where HMRC's published position is that cryptoassets such as Bitcoin are not currency). But, in order to constitute a means of payment, surely it would need to be demonstrated that the relevant cryptoasset is actually accepted as a means of payment (even by a select community)? Cryptoassets such as Ether (the second most traded cryptoasset) are accepted as means of payment by a variety of businesses. However, even Ether arguably has functions beyond use as a means of payment such that it is not entirely clear whether it constitutes a currency for VAT purposes.

What about other cryptoassets which are not currencies? In *Hedqist*, it was concluded that Bitcoin did not fall within article 135(1)(d) because that exemption applies only to derivatives of currency (not currency itself). However, today an array of cryptoassets exist which are derivatives relating to both cryptocurrencies and fiat currencies. For example, stablecoins are a category of cryptoassets whose value is benchmarked against a commodity, fiat currency, or basket of assets. In terms of both legal rights and economic reality, a stablecoin is arguably a security or derivative capable of falling within article 135(d) or (f). But clearly everything turns on the precise characteristics of the digital asset under consideration.

Depositing and staking

Not all transactions concerning cryptocurrencies will be treated as exempt. In a binding ruling (V2679-21) issued on 5 November 2021, the Spanish General Directorate of Taxation (GDT) considered the VAT treatment of holding such assets (for greater customer security) and staking.

Whilst the sale and purchase of cryptocurrencies are exempt, the GDT ruled that deposit services are not: taking custody of cryptocurrencies in order to provide better security for clients was said to be similar in nature to renting a safe deposit box, which is specifically excluded from exemption by article 135(2)(d). However, the GDT did not explain why it considered that the accepting of cryptocurrencies (which can constitute currencies) on an online platform (which it said was taxable) is different from a bank accepting money in an online bank account, which would be exempt for VAT purposes.

The taxpayer also offered a service by subscribing a 'smart contract' to the holders of cryptocurrencies so that they could participate in 'staking': this is where an owner receives compensation (generally a small amount of that cryptoasset) by leaving their cryptoassets locked in deposits to generate and validate blocks within the blockchain network. The GDT observed that the staker was carrying out an exempt activity since their profits resulted from the transfer of cryptocurrencies (within article 135(1)(e)). However, the service provided by the taxpayer was merely facilitating the holder's staking activity: that was not a financial transaction but was merely the provision of a platform and therefore constituted a taxable supply.

This ruling is a reminder that the limitations of the exemption for financial transactions apply to cryptoassets in the same way as they do to any other type of asset. In all cases it is critical to identify the precise nature of the service being provided and whether it falls within the relevant exemption: supplies of services such as holding financial assets or providing the means for a customer to undertake financial transactions do not necessarily constitute financial transactions themselves. Difficult cases are likely to arise where a provider is supplying a number of services to the customer and the established principles on single and multiple supplies will be applicable.

Non-fungible tokens (NFTs)

NFTs are liable to cause confusion because, whilst they are often associated with an asset (digital or tangible), they do not necessarily confer ownership over that asset. This distinction was observed in another recent ruling of the GDT (binding ruling V0482-22, 10 March 2022). In this case, the individual created digital artwork (including images, videos and music) and sold NFTs associated with that artwork via an online auction.

Significantly, it was recognised that there were two digital assets involved in this case: first, the underlying digital artwork and, second, the NFT which conferred certain rights of use attaching to that artwork (but not ownership). The purchaser of the NFT acquired the rights of use but not the artwork itself. This was considered critical to the question of whether or not the NFTs constituted electronically supplied services for VAT purposes: whilst the underlying artwork might have been subject to personalisation by the taxpayer, the NFTs were digital certificates of authenticity which (in this particular case) had been generated automatically, and which therefore fell to be treated as electronically supplied services (subject to the relevant place of supply rules).

