Memorandum

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Initial Token Offerings in Swiss Taxation: Presentation and Analyse of Tax Practice

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Preliminary remarks

On 8 February 2018, representatives of Swiss tax administrations presented for the first time *considerations* on the tax treatment of Initial Token Offerings (ITO). It is the purpose of this Memorandum to explain and to analyse these considerations within a refined overall framework and to point out tax risks in particular from the point of view of the issuer. ITO and Tokens demonstrate the tax challenges of the *digital economy* for the tax practice and the legislator.

This Memorandum is a *preliminary draft* of a legal publication on ITO in Swiss tax law.

1. General Meeting of the IFA Swiss Branch on 8 February 2018

1.1. Considerations of representatives of tax administrations and first settings of the course

At the extraordinary General Meeting of the Swiss Branch of the International Fiscal Association (IFA) on 8 February 2018 in Basel, representatives of the Federal Tax Administration (*Franco Gennari*, Head Division Securities and Financial Derivatives; *Ralf Imstepf*, Head Legal Division, Main Division Value Added Tax), the Tax Administration of the Canton Zug (*Guido Jud*, Head Tax Administration) and the Tax Administration of the Canton Zurich (*Thomas Gammeter*, Head Division Securities) presented in cooperation with the Swiss IFA-Branch (*Maurus Winzap*; *Stefan Oesterhelt*; *Remo Schmid*) for the first time considerations on the tax treatment of Initial Token Offerings (ITO) regarding federal income tax (*direkte Bundessteuer*), withholding tax (*Verrechnungssteuer*), stamp duties (*Stempelabgaben*) and value added tax (*Mehrwertsteuer*).

The purpose of the extraordinary General Meeting was to concretise the tax law provisions and to put up for discussion appropriate fundamentals for the tax treatment of ITO and to set the first courses for the Swiss tax practice.

1.2. Preparation of Guidelines

The tax practice of ITO will further develop and concretise. It is expected that the Federal Tax Administration and Cantonal Tax Administrations will publish guidelines regarding federal income tax (*direkte Bundessteuer*), withholding tax (*Verrechnungssteuer*), stamp duties (*Stempelabgaben*) and value added tax (*Mehrwertsteuer*). At the present time, however, not all tax questions have yet been answered or identified.

A committee of the Main Division Value Added Tax of the Federal Tax Administration is working on guidelines. Rules that shall facilitate the application of the place-of-receipt principle shall be developed.

2. Three levels: Issuer, Investors and Employees

In order to present the tax treatment of ITO, three levels are distinguished:

2.1. Issuer

The issuer is often a start-up enterprise in the legal form a corporation or a foundation.

In the field of business taxation, the assessment of taxable income of legal entities follows the statutory financial accounts (Article 58(1)(a) of the DBG) (*principle of linkage*). The tax treatment of ITO at the level of the issuer follows, therefore, in the first step the provisions on financial accounting and financial reporting (Article 957 et seq. of the OR). In particular, the provision on accrual and the provision on matching of revenue and cost (Article 958b of the OR), the provision on balance sheet eligibility (Article 959 of the OR) and the provision on valuation of assets and liabilities (Article 960 et seq. of the OR) have to be taken into account.

The tax law provisions (Article 58(1)(b) and (c) of the DBG) may amend the statutory income *upwards* in the second step, if an accounted expense does not qualify as business expense for tax purposes.

2.2. Investors

At the level of investors, business investors and private investors are distinguished:

a) Business investors

Business investors may be legal entities, partnerships or sole proprietorships. The duty to keep financial accounts and to prepare financial reports applies to sole proprietorships and partnerships that have achieved revenue of at least CHF 500,000 (Article 957(1)(1) of the OR). The principle of linkage is applicable analogous (Article 18(3) of the DBG). If the revenue threshold is not achieved, financial accounts on income and expenses and on the financial situation must be kept only (Article 957(2)(1) of the OR).

