TITLE

Do we need special VAT rules for non-fungible tokens (NFT)? Part 2

NFTs are conquering the market more and more, and the potential seems almost unlimited. In the first part of the article[1] it was explained how NFT can be defined and how they can be integrated into the existing VAT regulations. In this second part, we will examine whether the concrete VAT consequences take sufficient account of the specific problems of this new technology and what challenges arise for market participants in the context of the issuance, transfer, use and storage as well as trade of or with NFT.

By Christoph Drexl, Linda Graff Brakemeier, Zsuzsanna Serra

As explained in the first part of the article, NFTs should regularly be qualified as utility tokens within the scope of the current fields of application, whereby a subsumption under the definition of investment token also appears possible with the corresponding design. The existence of hybrid forms is explicitly recognized by the FTA. In its practice publication, it offers guidelines on how the production or issuance, trade, use and storage of utility and investment tokens are to be assessed for VAT purposes. However, questions remain unanswered, as will be shown in the following.

Practical issues in the production of NFT

The FTA does not explicitly comment on the question of how the production ("minting") of an NFT is to be assessed for VAT purposes. The minting of an NFT should not be covered by VAT unless it is embedded in an exchange of services (e.g. if an artist creates an NFT as part of his/her creative work). But what about when the NFT is mined by the artist on behalf of another person, possibly even directly into his or her wallet, so that formally no further act of transfer is necessary? Here, despite the perceived uniformity of the process, there are in fact two legally distinct acts that are carried out one after the other: the minting (which does not fall within the scope of application of VAT) in the sense of the mere generation of the NFT and the (subsequent) transfer of the values embodied in the NFT.

Things get trickier when the NFT ultimately embodies values that already belong to the third party (e.g. an NFT is minted on behalf of the third party, which is merely intended to confirm the third party's ownership of a certain object), because here the NFT, which only receives its value through the good embodied by it, becomes a commodity itself, so to speak. We will come back to this in the next section.

Practical issues in the emission/initial transfer of NFTs

Since NFTs are usually utility tokens or, as the case may be, investment tokens, according to the practice of the FTA, the VAT treatment in the context of the emission and transfer must be based on the good embodied by the token. Thus, the issuance of an NFT against payment can be a taxable or tax-exempt service or supply, depending on the exact service embodied by the NFT. This view appears logical and makes sense, provided that the NFT is denied an existence independent of the asset it represents and thus an independent value. Especially in the above-mentioned example (not mentioned in the FTA's publications), in which someone is commissioned to generate an NFT that is linked to an asset, which

[1] WEKA VAT Newsletter 03, March 2023

however already belongs to the principal, this view falls short in the opinion of the authors. For the principal, the value of the NFT is likely to be determined completely independently of the asset represented by it, because the underlying asset is already owned by him. The aim of the principal in such a case is therefore not to acquire the right to the asset underlying the NFT, but merely to securitize his special status associated with it in a digital way. Why then in such cases the qualification of the supply (as a supply of goods or of services) as well as the place of supply should be based on the asset securitized in the NFT is not easy to understand. Rather, it would probably be more plausible and appropriate to assume that the issuer of the token provides an electronic service.

According to the FTA, if NFT are transferred to a third party in order to compensate for supplies rendered, there is generally an exchange relationship in which the market value of each supply is deemed to be the consideration for the other supply. For VAT purposes, the opposing supplies are to that effect to be assessed according to the type and value of the respective supply.[2] This appears to be appropriate, because an NFT is by definition not to be understood as a mere means of payment.

As mentioned above, the FTA expressly recognizes the possibility that certain tokens may be hybrid forms that combine the properties of a utility token with those of a payment or investment token[3] , for example. However, if an investment or utility token also offers a payment function, the FTA denies the existence of a combination of different supplies and it remains a (pure) investment or utility token. It is unclear which legal norm the FTA is referring to when it formulates the assumption in the case of a combination of utility and investment tokens that the investment function is predominant and the token is therefore to be treated as an investment token. This is probably a rebuttable presumption that can be overturned on the basis of a specific case constellation. Anyhow, the practice formulated by the FTA appears to be pragmatic and practicable, because it relieves the taxpayer of the necessity of laboriously proving the status of the tokens and thus offers a certain legal certainty on relatively new terrain.

Practical issues in the trade and use of NFTs

As with the initial transfer of NFT, the type of supply and place of performance in the case of the purchase and sale of NFT is determined on the basis of the supply embodied in them. Thus, trading in NFT results in a taxable supply, provided that the place of supply of the supply embodied in the crypto token is in Switzerland and no tax exemption pursuant to Art. 21 para. 2 VAT Act applies.[4]

This sounds quite simple as far as it goes. However, it should be noted that a utility token can embody a merely determinable value according to the definition also recognized by the FTA[5] . In such cases, the utility token is conceptually close to a voucher. However, if the supply is merely determinable at the time of transfer, the question arises as to how exactly the time of supply and thus the moment when the tax liability arises is determined? In relation to an NFT (in the sense of a sub-type of a utility or investment token), it may first be helpful to remember the uniqueness of an NFT when answering this question. The requirement of