This ruling reinforces that it is critical to identify the actual rights being acquired by the purchaser – in this case it was rightly observed that purchasing an NFT corresponding to an asset is not necessarily analogous to purchasing that asset. However, there will be other cases in which a digital asset represents more than a right to use an underlying asset and may represent full beneficial ownership: it all turns on the rights comprised within the digital asset.

VAT in the metaverse

If a business supplies services in return for consideration in the real world then, subject to the place of supply, such services will generally be within the scope of VAT. But what if the transactions take place only in a virtual world? Those were the facts in a recent decision of the German Federal Tax Court (VR38/19, 18 November 2021).

The online platform 'Second Life' allows players to create a virtual personification of themselves (referred to as an avatar) which lives in a 3D virtual world (often referred to as a metaverse). Transactions in this metaverse take place using an in-game currency, Linden Dollars, which can be earned by 'working' in the metaverse and can be transferred to other players or sold to other users in exchange for a real currency via an exchange managed by the gaming operator.

Between 2014 and 2017 the taxpayer in this case had purchased virtual land in the Second Life world, partially redesigned it and then rented it out to other users under 'rental agreements' in return for Linden Dollars. He then exchanged his Linden Dollars for US dollars which he withdrew.

The tax authority assessed the taxpayer for VAT on the services that he provided (the consideration being the Linden Dollars). The Cologne Tax Court appears to have considered this a straightforward case: the taxpayer was liable to VAT since he had provided services in return for payment and those services had been provided under a legal relationship created by the rental agreement between the taxpayer and another user (via their avatars). It was irrelevant that this all occurred within the framework of a virtual world.

The Federal Tax Court took a fundamentally different approach: transactions which confer advantages that a limited to a game or virtual world, and which confer no real-world economic advantage on the recipient do not constitute participation in real economic life and therefore are outside the scope of VAT: 'Pure game advantages that a player gives another player in the course of the game according to the rules applicable … do not justify any consumption within the meaning of the common VAT law, but merely represent non-economic advantages of the game world.'

However, when the taxpayer exchanged Linden Dollars for fiat currency, that was capable of constituting a service for VAT purposes since he assigned his rights in return for payment, and that did constitute a real economic activity. However, in this case the recipient of those services was the gaming operator and, since the operator was located in the USA, no supply was treated as taking place within Germany.

The Federal Court's decision is certainly pragmatic in that it decides that VAT does not apply to transactions within a virtual world. It is challenging enough for

tax authorities to enforce VAT compliance in the real world without also requiring them to police multiple metaverses, so most tax authorities will probably breathe a sigh of relief that the Federal Court declined to bring metaverse transactions within the scope of VAT. Such a decision might also have unexpected consequences: the Court itself observed that, if the services had been subject to VAT, then the taxpayer would have been entitled to deduct input tax on his in-game costs, such as the costs of developing the virtual land.

However, the Federal Court's decision is fact-specific and a future case might bring a different outcome as the barriers between the real world and various virtual worlds become increasing blurred. If a real-world fashion retailer also sells virtual clothing to be worn by avatars in the metaverse, is that sale subject to VAT? Meta (previously Facebook) has announced that it will be extending its social media platforms into virtual worlds and it intends to sell metaverse clothing – will there be future cases arguing whether transactions affect only the virtual world or also the real world?

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How should we approach cryptoasset transactions?

What the above cases demonstrate is that digital assets should not necessarily be seen as a unitary category of assets, but rather they are a series of types of assets which fall to be analysed by reference to their unique characteristics. Once all of the technobabble is torn away, what are the legal rights of the grantor and the holder of the asset? What are its functions and uses? Does it in fact confer rights in respect of a different asset? Does it allow the holder to participate in the real-world economy? Is this asset essentially a new vehicle for effecting a well-known type of transactions? In most cases the primary challenge is identifying the characteristics of the relevant asset or transaction but, once that has been achieved, it is a question of applying well-established VAT principles to ascertain the correct treatment. As technology continues to develop, what can be said with some certainty is that the recent rulings are likely to be the first of many. ■

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