The Federal Tribunal has established case-law to distinguish self-employment activity from private asset administration (real estate trading, securities trading, art trading, participation trading, etc.). The Federal Tax Administration has outlined the tax practice on *securities* trading in Circular No 36

from 27 July 2012. Contrary to a view that is held sometimes, the differentiation between self-employment activity and private asset administration in the context of acquisition, holding and selling Tokens is at issue and according to the author's view the case-law on *securities* trading is most appropriate.

b) Private investors

Private investors are individuals. The tax treatment of Tokens follows the tax law provisions on movable private assets (Article 20 of the DBG). The Federal Tax Administration has outlined the tax practice on bonds and financial derivatives in Circular No 15 from 3 October 2017.

2.3. Employees

The tax treatment of Tokens follows the tax law provisions on employment income, in particular on the taxation of employee participations (Article 17a et seq. of the DBG). The Federal Tax Administration has outlined the tax practice on qualifying (*echte*) and non-qualifying (*unechte*) employee participations in Circular No 37 from 22 July 2013.

According to the view of the Tax Administration of the Canton Zurich, Tokens that are granted by the issuer to employees may qualify as qualifying (*echte*) employee participations (Article 17a(2) of the DBG).

3. Legal analysis of the legal relationship as starting point

3.1. Coins and Tokens

Enterprises, in particular start-ups, use Initial Coin Offerings (ICO) or Initial Token Offerings (ITO) to raise funds or to announce product development projects. Such projects include in particular the formation of special purpose vehicles, the development of a platform and of goods and/or services.

In the context of fund raising, the enterprise (issuer) may generate Coins or Tokens:

- A *Coin* is a *digital coin* that is usable for payments. It can be distinguished between native coins that are part of the respective blockchain protocol (e.g. Bitcoin, Ether, Ripple) and non-native coins that are generated on an existing protocol (e.g. ERC-20 on the Ethereum blockchain).
- A *Token* is a *digital marker* that is not only usable for payments, but may also be related to a product development project, a participation on a particular success measure of the issuer, a particular delivery of goods or a particular provision of services by the issuer. Therefore, a Token serves to identify the parities of the legal relationship. Tokens are usually not generated on an own blockchain, but on existing blockchains. Issuers use for the generation of Tokens often the Ethereum blockchain.

3.2. Legal classification of Tokens

The analysis of the tax treatment of ITO and Tokens in a particular case requires a legal analysis of the legal relationship between the issuer and the investor. The legal relationship can be structured

in different ways. The issuer may commit to the investors to pay a particular amount, to deliver a particular good or to provide a particular service. Such commitments have to be analysed with regard to federal income tax (*direkte Bundessteuer*), withholding tax (*Verrechnungssteuer*), stamp duties (*Stempelabgaben*) and value added tax (*Mehrwertsteuer*). Tax risks for the issuer may be embedded in such commitments. Therefore, Tokens have to be classified for tax purposes at the time of the ITO.

Starting point of the *classification* of Tokens for *tax purposes* is the *legal analysis* of the legal relationship between the issuer and the investor and the Token holder respectively and the legal qualification of Tokens generated by the issuer. At the level of the issuer, the legal relationship may trigger at the beginning a booking entry in an asset account, in a debt account, in an equity account, in an expense account and /or in a revenue account. According to the Token Framework established by *Kogens / Luchsinger Gähwiler*, Tokens may be qualified within three categories (*Kogens / Luchsinger Gähwiler*, How Crypto-Tokens qualify under Swiss law: A comprehensive framework, 23 November 2017):

- *Coins as Virtual Currency* (Cryptocurrency): The issuer does not commit to Token holders to pay a particular amount, to deliver a particular good or to provide a particular service. The Token holder can use the Token for payments.
- Tokens with financial claims
  - *Debt Token*: The issuer commits to the Token holder to repay the paid amount and, if applicable, interest.
  - *Equity Token*: The issuer does not commit to the Token holder to repay the paid amount. The Token holder has a right to participate to a proportion of the annual profit and/or the liquidation proceeds.
  - *Participation Rights Token*: The issuer does not commit to the Token holder to repay the paid amount. The Token holder has a right to participate to a proportion of a particular success measure of the issuer (e.g. EBIT, licence revenue).
- *Utility Token*: Tokens for other purposes.

