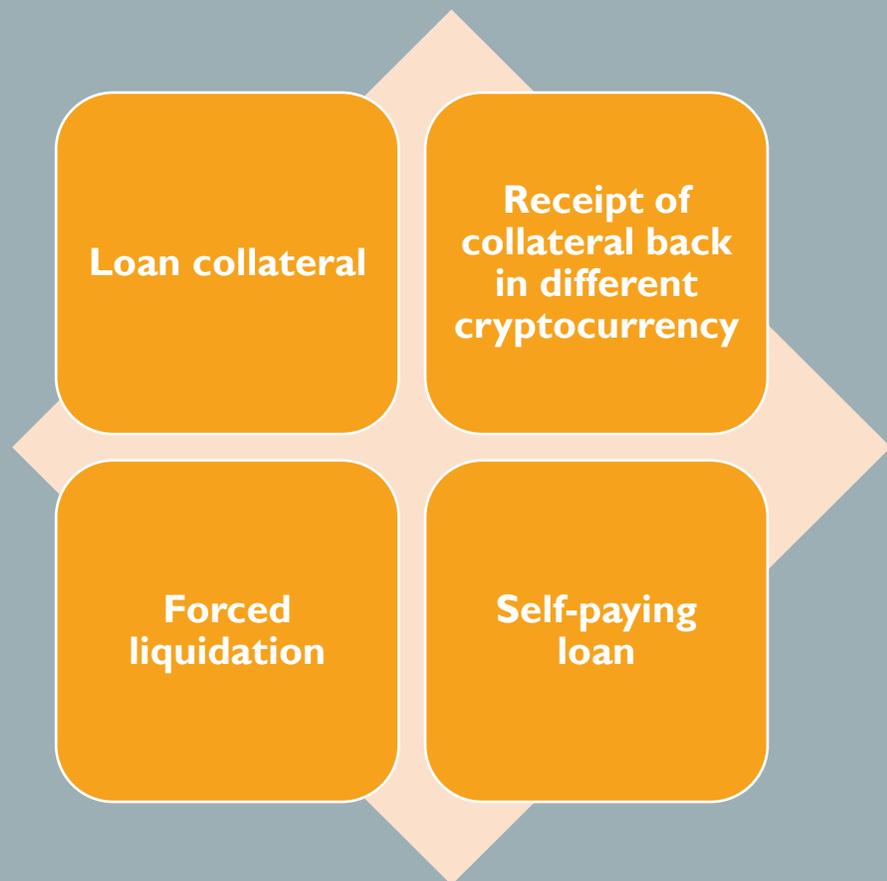


Decentralized finance (DeFi) transactions – some tax implications

By Nupur Jalan

Lending transactions



LOAN COLLATERAL

- The economic ownership of the collateral will remain with the borrower. Hence, the deposit of some tokens as collateral should not generate taxable event.
- Accordingly, there should not be any tax implications.

FORCED LIQUIDATION

- Because of the volatility in the crypto market, sometimes the value of the collateral decreases and the loan to value ratio cannot be maintained. In such cases, the platform issues margin calls (for ex.: MakerDAO requires collateral of minimum 150% of the value of loan).
- Accordingly, borrower have to add additional collateral for the initial loan. Where margin calls are not met, the platform can opt for forced liquidation of borrower's collateral.
- The taxation regime could vary depending on the tax law of the country, for ex.: Per US tax law, the borrower is required to pay capital gain taxes on the forced liquidation, immaterial of the fact that they didn't receive the profits.

RECEIPT OF COLLATERAL BACK IN DIFFERENT CRYPTOCURRENCY

- The difference in value (i.e., value of original collateral and the value of collateral received back) may be taxable as capital gain taxes depending on the local tax law of the country.

SELF-PAYING LOAN

- Some protocol offers option of self-paying loans. In such cases, borrower deposits the collateral, borrows the capital and the loan is repaid overtime by the yield protocol earns from the collateral (for ex. Alchemix protocol).
- The taxation regime may vary depending on the local law of the country. For ex., Per US tax law this debt cancellation income triggers tax liability.

Staking and interest income

Issuance of additional tokens

- The platform may distribute interest/ rewards by deposit of additional coins in lender's wallet. The taxation mechanics may vary per the laws of the country. In most cases, this should be treated as an ordinary income. For ex. – Per US tax law this is treated as ordinary income.

