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# INITIAL COIN OFFERING AND THE RELATED TAX CONSEQUENCES

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**Initial Coin Offering (ICO), also referred to as Token Generating Event (TGE), is a new and, until now, loosely regulated form of crowdfunding, which is mainly used by companies whose business model is based on the blockchain technology. In the centre of this new form of financing is Switzerland; in particular the so-called Crypto Valley Zug. In addition to regulatory challenges, aiming to limit the risk of fraud, a TGE also leads to new tax related questions.**

## 1. Introduction

During a Token Generating Event (hereafter „TGE“) start-ups and established companies issue cryptocurrencies (hereafter „Tokens“) which are based on the blockchain technology. The raised proceeds will be used by the company to fund the announced project. In contrast to collective debt raising, an initial public offering, or the increase of the company's equity, raising funds in the form of a TGE is hardly regulated. In addition, a TGE can be structured in such way that the investors are not entitled to ownership, profits, or participation rights. In the cases of the TGEs we consulted, even the effective use of the funds raised for the announced projects was contractually waived. Hence, the only obligation of the issuer is to deliver the token.

The function and features of the issued token highly depend on the nature of the project. Given that the funds raised during the TGE are required to finance the project, the virtual currency does not have an intrinsic value at the time of issuance. Only when the project (in most cases a software application such as a platform) has been successfully completed, the token becomes usable. Depending on the number of tokens purchased, the subscribers are entitled to use the developed service. Speculative investors, who have no interest in the end-product, wager that the project will be a great success. In such cases, the demand for the tokens will grow strongly, leading to capital gains for the investors. Of course, participating in a TGE can be lucrative not only for speculators, but also for the future users of the developed solution since they can pre-order the services at a lower price than what would need to be paid in the future.

Until now there is neither prevailing legal practice nor administrative guidelines on the tax treatment of TGEs. Therefore, this article aims to be an attempt to situate this new form of financing into the existing Swiss legal system. In many cases a company disposes over its own inventory of cryptocurrencies after the TGE. The potential tax consequences arising from holding tokens after the TGE are presented in the second part of the article. Financial regulatory aspects – which are very important when conducting a TGE – are not subject of discussion in this article.

## 2. Corporate law structuring

The first step for founders considering a TGE is to determine the legal form of the issuing entity. This decision depends on the particular case and affects significantly not only the taxation at the time of the TGE but also the tax consequences in the following periods. When making

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this decision, also corporate law aspects must be considered carefully. Numerous TGEs in Switzerland are carried out by a foundation (Stiftung) as the issuer of the tokens. However, it is also possible – and in particular from a long-term perspective more practical – to use a corporation as the issuer of the tokens.

### 2.1 Foundation as issuer of the tokens

Using a foundation to carry out the issuance of a cryptocurrency is not primarily driven by particular tax or regulatory motives. It shall rather increase the investors' trust in the project and the issued currency (Good Governance). This because the use of the foundation's assets in conformity with the foundations statutory purpose is monitored by the supervisory authority. The supervision ensures that not only the financial interests of the initiators of the project are in the foreground, but those of the project itself. This helps to foster trust in the project and ultimately increase the value of the issued currency and procure additional funds.

The disadvantage of a foundation is that the dedicated assets (consisting of the funds raised during the TGE and all later receipts) may be used only in the context of the notarised purpose of the foundation. If the objectives of the foundation change or if new projects are intended to be launched, a time-consuming revision of the deed of foundation is necessary to adjust the foundation's purpose. It is therefore important to carefully define the foundation's purpose in advance of the TGE.

If a foundation conducts the TGE, an operating company owned by the project initiators is usually responsible for the operational realization of the project. This operating company employs the programmers and technicians. For the realization of the project a service agreement is concluded between the two companies. The scope of the service agreement must be consistent with the foundation's statutory purpose.

### 2.2 Corporation as issuer of the tokens

A corporation as an issuer has several advantages over a foundation: On the one hand, token sales revenues are not tied to a specific purpose; on the other hand, tokens do not have to be issued separately from the operational implementation of the project. However, if it is intended to issue the tokens in Switzerland, whereas the actual realization of the project should take place in another country, an organizational separation can still make sense.

## 3. Tax treatment of the TGE

### 3.1 Properties of the tokens as basis for tax appraisal

Decisive for the tax treatment of a TGE is primarily the function of the issued tokens. Roughly speaking, a distinction can be made between three different types of functions:

- A *Currency Token* is a digital currency, like bitcoin. Coding mechanisms determine the denomination of the currency and enable the verification of remittances.
- In contrast a *Utility Token* is a digital currency, which enables access to specific services or platforms.
- *Tokenised Securities* on the other hand constitute rights against the issuer of the tokens or a third party. These may be rights to assets or codetermination. From an accounting perspective they may be equity or debt.