4. Analyse of the tax risks of the issuer

Tax risks for the issuer may arise in particular if the issuer is a taxpayer. The issuer can be taxpayer with regard to income tax, issuance stamp duty, withholding tax and value added tax.

a) Issuance stamp duty

The issuance of *shares* by corporations and *contributions* to capital reserve by shareholders are subject to issuance stamp duty at a rate of 1% (Article 5(1)(a) and (2)(a) of the StG). The corporation has to pay the issuance stamp duty of 1% on the issuance amount of the shares or the contributed amount respectively to the Federal Tax Administration.

b) Withholding tax

The payment of *interest* on bonds that qualify as collective financing schemes (Article 4(1)(a) of the VStG) and *dividends* on shares (Article 4(1)(b) of the VStG) are subject to withholding tax. The corporation has to withhold the tax at a rate of 35% from the gross amount at the time of payment and to transmit to the Federal Tax Administration.

c) Value added tax

The *delivery of goods* and the *provision of services* against consideration may be subject to value added tax, if place of delivery (Article 1(2)(a) of the MWSTG) or seat or domicile respectively of the recipient is in Switzerland (Article 1(2)(a) and Article 8(1) of the MWSTG). The issuer must transmit the value added tax of 7.7% on the consideration to the Federal Tax Administration. At the time of invoicing, the issuer may contractually charge the value added tax to the recipient (Article 6 of the MWSTG).

d) Source taxation and social security contributions

In the context of granting Tokens to employees, a risk may also arise with regard to source taxation (Article 83 et seq. of the DBG) and social security contributions on the employment income. The grant of Tokens has to be analysed from the point of view of *employee participations* (Article 17a et seq. of the DBG).

e) Tax Compliance: qualification for tax purposes at the time of the ITO

The issuer must know the tax law obligations related to the ITO and must fulfil these obligations in accordance with the tax law. The Tokens must be qualified for tax purposes at the time of the ITO. The issuer must know whether the financial proceeds from the ITO have to be accounted as revenue, the generation of the Tokens is subject to issuance stamp duty, the payments to the Token holders are subject to withholding tax and delivery of goods and the provision of services are subject to valued added tax. The issuer must also know whether the Tokens granted to the employees are subject to source taxation and social security contributions. These tax risks are shown in particular by the practical obstacles that are opposed to the subsequent reclaim of the withhold tax, the value added tax, the source tax and the social security contributions.

5. Tax treatment of ITO and Tokens

The tax treatment of ITO shall be presented and analysed by use of the three cases used by *Gennari / Imstepf / Jud / Gammeter / Winzap / Oesterhelt / Schmid* at the General Meeting of the Swiss IFA-Branch on 8 February 2018:

- Participation Rights Token: Right to a proportion of the EBIT
- Participation Rights Token: Right to a proportion of the licence revenue
- Utility Token: Right to an activity of the issuer

5.1. Participation Rights Token: Right to a proportion of the EBIT

a) Facts

The issuer is a start-up enterprise in the legal form of a corporation and wants to finance the development of a robot with an ITO. The issuer hopes to generate profits from the sale of the robot. In the context of the ITO, the issuer generates 20 million Participation Rights Tokens with a value of CHF 1 per Participation Rights Token by means of a Smart Contract that is implemented on the Ethereum Blockchain. The investors pay the issuance amount in Ether. At the time of payment, the Ether amount is converted and exchanged into CHF through a broker.

The issuer commits in the Terms of Token Sale to pay in Ether each year 30% of a positive EBIT to the Token holders through the Smart Contract in proportion of the percentage share to the total number of Participation Rights Tokens. The issuer does not commit to the Token holder to repay the received Ether amount.

The Participation Rights Token will be tradeable on a crypto exchange.

b) Legal analysis and qualification for tax purposes

The legal relationship between the issuer and the Token holder is a contractual relationship that *does not provide a repayment right* of the Token holder. The payments of the issuer to the Token holder depend on the annual EBIT of the issuer.

