BOITELLE TAX

Investment in Crypto assets : decrypting the tax aspects

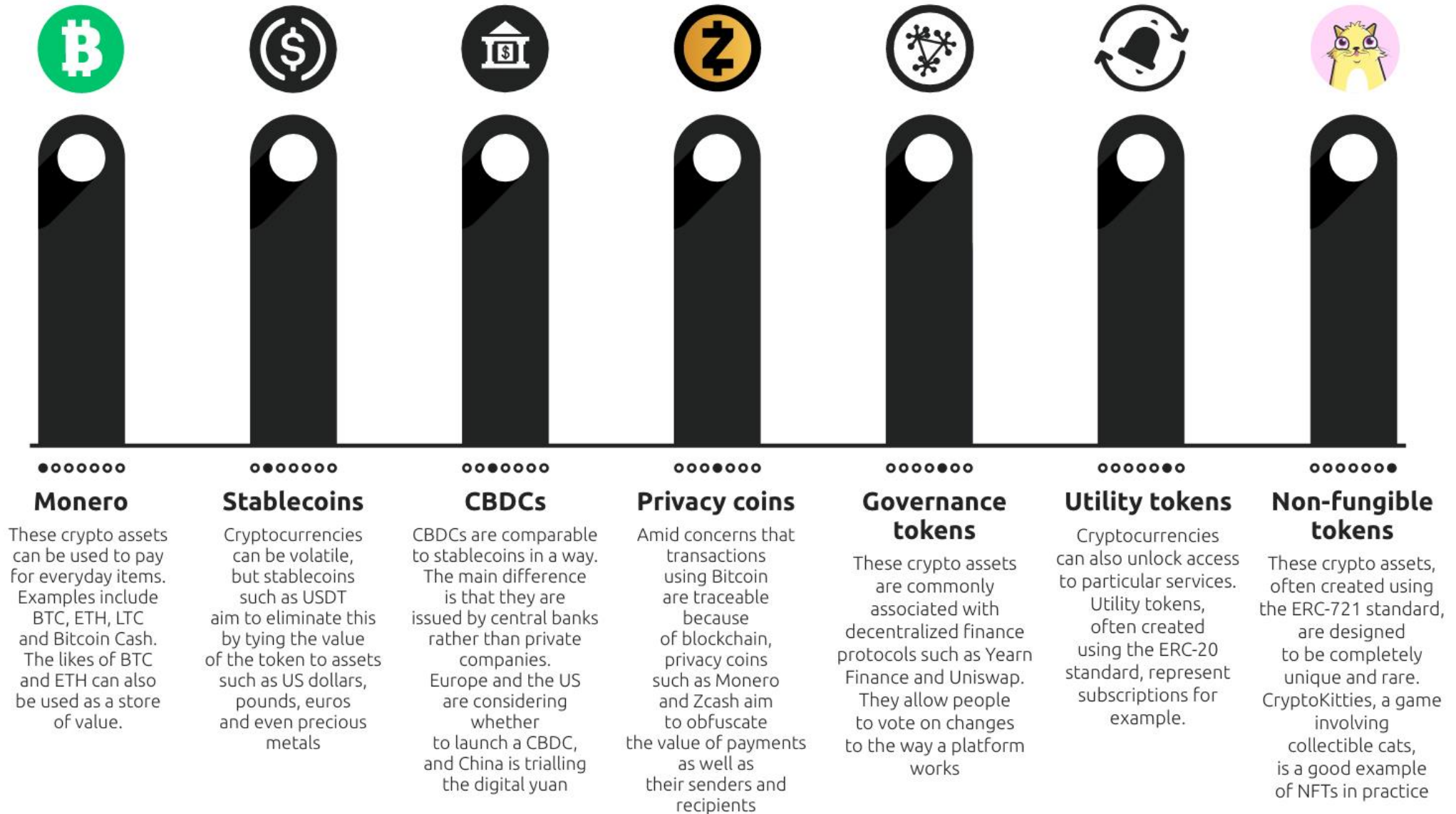**TTN Austin Tax Conference**

27 May 2022

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Agenda

- Definition and examples
- Relevance for domestic tax law
- Swiss tax aspects
- Staking
- Case studies (3)

Definition

- No legal definition yet
- Crypto assets are transferable digital representations designed in a way that prevents their copying or duplication
- Crypto assets rely on the blockchain
  - Blockchain : secure technology used to record property of crypto assets and allows users to make various transactions
- Various types of crypto assets: most notably, cryptocurrencies (e.g. bitcoin, XRP, ether, etc.), but also NFTs

TYPES OF CRYPTO ASSETS

Monero
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These crypto assets can be used to pay for everyday items. Examples include BTC, ETH, LTC and Bitcoin Cash. The likes of BTC and ETH can also be used as a store of value.