[2] Cf. Art. 24 para. 3 VAT Act as well as MWST-Info 04, Tax object, point 2.7.3.4
[3] For the definition of the token types, cf. the explanations in VAT Info 04, Tax object, point 2.7.3.1
[4] MWST-Info 04, Tax object, point 2.7.3.4
[5] MWST-Info 04, Tax object, point 2.7.3.1

uniqueness makes it rather unlikely that an NFT embodies a merely determinable good, e.g. a bottle of Domaine de la Romanée-Conti, vintage 2002. Rather, it must then be a very specific bottle. This also makes it clear that at the moment of transfer of an NFT in the course of a trade, it is usually already clear which asset exactly is embodied by it, whereby this or the right to it is transferred at the same time as the NFT. It should be noted that from then on, the user can access the right embodied by the NFT an infinite number of times, the NFT does not consume itself, so to speak. This means that the time of performance cannot be determined differently from the time of transfer of the NFT (this is different in connection with normal utility tokens that do not represent NFTs: normal utility tokens can be used and thus consumed, so to speak, e.g. if they provide access to a certain storage capacity. Here, the transfer of the token and its use may be separated in time. The FTA answers the question on the time of supply by stating that this is to be determined at the moment of use of the token and thus of real fulfillment).

Another point that can lead to difficulties in practice when trading in NFT that embody an intangible value and thus qualify as a service when transferred is that in the context of NFT trading, the transaction participants often act anonymously or via pseudonyms. According to Art. 8 para. 1 VAT Act, the place of supply of services is the place where the recipient of the service has his or her place of business or a permanent establishment. If the buyers are anonymous, it is almost impossible to identify the recipient and thus the place of supply with legal certainty. This applies all the more where all relevant processes in a transaction are regulated automatically via a so-called smart contract.

The providers of NFT then often only have the option of entering into transactions if the buyer identifies himself, e.g. within the framework of a know-your-costumer process, with his civil or official company and submits the corresponding documents (e.g. copy of ID and/or extract from the register of residents or extract from the commercial register).

A (daring) look into the future

As shown by the above example of the order to produce an NFT to embody an asset already owned by the principal, the equation of the NFT with the asset embodied by it as provided for in the current legal situation may well cause difficulties in the real world. It should be noted that currently civil law ownership in many legal systems is only possible in objects, as is also stipulated in Switzerland by Art. 641 para. 1 of the Swiss Civil Code. It should be noted that the term "thing" in civil law is to be understood very narrowly and therefore exclusively understands physically existing objects and works. This has far-reaching consequences, because if no ownership of an NFT itself is possible because it lacks corporeality, it cannot itself be stolen. Regardless of legal constructs, this then leads to the underlying asset belonging to the person who has the NFT, no matter how it came into their possession ("code is law"). In the case of theft of the NFT, there is at most a claim for damages, but no claim for restitution. It should be clear that this does not always lead to a result that satisfies the sense of justice.

It is all the more remarkable that recently a British court (High Court) recognized in a revolutionary way the possibility of civil ownership of NFT itself. [6]A Chinese court has also considered NFT as legally protected virtual property. [7]

[6] https://taxtech.blog/2022/05/17/eigentum-an-non-fungible-token-nft-ein-uk-gericht-sagt-ja/

[7] https://www.finanzen.ch/nachrichten/devisen/neue-erkenntnisse-aus-gerichtsurteil-in-china-nfts-gesetzlich-geschuetztes-virtuelles-eigentum-1031971166

Should a trend develop from this, effects on VAT law could not be ruled out in the opinion of the authors. At the very least, a publication of the FTA's practice specifically on NFT would then be desirable. For if the NFT itself acquires an independent status as a tradable asset that is independent of the (virtual or physical) object it embodies, then the VAT treatment of trade in NFT must also be independent of it. Consequently, the question would have to be resolved whether every trade would then automatically lead to two flows of services, one with regard to the NFT and one with regard to the asset embodied in it? And how would the NFT itself then be valued, as an IP right? Or as a service provided electronically? Or as a service of its own kind? According to which principles would the remuneration be divided between these two services? Would there be a single supply or a combination of services, or would the NFT be assessed as an ancillary service and the value embodied in it as the main service?

Conclusion

At first glance, the existing regulations seem to be sufficient to lead to practicable solutions in practice. In individual cases, however, it can still be tricky to assess the VAT treatment of transactions with NFT with legal certainty. It remains to be seen whether the rapidly developing economic importance of NFT will also lead to separate VAT regulations specifically tailored to them.

AUTHORS

Christoph Drexl is a partner at PrimeTax AG. He specializes in the area of VAT and advises clients on complex issues of national and international VAT law.

Linda Graff Brakemeier is a Director at PrimeTax AG. She has more than 20 years of VAT experience as a consultant and in-house tax manager and advises clients on national and international VAT issues.

Zsuzsanna Serra, LL.M, is a consultant at PrimeTax AG. Ms Serra advises clients mainly on national and international VAT issues.