The legal relationship between the issuer and the Token holder is not a loan (Article 312 et seq. of the OR), not a jouissance right (Article 657 of the OR) and not a usufruct (Article 745 et seq. of the ZGB). It may, however, be regarded as financial derivative. According to the view of the Federal Tax Administration, the financial derivative qualifies as an instrument *sui generis* following an open-end share certificate (Paragraph 1(c) of the Annex III to the Circular No 15) on grounds that the underlying is the annual EBIT of a corporation.

c) Tax treatment

At the level of the issuer, the amount paid by the investors of total CHF 20 million has to be accounted as taxable revenue. According to the view of the Tax Administration of the Canton Zug, the commitment of the issuer to use the financial proceeds as an expense for the development of the product may give reason to account a tax-deductible provision of the same amount. According to the author's view, this financial accounting that is recognised for tax purposes may be established with the financial reporting *principle of accrual* and *principle of matching of revenue and cost* (Article 958b of the OR) (*Peter Böckli*, Neue OR-Rechnungslegung, 2014, 32 f). On the one side, expenses and revenue have not to be accounted in the period in which the payment occurs or the funds are received. Expenses and revenue have to be accounted in the period in which they are economically induced (*principle of accrual*). On the other, expenses that aim to generate revenue have to be allocated temporally and factually to the respective revenue (*principle of matching of revenue and cost*). These provisions of financial reporting may cause that expenses have to be *advanced* to that period in which the respective revenue has to be accounted.

According to the view of the Federal Tax Administration, the financial proceeds are not subject to issuance stamp duty (Article 1(1) of the StG), not to turnover stamp duty (Article 14(1)(a) of the StG) as an exempted turnover not to value added tax (Article 21(2)(19)(e) of the MWSTG). The provision has to be dissolved over time and accounted against the developing expenses. According to the author's view, this financial accounting that is recognised for tax purposes may be established with the financial reporting provisions on accrual and matching of revenue and cost (Article 958b of the OR). After completion of the product development, an accounting profit, an accounting loss or a balanced result may result from the fund raising.

The payments to the Token holders are accounted as tax-deductible expenses and are according to the view of the Federal Tax Administration not subject to withholding tax (Article 4(1) of the VStG). The payments are not interest (Article 4(1)(a) of the VStG), not dividends (Article 4(1)(b) of the VStG), not income from unites in collective investment schemes (Article 4(1)(c) of the VStG) and not interest on bank deposits (Article 4(1)(d) of the VStG).

At the level of the business investor, there is an income tax-free exchange of assets at the time of the generation of the Participation Rights Tokens. The Participation Rights Tokens have to be capitalised for the first time at cost (Article 960a(1) of the OR). The payments by the issuer and the capital gains from the sale of the Participation Rights Tokens have to be accounted as taxable revenue.

At the level of the private investor, there is an income tax-free exchange of assets at the time of the generation of the Participation Rights Tokens. According to the view of the Tax Administration of the Canton Zug, the Participation Rights Tokens – and contrary to a view that is held sometimes – have to be declared in the list of securities of the tax return rather than other asses. The Federal Tax Administration determines for the most important cryptocurrencies the wealth tax base and provides the list to the Cantonal Tax Administrations and the taxpayers. With regard to the valuation of Tokens, the tax practice will have to develop appropriate rules. The payment of the issuer is taxable investment income (Article 20(1) of the DBG). There is no tax-free income in the amount of the paid amount to the issuer. Capital gains from the sale of the Participation Rights Token are tax-free capital gains (Article 16(3) of the DBG).

According to the view of the Federal Tax Administration, the Participation Rights Tokens qualify as taxable securities for turnover stamp duty purposes (Article 13(2)(c) and Article 13(2)(a)(2) of the StG). The transfer of Participation Rights Tokens against consideration is subject to turnover stamp duty if a securities dealer in accordance with the stamp duty law is contractual party or intermediary (Article 13(3) of the StG). The Federal Tax Administration establishes the qualification as taxable security on grounds that the Participation Rights Tokens qualify as sub-participations (Article 13(2)(c) of the StG) of shares issued by a corporation (Article 13(2)(a)(2) of the StG). On these grounds, the Federal Tax Administration establishes the exemption form the turnover stamp duty at generation of the Participation Rights Token: the issuance of sub-participations of shares issued by a corporation is exempted from turnover stamp duty (Article 13(2)(c) and Article 13(2)(a)(2) and Article 14(1)(a) of the StG). The transfer against consideration as exempted turnover is not subject to value added tax (Article 21(2)(19)(e) of the MWSTG).