Stablecoins
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Cryptocurrencies can be volatile, but stablecoins such as USDT aim to eliminate this by tying the value of the token to assets such as US dollars, pounds, euros and even precious metals

CBDCs
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CBDCs are comparable to stablecoins in a way. The main difference is that they are issued by central banks rather than private companies. Europe and the US are considering whether to launch a CBDC, and China is trialling the digital yuan

Privacy coins
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Amid concerns that transactions using Bitcoin are traceable because of blockchain, privacy coins such as Monero and Zcash aim to obfuscate the value of payments as well as their senders and recipients

Governance tokens
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These crypto assets are commonly associated with decentralized finance protocols such as Yearn Finance and Uniswap. They allow people to vote on changes to the way a platform works

Utility tokens
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Cryptocurrencies can also unlock access to particular services. Utility tokens, often created using the ERC-20 standard, represent subscriptions for example.

Non-fungible tokens
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These crypto assets, often created using the ERC-721 standard, are designed to be completely unique and rare. CryptoKitties, a game involving collectible cats, is a good example of NFTs in practice

Source: What are crypto assets?

Relevance

- The rise and spread of cryptoassets raises various questions regarding their tax treatment
- No legal provisions for now, but a practice from tax authorities has developed based on the existing provisions

Swiss tax aspects

- Payment tokens
- Asset tokens
- Utility tokens

Swiss tax aspects : payment tokens

- Can be used as a means of payment = cryptocurrencies

- **Wealth tax**:
  - Considered as valuable movable and intangible assets that are part of movable capital
  - Thus, subject to wealth tax and must be declared at the market value at the end of the tax period (cf. art. 13 al. 1 and 14 al. 1 LHID)
  - Valuation method : Federal Tax Administration publishes the taxable value of the most common cryptocurrencies in its price list. For other cryptocurrencies, the market value of one of the major trading platforms can be used.

Swiss tax aspects : payment tokens

- **Income tax:**
  - Principle: mere holding of payment tokens does not generate income tax
  - If used to pay salaries to employees, taxable as income from a lucrative activity (art. 17 al. 1 LIFD).
    - Amount declared: amount at the time of collection, converted into CHF
  - Private wealth of individuals: profits/losses from purchases or sales are non-taxable capital and non-deductible losses (art. 16 al. 3 LIFD)
    - Depending on the type, extent and financing, such activity can be qualified as an independent lucrative activity resulting from the disposal of payment tokens and become subject to income tax (art. 18 al. 2 LIFD).

Swiss tax aspects : payment tokens

- **Withholding tax:**
  - Payment tokens are not subject to withholding tax (art. 4 al. 1 LIA *a contrario*)

Swiss tax aspects : asset tokens

- Incorporate cashable rights against the counterparty/issuer
- Constitute a fixed predetermined participation of the investor to a reference value of the issuer's business
- Tax qualification of asset tokens depends on the nature of the relationship between the investor and the issuer :
  - Each contractual obligation of the issuer to the investor must be examined as to its tax qualification and assessed for each tax

Swiss tax aspects : asset tokens

3 categories of asset tokens :

- Debt asset tokens
  - Formal/factual obligation of the issuer to repay all or most of the investment and possibly to pay the interest

- Contractually based asset tokens
  - Investor entitled to a financial benefit calculated on the basis of a proportional share of a specified reference data in relation to the issuer with profit and/or liquidation result

- Asset tokens with participation rights (equity asset tokens)
  - Right to share in the profits governed by the statutes

Swiss tax aspects : debt asset tokens

- From a tax standpoint, considered as debt securities

- <u>Tax treatment at issuer level:</u>

- **Profit tax:**
  - Do not qualify as taxable income

- **Withholding tax:**
  - Bond interests subject to WHT (art. 4 al. 1 let. a LIA)