Most companies conducting TGEs in Switzerland have issued Utility Tokens. For this reason, the Utility Token is given special emphasis in this article. The regulatory requirements for such TGEs are usually limited to compliance with KYC provisions in accordance with the Federal Act for the Combating of Money Laun-

dering and Terrorist Financing. If other types of tokens are issued, more complex regulatory issues arise.

For more detailed information regarding regulatory law please refer to the "Guidelines for enquiries regarding the regulatory framework for initial coin offerings (ICOs)" published February 16, 2018 by the Swiss Financial Market Supervisory Authority (FINMA).

### 3.2 Corporate income tax treatment of Utility Tokens

The tax treatment of the TGE does not differ essentially whether a corporation or a foundation carries out the TGE. However, on federal level (and in most cases also on cantonal level) the tax rate for foundations is lower than the rate applicable for corporations. The effects on the income and expense side of the profit and loss statement resulting from a TGE are reflected hereinafter in separate subchapters.

*a) Income arising from a TGE*

According to Art. 58 Para. 1 lit. a of the Direct federal tax law ("DBG") (at cantonal level Art. 24 Para. 1 StHG) the statutory accounts of a Swiss company are the basis for determining taxable income. As the tax treatment generally has to follow the accounting treatment ("Massgeblichkeitsprinzip"), no separate tax accounts have to be prepared (PETER BRÜLISAUER/FLURIN POLTERA, in: Martin Zweifel/Peter Athanas (Hrsg.), Kommentar zum Schweizerischen Steuerrecht I/2b, Art. 58 DBG N 11).

As a result of this, the tax treatment of a TGE is highly dependent from the provisions of the Swiss Commercial Law ("OR"). According to Art. 959b ff. OR the income statement includes revenues from supplies and services, revenue from other sources, and all operating and non-operating expenditures. "Revenues from supplies and services" comprises all actual operating turnovers from the sale of products produced or services rendered (MARKUS NEUHAUS/JÖRG BLÄTTLER, in: Honsel/Vogt/Watter (Hrsg.), Kommentar zum Obligationenrecht II, Art. 663 OR N 14). In most cases the company receives a cash payment for the sold supplies and services. However, it is also possible that other goods or services are received in consideration for the company's goods or services (barter). If this is the case, the market value of the received consideration is relevant for accounting purposes (BGer dated 13 February 2008 2C_506/2007).

It can therefore be concluded that the sale of Utility Tokens – where the receipt of the funds results neither in an interest in the company nor in a debt liability – is to be captured as proceeds from supplies and services. Therefore, also from a tax perspective, the funds collected simply reflect the purchase price for the sale of a defined quantity of tokens. In most cases, the purchase price is paid in Ether, Bitcoin or another cryptocurrency. The amount of income depends on the units of cryptocurrencies received and the prevailing exchange rate.

As mentioned initially, the tokens issued are intended to enable access to specific service or platform. As the development of the service or platform is financed with the funds from the TGE, the issued currency cannot be used for the intended purpose yet. The sale of Utility Tokens is therefore to some extent a prepayment (without having the right of a repayment).

*b) Expenses and costs of a TGE*

In general proceeds from supplies and services are (at least partially) offset by costs of raw material, goods and employees and other expenditures incurred for the purchase or production of the products and services sold.

In the case of prepaid purchases, long-term project financing, or production orders, the rendering of the services and the payment of the consideration do not accrue at the same time. The principle of accrual accounting under Art. 958b Para. 1 OR requires that income and expenses, which arise in a period, are also accrued and recognised accordingly. Moreover, a correct accrual of expenses (i.e. full recognition of liabilities, accrued costs and reserves) is of significant importance in order to safeguard the principle of prudence and imparity as to Art. 960a OR. Based on the imparity principle, income is realised when a legally and effectively enforceable claim has arisen. On the other hand, expenses are already recognised when losses or risks are probable and recognisable from the transactions prior to the closing date (cf. HWP Band 1, I.2.3, S 8).

Since the project to be realized is still largely to be created at the time of the TGE, the generated income from the token issuance should (at least partially) be offset by the future operating expenses that are necessary to make the token ready for use. Therefore, at the point when the revenues are recognised as income, the future development and operational costs must be accrued as a provision, to ensure that the associated income and expense are recognised periodically. Hence, the provision makes sure that the net profit/loss of the period is determined in accordance with the applicable accounting principles.