In plain language, the qualification as an instrument sui generis following an open-end share certificate establishes a sub-participation (Article 13(2)(c) of the StG) of shares issued by a corporation (Article 13(2)(a)(2) of the StG) and, therefore, a taxable security. It remains to be seen whether this qualification will be of significance in practice as the transfer against consideration is only subject to turnover stamp duty if a securities dealer is party or intermediary (Article 13(3) of the StG). Tax law links the charging provision to the involvement of a securities dealer (e.g. bank or financial institution). At this point, Tokens demonstrate the tax challenges of the *digital economy* for the legislator. Whether Participation Rights Tokens with annual EBIT of a corporation as underlying qualify as taxable securities has to be further analysed. The financial underlying of a share is not EBIT, but the annual profit (Article 660(1) of the OR) and/or the liquidation proceeds (Article 660(2) of the OR).

5.2. Participation Rights Token: Right to a proportion of the licence revenue

a) Facts

The issuer is a start-up enterprise in the legal form of a corporation and wants to finance the development of a software with an ITO. The issuer hopes to generate licence revenue from the licencing of the software. In the context of the ITO, the issuer generates 10 million Participation Rights Tokens with a value of CHF 1 per Participation Rights Token through a Smart Contract that is implemented on the Ethereum Blockchain. The investors pay the issuance amount in Ether. At the time of payment, the Ether amount is converted and exchanged into CHF through a broker.

The issuer commits in the Terms of Token Sale to pay in Ether each year 20% of the licence revenue to the Token holders through the Smart Contract in proportion of the percentage share to the total number of Participation Rights Tokens. The issuer does not commit to the Token holder to repay the received Ether amount.

The Participation Rights Token will be tradeable on a crypto exchange.

b) Legal analysis and qualification for tax purposes

According to the view of the Federal Tax Administration, the legal relationship between the issuer and the Token holder qualifies as a financial derivative that in turn qualifies as an instrument sui generis following an open-end share certificate (Paragraph 1(c) of the Annex III to the Circular No 15). The underlying is the annual licence revenue.

c) Tax treatment

The tax treatment of the ITO and the Participation Rights Tokens corresponds to the analysis in Paragraph 5.1.c).

The question again arises whether the Participation Rights Tokens with annual licence revenue as underlying qualify as sub-participation of shares issued by a corporation. The financial underlying of a share is not EBIT, but the annual profit (Article 660(1) of the OR) and/or the liquidation proceeds (Article 660(2) of the OR).

5.3. Utility Token: Right to an activity of the issuer

a) Facts

The issuer is a start-up enterprise in the legal form of a foundation and wants to finance the development of software (Open Source Blockchain Protocol) with the financial support of investors. The issuer wants to release the software through an open source licence and does not hope to generate profits from the development of the software. The purpose of the foundation is the development and the release of the software. The issuer receives from investors Bitcoin and Ether in the amount of CHF 50 million that are exchanged into CHF through a broker.

In case of development and release of the software, the issuer commits to generate CHF 100 million of Utility Tokens and to record on the Open Source Blockchain a proposal according to which the allotment of the Utility Tokens shall take into account the investors. The access to the Open Source Blockchain Protocol shall not be possible without Utility Tokens.

The Utility Tokens will be tradeable on a crypto exchange.

b) Legal analysis and qualification for tax purposes

The issuer must use the financial proceeds according to the purpose of the foundation for the development and release of the software. There are no further commitments of the issuer to the investors. The issuer does not commit to develop and to release the software and that the allotment of the Utility Tokens will take into account the investors according to the proposal.

The legal relationship between the issuer and the investors is not a loan (Article 312 et seq. of the OR), not a jouissance right (Article 657 of the OR) and not a usufruct (Article 745 et seq. of the ZGB). According to the view of the Federal Tax Administration, it may be regarded as a mandate (Article 394 et seq. of the OR). The mandate includes an activity of the issuer, i.e. the development and the release of the software and the record of a proposal according to which the allotment of the Utility Tokens shall take into account the investors.

c) Tax treatment

At the level of the issuer, the amount paid by the investors of total CHF 50 million has to be accounted as taxable revenue. According to the view of the Tax Administration of the Canton Zug, the commitment of the issuer to use the financial proceeds as an expense for the development and the release of the software may give reason to account a tax-deductible provision of the same amount. The exemption from the federal income tax and the cantonal/communal income and capital taxes seems rather not to be possible (Article 56(g) of the DBG and Article 23(f) of the StHG; see also foundations with predominant commercial activity according to § 66(1) of the StG-ZG). The financial proceeds are not subject to issuance stamp duty and not to turnover stamp duty.