Swiss tax aspects : debt asset tokens

- <u>Tax treatment at investor level:</u>

- **Wealth tax:**
  - Subject to cantonal wealth tax (art. 13 al. 1 and 14 al. 1 LHID)

- **Withholding tax:**
  - Bond interests subject to WHT (art. 4 al. 1 let. a LIA)

Swiss tax aspects : debt asset tokens

- **Income tax:**
  - Interests subject to income tax at the moment of its realization (art. 20 al. 1 LIFD and art. 7 al. 1 LHID)
  - If used to pay salaries to employees, taxable as income from a lucrative activity (art. 17 al. 1 LIFD).
    - Amount declared: amount at the time of collection, converted into CHF
  - Private wealth of individuals: profits/losses from purchases or sales are non-taxable capital and non-deductible losses (art. 16 al. 3 LIFD)
    - Depending on the type, extent and financing, such activity can be qualified as an independent lucrative activity resulting from the disposal of foreign capital tokens and become subject to income tax (art. 18 al. 2 LIFD) and losses deductible.

Swiss tax aspects : contractually based asset tokens

- Issued as part of a collective capital raising

- Investor's right to an annual payment independent of whether the issuer pays a dividend to shareholders

- Swiss tax standpoint:
  - Contractually based asset tokens considered as derivative financial instruments sui generis

Swiss tax aspects : contractually based asset tokens

- <u>Tax treatment at issuer level:</u>

- **Profit tax:**
  - To be recorded as income and taxable at the time of issuance
  - Related payments/expenses considered as justified expenses and thus tax deductible (art. 58 al. 1 LIFD and art. 25 LHID)

- **Withholding tax:**
  - Not subject to WHT (art. 4 al. 1 LIA a contrario)
  - 2 exceptions:
    - If, at the time of maturity, shareholders and relatives hold a max. of 50% of the asset tokens
    - If share of profit participation fixed in such a way that payment to token holders doesn't exceed 50%

Swiss tax aspects : contractually based asset tokens

- <u>Tax treatment at investor level:</u>

- **Wealth tax:**
  - Subject to wealth tax (art. 13 LHID)

- **Withholding tax:**.
  - Not subject to WHT (art. 4 al. 1 LIA a contrario)

Swiss tax aspects : contractually based asset tokens

- **Income tax:**
  - Payments considered as income from movable capital and thus subject to income tax (art. 20 al. 1 LIFD and art. 7 al. 1 LHID)
  - If used to pay salaries to employees, taxable as income from a lucrative activity (art. 17 al. 1 LIFD).
    - Amount declared: amount at the time of collection, converted into CHF
  - Private wealth of individuals: profits/losses from purchases or sales are non-taxable capital and non-deductible losses (art. 16 al. 3 LIFD)
    - Depending on the type, extent and financing, such activity can be qualified as an independent lucrative activity resulting from the disposal of contractually based tokens and become subject to income tax (art. 18 al. 2 LIFD).

Swiss tax aspects : asset tokens with participations rights (equity asset tokens)

- Tax treatment at issuer level:
- **Profit tax:**
  - Constitute capital contributions, thus not subject to profit tax

- **Withholding tax:**
  - Earnings subject to WHT
  - Corresponding payments subject to WHT as dividends

- **Stamp duty:**
  - Issuance subject to stamp duty (art. 5 al. 1 let. a LT)

Swiss tax aspects : asset tokens with participations rights

- <u>Tax treatment at investor level:</u>
- **Wealth tax:**
  - Subject to wealth tax

- **Withholding tax:**
  - Subjet to WHT (art. 4 al. 1 let. b LIA)

- **Stamp duty:**
  - Subject to transfer stamp duty if legal relationship transferred in accordance with art. 13 al. 2 let. a ch. 2 LT

Swiss tax aspects : asset tokens with participations rights

- **Income tax:**
  - Dividends considered as income from movable capital and thus subject to income tax (art. 20 al. 1 let. a LIFD and art. 7 al. 1 LHID)
  - If used to pay salaries to employees, taxable as income from a lucrative activity (art. 17 al. 1 LIFD).
    - Amount declared: amount at the time of collection, converted into CHF
  - Private wealth of individuals: profits/losses from purchases or sales are non-taxable capital and non-deductible losses (art. 16 al. 3 LIFD)
    - Depending on the type, extent and financing, such activity can be qualified as an independent lucrative activity resulting from the disposal of asset tokens with disposal rights and become subject to income tax (art. 18 al. 2 LIFD).