Ex: AAVE aTokens

Increase in the value of existing tokens

- Sometimes lenders are rewarded not in form of additional tokens, but as an increase in the value of interest-bearing tokens of the lender.
- The taxation mechanics may vary per the laws of the country. Since, only the value of existing tokens has increased, this could be taxed as capital gains. For ex. – Per US tax law this is treated as capital gains.

Ex: cTokens

Governance tokens

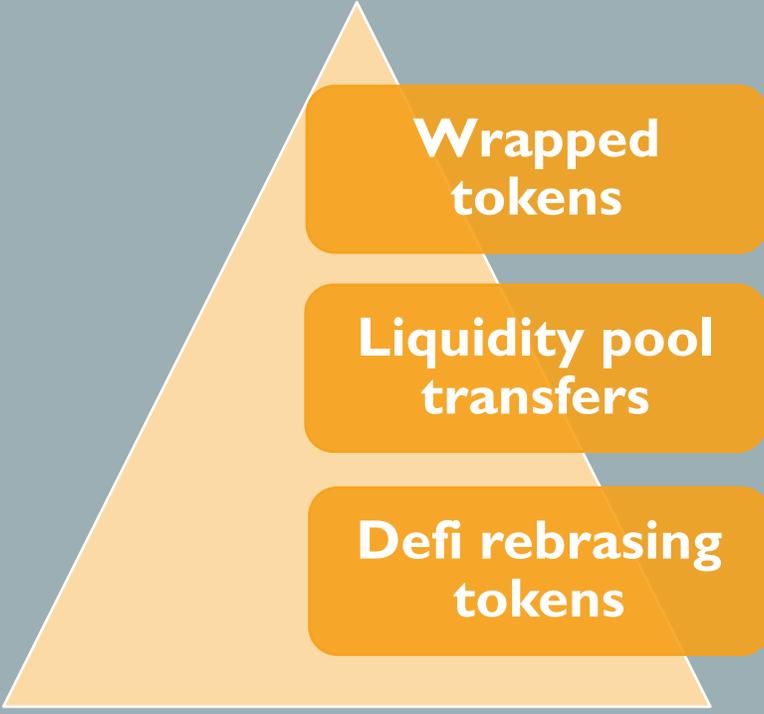
Receiving governance tokens

- Also, known as yield farming, many DeFi platforms distribute tokens as incentives for activities. These holders can vote for issues that need decision. In most cases, these should be taxed as ordinary income. For ex.: Per US and Australia tax laws, these are subject to income tax. Further, tax is usually based on token value at the time of reward.

Trading governance tokens

- Trading of governance tokens whose value has increased from the time of receipt could generate capital gain tax.
For ex.: Per US tax law, these are subject to capital gain tax

Others



Wrapped tokens

Liquidity pool transfers

Defi rebrasing tokens

WRAPPED TOKENS

- A token whose value is pegged to another coin/ token is referred to as wrapped tokens. Also, some protocols may have specific requirement to wrap tokens before they can be deposited.
- The tax implications in case of wrapping of tokens can be debatable. One may argue that wrapped version has distinctive features vis-à-vis the original token, hence this creates taxable event. While, on the other hand it can be argued that wrapped token is mere representation of original token and it doesn't generate any taxable event.

LIQUIDITY POOL TRANSFERS

- When someone provides liquidity, and deposits funds in liquidity pool they receive liquidity pool tokens. The value of these tokens increases based on pool demands and trading fees.
- The liquidity provided is converted back to original currency at time of withdrawal.
- The withdrawal may hence generate taxable event.
- Separately, there may be tax implications at the time of deposit too, on the argument that it is crypto-to-crypto trading (i.e., liquidity pool tokens are received for the crypto deposited). For ex. : Per US tax law crypto-to-crypto trading are taxable.

DEFI REBRASING TOKENS

- In this case, protocol periodically adjusts the total coin supply based on the token's price fluctuations
- There could be 2 approaches to taxes here:
 - Capital gains tax when these tokens are sold at value more than value existing at the time of deposit.
 - Treating the rebracing income received everytime as dividend income or ordinary income.

Conclusion

In all:

- *Exchange of one token with another in most cases would be taxable (where applicable) under the head capital gains.*
- *Crypto currency earned directly in most cases would be taxable (where applicable) as ordinary income.*