Based on the rather restrictive tax rules for provisions (Art. 63 DBG), we recommend in any case filing an advanced ruling with the competent cantonal tax authorities. In our experience, such ruling can be successfully agreed if the project description, the project costs, and the defined milestones are set out in detail. Provided that the funds received from the TGE are equal to the expected costs of the development of the project, no tax consequences arise from the TGE. If however, the receipts from the TGE exceed the expected costs, the resulting profit is subject to tax.

In the following periods the recorded provision can be continuously released by the expenses incurred for the development of the platform or service. If the operational activities are performed by a company other than the one that carried out the TGE (cf. the above-mentioned foundation model), the expenses incurred are mainly related to the service fee remitted to the operating company. Such a fee would of course have to be at arm's length. In accordance with Art. 63 Para. 2 DBG the provision must be released at the end of the period, in which the development is completed. It must also be released, if the project is prematurely terminated.

### 3.3 VAT treatment of the issue of Utility Tokens

Any service rendered by a taxpayer against consideration is subject to VAT, unless the Swiss VAT Law ("MWSTG") provides for an exemption (Art. 18 Para. 1 MWSTG).

If a company receives funds without having rendered a service or delivered a product, no commercial relationship exists. Such funds (so-called «non-considerations») are therefore not subject to VAT (Art. 18 Para. 2 MWSTG). A service or product sale within the meaning of the Swiss VAT Law is the granting of a usable economic value to a recipient in expectation of a consideration. Usable economic values are goods and services which in any form serve to satisfy a need or demand. Not usable in the sense of the Swiss VAT Law are, for example, land and capital (money) (cf. Botschaft zur Vereinfachung der Mehrwertsteuer dated 25 June 2008, S. 6940).

The tokens issued during a TGE are digital means of payments, i.e. a balance with the possibility of making a sort of payment in elec-

tronic form in order to receive a certain consideration. In contrast to the consideration to be received, the tokens as such have no intrinsic value.

When one means of payment is exchanged for another means of payment there is a lack of granting a usable economic value. Therefore, no service or sale in the sense of the Swiss VAT Law is given. Based on this the issuance of tokens is to be qualified as a non-consideration in the sense of Art. 18 Para. 2 MWSTG and is therefore not subject to VAT. VAT consequences do, however, arise, when the tokens are effectively used to obtain access to the platform or service. At this point the question arises as to how the consideration subject to VAT is to be determined in CHF.

If the tokens do not qualify as digital means of payments than VAT consequences can arise, if there is no other exemption applicable. If the token qualifies as a security token the issuance of the token might fall under the exemption of Art. 21 Abs. 2 Ziff. 19 lit. e MWSTG (issuance of securities).

## 4. Possible tax consequences of holding cryptocurrencies

As stated above, after the TGE, the development of the announced project is in the foreground. The incurred expenditures in the form of direct costs and overheads are continuously reducing the recorded provision. As soon as the development phase has been completed, any remaining balance of the provision must in principle be released and is subject to tax.

In addition to this, the taxation of the company's own inventory of cryptocurrencies plays a key role for a company performing a TGE. This is because the payments for the token sale are in most cases received in other cryptocurrencies, such as Bitcoin or Ether, and because the company does frequently not sell all of the issued tokens during the TGE but also keeps a fraction of the tokens created for its own stock. The tokens not sold are often sold or assigned to various stakeholders such as employees, founders, major investors or advisers at a later point in time.

Hereinafter the tax treatment of the token inventory will be analysed in detail. As it is also the case for the taxation of the TGE, the tax consequences arising from holding cryptocurrency depends again on the applicable commercial law provisions and the specific functions of the currency. Regarding the VAT consequences on the sale of the inventory of cryptocurrencies please refer to the preceding section.

### 4.1 General commercial law classification of cryptocurrencies

Until now the legislator has not commented on the commercial law treatment of cryptocurrencies held by companies. However, recently, the professional organisation EXPERT-suisse has updated its Q&A Document, „Ausgewählte Fragen und Antworten zum neuen Rechnungslegungsrecht“ and addressed the question whether and how cryptocurrencies – in particular Bitcoin – are to be accounted for in the statutory accounts. The professional organisation affirms that Bitcoin is capable for accountability in accordance with Art. 959 Para. 2 OR. This is because the following conditions are satisfied: disposability, probable inflow of funds and reliable estimation of the value. In addition, they addressed the question of how Bitcoin should be recognised in the balance sheet (i.e. cash and cash equivalents, securities, inventories, etc.).

