HMRC internal manual

# Cryptoassets Manual

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## CRYPTO61214 - Decentralised Finance: Lending and staking: Income tax: Making a DeFi loan: Nature of the return

How the return (see CRYPTO61130 (https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto61130)) is taxed upon receipt by the lender/liquidity provider will depend on whether the return has the nature of capital or revenue. The nature of the return received by the lender/liquidity provider will depend on how the transaction is structured. The lending/staking of tokens through decentralised finance (DeFi) is a constantly evolving area, so it is not possible to set out all the circumstances in which a lender/liquidity provider earns a return from their activities and the nature of that return. Instead, some guiding principles are set out. General guidance on determining the nature of a receipt or an expense can be found at BIM35000 (https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim35000).

You will need to determine whether the return has the nature of income in the hands of the lender/liquidity provider or whether the return has the nature of capital. That is, was the return earned by the lender/liquidity provider by providing a service to the borrower/DeFi lending platform, or was the return realised from the capital growth of an asset owned by the lender/liquidity provider?

Due to the various operating models, the answer may not always be clear. Below is a list of factors which will help determine the nature of the return:

- Whether the return to be received by the lender/liquidity provider is known at the time the agreement is made. If the return to be received has been agreed, for example 5% per annum, this would indicate a revenue receipt. If the return to be received is unknown and speculative (and could result in a loss from the activity), this would indicate a capital receipt.
- If the return is realised through the disposal of a capital asset, this would indicate a capital receipt. If the return is paid by the borrower/DeFi lending platform to the lender/liquidity provider, this would indicate a revenue receipt.
- Whether the return is paid periodically throughout the period of the lending/staking or whether it is paid upon repayment of the principal. A one-off payment is more likely to have the nature of capital while a recurring payment is more likely to have the nature of income.
- Whether the period of the lending is fixed or indefinite, short-term or long-term.

This list is by no means exhaustive, and no single factor is determinative.

### When the return may have the nature of revenue

In some cases, the return will be received by the lender/liquidity provider in return for the service of lending the tokens to the borrower/staking tokens with a DeFi lending platform. This may be compared to interest which is received by a lender in exchange for the service of lending of money (despite the return paid for the service of lending tokens not being considered, for tax purposes, as interest).

For example, a borrower may agree to pay 5% per annum of the principal to the lender over the period of the borrowing. In this case, the return is received by the lender in exchange for the provision of a service. If interest can be defined, in summary, as compensation for the use of money, then by analogy the return received by the lender/liquidity provider may similarly be thought of as compensation for the use of the tokens. As a result, in such circumstances it is expected that the return will, disregarding that it is not paid in respect of money or currency (CRYPTO61110 (https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto61110)), have a similar nature to interest.

The case of Ryall v Hoare [1923] 8TC521 considered the scope of the miscellaneous income provisions (as they were then). Rowlatt, J., when considering whether a receipt represented “profits or gains” or “capital accretion”, said the following at page [525]:

> "“Profits or gains” mean something which is in the nature of interest or fruit, as opposed to principal or tree.’”

Using the above analogies, interest earned from the lending of money is the “interest or fruit” while the money advanced is the “principal or tree”. In circumstances where the return can be considered remuneration for the provision of a service of lending/staking tokens, the return is the “interest or fruit” while the tokens are the “principal or tree”: the return will therefore be a revenue receipt.

It will generally be expected that where it can be demonstrated that the return is paid to remunerate the lender/liquidity provider for the provision of a service of lending/staking tokens, the return received by the lender/liquidity provider will have the same nature as interest and so be considered to be an income (revenue) receipt.

### When the return may have the nature of capital

There may be cases where the return received by the lender/liquidity provider is not comparable to interest, or a reward for the provision of a service, but rather is considered to be a capital return. This will be the case where the lender/liquidity provider is not rewarded by the borrower or the DeFi platform for providing their services, but rather the lender/liquidity provider seeks to benefit from their activities through the growth in value of a capital asset.

For example, it may be the case that the lender realises their return through disposing of a capital asset, which represents their lending and where the disposal proceeds are uncertain and speculative, rather than receiving an agreed rate of return from the borrower. Depending on the specific facts, it may be considered that the lender has realised their return from the increase in value of a capital asset and it will therefore be considered a capital receipt.

If, however, the disposal proceeds of the capital asset which represents the tokens lent/staked by the lender/liquidity provider is agreed when the tokens are advanced, then the return may have the nature of income rather than capital as the lender/liquidity provider will be providing a service for an agreed reward. This highlights the need to obtain all the facts of a transaction before reaching a conclusion as to the nature of the return.

It should be noted that the above examples are demonstrative only. In a real-world example there would be additional factors to consider which may change the conclusion reached.

If you encounter difficulty with determining the nature of the return then please refer the case for advice, following the guidance at CRYPTO100500 (https://www.gov.uk/hmrc-internal-manuals/cryptoassets-manual/crypto100500).

← Previous page (/hmrc-internal-manuals/cryptoassets-manual/crypto61213)