Swiss tax aspects : utility tokens

- Utility tokens give the investor the right to use digital services, available in most cases on a decentralized platform
- Its tax qualification largely depends on the nature of the relationship between the investor and the issuer
    - All contractual obligations of the issuer towards the investor must be examined as to their tax qualification and assessed separately for each tax
- Issued within the context of a collective capital raising, without (digital) participation rights in the form of shares or participation or profit sharing certificates being issued
- Considered as a mandate relationship (art. 394ss CO)

Swiss tax aspects : utility tokens

- Tax treatment at issuer level:
- **Profit tax:**
  - Constitute taxable income and must be recorded as income at the time of issue in the income statement
  - Also possible : tokens recorded as liabilities or advances without the right to payment. At the end of the fiscal period, the account is partially dissolved up to the amount of the accrued costs, including a possible profit margin which must be shown independently of the accounting method
- **Withholding tax:**
  - Not subject to WHT (art. 4 al. 1 LIA)
- **Stamp duty:**
  - Issuance of utility tokens is not subject to stamp duty

Swiss tax aspects : utility tokens

- <u>Tax treatment at investor level:</u>

- **Wealth tax:**
  - From a tax standpoint : utility tokens considered as movable capital subject to cantonal wealth tax (art. 13 al. 1 and art. 14 al. 1 LHID)

- **Withholding tax:**
  - Not subject to WHT (art. 4 al. 1 LIA a contrario)

Swiss tax aspects : utility tokens

- **Income tax:**
  - Absence of payments from the issuer to investor : no impact on the taxation income (art. 20 al. 1 let. a LIFD and art. 7 al. 1 LHID a contrario)
  - If used to pay salaries to employees, taxable as income from a lucrative activity (art. 17 al. 1 LIFD)
    - Amount declared : amount at the time of collection, converted into CHF
  - Not considered as employee shareholdings (art. 17b al. 1 LIFD and art. 17a al. 2 LIFD)
  - Private wealth of individuals: profits/losses from purchases or sales are non-taxable capital and non-deductible losses (art. 16 al. 3 LIFD)
    - Depending on the type, extent and financing, such activity can be qualified as an independent lucrative activity resulting from the disposal of contractually based tokens and become subject to income tax (art. 18 al. 2 LIFD).

Staking

- Staking is a process that allows to reap rewards while locking in certain cryptocurrencies via a consensus system called "Proof of Stake".

- In exchange for blocking cryptocurrencies and providing services to the blockchain, cryptocurrencies owners receive new coins – sort of interest.

- Only possible for certain cryptocurrencies : e.g. Tezos, Ethereum 2, Dash, but NOT bitcoin

- → Staking is a way to fructify certain cryptocurrencies and generate income from them.

Staking
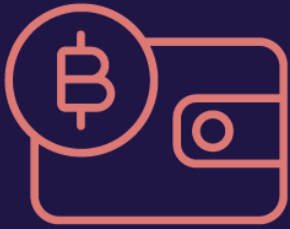
Crypto investors stake holdings by simply leaving them in their crypto wallet

The network uses holdings to forge new blocks on the blockchain

Info is "written" into the new block & the investor's holdings are used to validate it

The network rewards the staker for allowing their holdings to be used as validators

Source : sofi.com

Swiss tax treatment of staking

- Income realized from staking is treated as income from movable assets (art. 20 al. 1 LIFD). The amount to be declared is the market value at the time of realization, converted into CHF

- If individuals stake without passing through a staking pool, it must be examined whether this constitutes an independent lucrative activity

  - If it does, the staking income is taxable as income from a self-employed activity (art. 18 al. 1 LIFD)

Case Study 1 - Staking

- Geneva resident individual invested in crypto assets such as Elrond (EGLD) and Verasity (VRA)