For the classification as cash or cash equivalent it is implicitly required that the currency qualifies as a legal currency. Bitcoin does not satisfy this requirement. In addition the volatility of Bitcoin is very high and the general acceptance as a

means of payment is lacking, so that important economic properties of a currency are currently not given. The Swiss Federal Council concluded the same in its report on virtual currencies dated 25 June 2014 (cf. Section 2.2.1). The Council argued that due to the high volatility, Bitcoin does not fully satisfy the basic functions of money (means of exchange, accounting unit and means of storing value). Therefore, Bitcoin is not to be classified as a currency, but as an asset.

According to EXPERTsuisse, Bitcoin is to be qualified either as securities (current or fixed assets) or as inventories. The former is indicated, if holding of Bitcoin does not accord with the company's ordinary business. If in the course of its ordinary business a company continuously and to a significant extent trades Bitcoin, a classification as inventories may be appropriate. In the author's view this commercial law qualification applies also for other cryptocurrencies, if the basic conditions of Art. 959 Para. 2 OR are met.

### 4.2 Tax treatment of the inventory of cryptocurrencies

a) Inventory of Bitcoin and other cryptocurrencies

Based on the above, Bitcoin, Ether or other cryptocurrencies, which the company holds after the TGE, are not to be accounted for as cash or cash equivalents, but either as securities or inventories. This is because they do not satisfy the requirements for qualification as a means of payment (see above).

The cryptocurrencies received by the company are recognised at the value on the day of the inflow. The applicable exchange rate in CHF is decisive for the initial recognition as income. As the exchange rates for cryptocurrencies vary depending on the trading platform, it is appropriate that the company relies on an average rate of as many trading platforms as possible for determining the applicable exchange rate. According to Art. 960a Para. 2 OR the valuation of the inventory for subsequent years must be in accordance with the historical cost principle (i.e. valuation cannot be above historical cost). An exemption of this principle is possible for assets which are publicly traded or that have an observable market price. On the basis of this (optional) provision, a company can value its inventory of cryptocurrencies at market prices. In such cases the company can record a fluctuation provision which is in line with the changing value of the inventory. This gives the possibility to offset and defer any gain/loss resulting from price movements of the inventory until the gain or loss is actually realized.

If at a later date the inventory of cryptocurrencies is sold, the company realises a taxable gain or loss in the amount of the difference between the book value and the actual sales price. At this time the fluctuation provision, if any, must be released.

b) Inventory of own tokens

The issued tokens are mostly based on so-called Smart Contract. Expenses incurred for the programming of these Smart Contracts constitute in principle production costs of the tokens. These production costs are relevant for the initial recognition of the issued tokens as inventory.

The tokens, which are sold during the TGE, reduce the inventory. At the same time the payment, which in most cases is received in other cryptocurrencies, is recognised as income at the prevailing exchange rate. The difference between the production costs and the corresponding inflow reflects the income arising from the TGE.

As stated above, the book value of the inventory of the tokens equals the historic production

cost. For the valuation of the inventory in subsequent years, the same principles as mentioned in the previous chapter are valid (i.e. historical cost principle with the option to value the inventory at market prices if such prices are observable).

If at a later point in time the retained tokens are sold, the company realises taxable income in the amount of the difference between the book value and the sales price. On the date of sale a fluctuation provision, if any, is to be released.

## 5. Conclusion

Conducting a TGE is a challenge not only from regulatory perspective, but also from a tax standpoint. As there are no specific legal provisions or published administrative guidelines to provide guidance, it is recommended that an advance ruling is filed with the competent tax authorities.

The aim of the ruling is to ensure that in the tax period of the TGE, a provision for the financing of the project can be set against the taxable revenues received from the token sale. The detailed description of the purpose of the business is of utmost importance to successfully obtain a ruling. Particular attention is to be accorded to the project description, the project costs and the defined milestones. The latter is crucial for the tax authorities in order to estimate the time when the project will be completed. Surprisingly, most of the TGE in Switzerland were performed without filing a tax ruling. In doing so many companies have exposed themselves to great legal uncertainty.

Without a tax ruling, a provision claimed in the financial statements will be reviewed by the tax commissionaire during the assessment procedure. The company will then be required to provide evidence that the provision was justified from a commercial law and tax perspective. This gives the tax authorities a wide range for action. Given the fact that the tax justification of a provision can be disputed, the taxation of the TGE remains afflicted with uncertainties, for which those involved could pay a high price. Furthermore, it is important to remember that the climate in the cryptoscene and the approach of the authorities may change one day. For example, it is possible that the cantons or even the Swiss federal tax administration may establish a practice, under which at least some of the revenues would have to be taxed in the tax period of the TGE (regardless of the expected cost for the development of the project).

For example it might be possible that stricter rules could apply to cases where the projects are developed and operated in foreign countries. This is because a provision in the amount of the received proceeds during the TGE could result in no Swiss taxes at all, if the entity responsible for the development of the project is located abroad.