According to the view of the Federal Tax Administration, the activity of the issuer may be regarded as entrepreneurial activity so that the issuer may become subject to value added taxation (Article 10 of the MWSTG). There is a provision of services for tax purposes (Article 18(1) of the MWSTG). The service of the issuer is the activity in accordance with the mandate. The turnover from the

financial proceeds is subject to value added tax (Article 8(1) of the MWSTG). The issuer must transmit the value added tax of 7.7% on the taxable turnover to the Federal Tax Administration. According to the place-of-receipt principle, the provision of services to recipients abroad is not subject to value added tax. The issuer bears the burden of proof that the seat and the domicile respectively of the investor are abroad. As a taxpayer, the issuer is entitled to claim input VAT and import VAT related to the development expenses.

The provision has to be dissolved over time and accounted against the developing expenses. This financial accounting is recognised for tax purposes. According to the view of the Tax Administration of the Canton Zug, the provision has to be dissolved in a way that the foundation generates a minimum annual profit of cost + 5%. After completion of the product development, an accounting profit, an accounting loss or a balanced result may result from the fund raising.

The allotment of the Utility Tokens to the investors constitutes the fulfilment of a contractual commitment under the mandate. At the level of business investors, the Utility Tokens have to be capitalised for the first time at cost (Article 960a(1) of the OR). At the level of the private investors, there is an income tax-free event.

The Utility Tokens are not taxable securities. The sale of Utility Tokens is not subject to turn over stamp duty.

6. Tax Rulings

6.1. Requirements

The requirements for drafting tax rulings have increased in the past. It is the task of the issuer to identify and to hold completely the *legally relevant pattern of facts* and to raise and to answer the *legally relevant questions*. Questions that are not answered in the tax ruling are not covered in a binding manner in the context of the principle of protection of legitimate expectations. The lack of a legally relevant fact may result that the tax ruling is not binding in part or, *in extremis*, not at all.

It is not the task of the tax administration to complete or to improve the tax ruling. The editorial responsibility is in the hands of the issuer. The tax administration agrees or does not agree with the submitted tax ruling.

6.2. Development and concretisation of the tax practice

The tax practice of ITO will further develop and concretise. At the present time, however, not all tax questions have yet been answered or identified.

With regard to the legal protection of the issuer, it will be further important to rule the tax treatment of ITO with the Federal Tax Administration and/or Cantonal Tax Administrations. Tax rulings are an important instrument for the tax administrations to develop and to harmonise the tax practice.

7. Conclusion and outlook

A first analysis of the tax practice of ITO has shown that Swiss tax law provides appropriate fundamentals at the level of the issuer, the investors and the employees and that the Swiss tax practice has set the first courses into the right direction.

The tax risks for the issuer may arise in particular if the issuer is a taxpayer. The issuer can be taxpayer with regard to income tax, issuance stamp duty, withholding tax and value added tax. In particular the withholding tax on interest and dividends and the value added tax on the provision of services have to be kept an eye on. Tax compliance requires the qualification for tax purposes at the time of the ITO. A legal analysis and a qualification for tax purposes may lead to the finding that there is a taxable interest or dividend payment or a taxable provision of services. In the context of granting Tokens to employees, a risk may also arise with regard to source taxation and social security contributions on the employment income. The grant of Tokens has to be analysed from the point of view of employee participations.

It is expected that the Federal Tax Administration and Cantonal Tax Administrations will publish guidelines regarding federal income tax (*direkte Bundessteuer*), withholding tax (*Verrechnungssteuer*), stamp duties (*Stempelabgaben*) and value added tax (*Mehrwertsteuer*). Tax rulings should be reviewed on a regular basis by the issuer and, if appropriate, supplemented and amended, if the tax ruling does not answer all legally relevant questions and, thus, is incomplete and/or tax risks were not identified or the tax practice has developed more advantageous than ruled in the tax ruling.

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