- Crypto assets are staked, e.g. annual return 21.45% (Elrond) and 18.25% (Verasity)

- Staking rewards are paid out daily and are taxable when effectively received at the market value on the day received

- Staking rewards constitute taxable income much like interest or dividend (ordinary income)

- Clients earns about USD 1 million of staking rewards annually
  - Marginal Geneva income tax rate is **45**%
  - Underlying tokens, and thus the rewards are highly volatile

- Elrond was at some point trading at USD 490, but now around USD 90

- **Rewards of USD 490 taxable at 45% (or USD 220), but worth only USD 90 currently… How to pay for the tax due ?**

- Verasity high was USD 0.086 and currently trading at USD 0.0081

Case Study 1 - Staking

Advice / strategy :

- Consistently sell 45% of all staking rewards received, immediately when received

- Or in case of considerable staking income : consider **establishing a company** to **defer tax** and **compensate profits with losses**, e.g. Geneva CIT rate is 14% (compared to max. 45% for individuals)

Conclusion :

- Staking while earning highly volatile staking rewards poses serious tax problems for individuals
  - This is probably not unique for Switzerland and perhaps a universal tax problem

Case Study 2 – private or pro ?

- Young Geneva resident banker invested about USD 100'000 in various crypto assets in 2017.

- By the end of 2021, his portfolio of crypto assets was worth more than USD 30 million and generated annual stalking income in excess of USD 1 million (or more than 5 times his annual salary).

- Wanted to quit his banking job and dedicated 100% to crypto investments and (luckily) sought tax advice in advance, also for his 2020 tax return.

Case Study 2 – private or pro ?

Swiss tax aspects:

- Staking income taxable (approx. USD 450'000 of income tax)
- Crypto assets subject to NWT of some USD 180'000 to 300'000 *per annum.*
- And what about capital gains ? Tax-free (private) or taxable (professional)?

Case Study 2 – private or pro ?

Swiss tax aspects:

- Key indicators of professional activity, derived from Circular Letter 36 on professional securities dealers:
  - Short holding period (less than 6 months)
  - Total transaction volume exceeds 5 times value of relevant movable assets on january 1
  - Realizing capital gains are 50% or more of net income during tax year
  - Use of debt instruments to finance the investments
  - Activities exceeding simple management of private wealth
  - Planned and systematic transactions, reinvestment of gains in similar instruments
  - Close connections with profesionnal activity and using special(ist) knowledge

Case Study 2 – private or pro ?

Solution :

- Client was already in a grey zone but would be at (high) risk of becoming a professional the moment he would give up his full time job as a banker to dedicate himself fully to crypto investments.

- We advised him to establish a Swiss limited company and to transfer all his crypto assets to such company before giving up his job.

- We further advised that an advance tax ruling should be sought for the restructuring of his private wealth but with (a) a step-up in basis and (b) recognition of tax-free capital gain upon contribution.

- Client sought a second opinion from a Swiss German tax adviser with several crypto clients, who confirmed ou advice and gave the same recommendations, but wasn't sure the ruling would be obtained.

- We then filed, negociated, and obtained the ruling from the Geneva tax administration, who told us we were the first to do so.

- We then implemented the structure for the client and finally filed his 2020 tax return.

Case Study 3 – utility tokens issuance

- Swiss based company managing sensitive KYC data for banks and asset managers on the blockchain

- Issuance of USD 100M of utility tokens, which are needed to access or manage the data (and are destroyed after use)

- Question 1 – tax impact of the issuance on the company

- Question 2 – tax impact for the company's shareholders

Case Study 3 – utility tokens issuance

Question 1 – tax impact of the issuance on the company

- Proceeds of issuance constitute taxable income (14% CIT)
- But : provisions can be made for the future services to be rendered
- Amortisation mechanism to be defined and residual profit to be calculated
- Possible mismatches for staking reserves or employee tokens

Case Study 3 – utility tokens issuance

Question 2 – tax impact for the company's shareholders

- Net wealth tax : 0.6 to 1%
- Tax value of shares approx. 10 times annual profit
- 100 MUSD issuance leads to tax value of USD 1 billion
- NWT 6 to 10 MUSD per year
- Use provisions also to reduce NWT value
- Alternative : start-up valuation for new companies

Thank you for your attention!

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