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Newsletter

Special Edition

Initial Coin Offerings in Switzerland:

For some good reasons, Switzerland and especially the Canton of Zug have been heavily promoted as attractive jurisdictions to launch coin offerings, also referred to as token generating events or token sales. In most instances the purpose of such offerings is the collective fund raising in order to finance a business idea. In return for their contributions, the investors receive, or are promised to receive, tokens generated on a blockchain enabled platform which may represent certain rights or at least the expectation that the token will develop into a virtual currency similar to Bitcoin or Ether. Whereas the tax treatment of such Initial Coin Offerings (ICO) remains to be clarified with the tax authorities, the Swiss financial regulator FINMA has now confirmed that ICOs do not generally fall outside of the Swiss financial and anti-money laundering regulation. Walder Wyss' previous advice on ICOs is entirely in line with the guidelines published by FINMA last week.

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Initial Coin Offerings in Switzerland

The purpose of this newsletter is to describe the structure of initial coin offerings (ICO) launched in Switzerland, the qualification of tokens under Swiss law as well as the regulatory and tax treatment of Swiss ICOs. Even though some of the recent Swiss ICOs followed a similar (two-tier) structure, neither the Swiss financial regulator FINMA nor the Swiss tax authorities have confirmed yet whether these structures would be compliant with Swiss regulation and tax laws. It is therefore advisable to pre-discuss any Swiss ICO with the competent Swiss authorities.

Structure of a Swiss ICO

Start-ups and lately also well established companies have become increasingly interested in the issuance of coins or tokens generated on a blockchain as a new way of financing. In an ICO (also referred to as token sale or token generating event, short TGE), the entity issuing the token raises funds from investors based on a white paper which describes the project to be financed in quite some detail. An ICO in Switzerland where the company to be financed is located outside of Switzerland involves the following steps: (i) setting up of an orphan foundation (*Stiftung*) (which is supervised by the Swiss Foundation Supervisory Authority) or a special purpose vehicle in the form of a limited liability company or a stock corporation, (ii) drafting the white paper describing the project and the use of the tokens yet to be issued, (iii) conclusion of a development agreement between the foundation and the company seeking the funds (iv) collecting crypto currencies such as Bitcoins or Ethers from investors by the foundation or the company based on the white paper in one or more often various investment rounds, and (v) issuance of the tokens to the investors.

Categories of tokens

At first, a token is nothing more than a unique string of characters, used to confirm, for instance, that a user is allowed to join an internet platform or a mailing list. In the crypto world, a token is an entry identified by a public key on the blockchain. A user controlling the token has the private key to create a new entry on the ledger which means he or she may transfer the record from his own public address to the public address of a third party. Often, tokens are divided into intrinsic tokens (also called native tokens) and asset-backed tokens (sometimes also called coloured coins).

Intrinsic tokens are not backed by any underlying. These tokens do not represent anything and are simply created by a software which then keeps record of the transfer of each token from the first holder to the next on a distributed public ledger. The best known intrinsic tokens are Bitcoins and Ethers, although Ethers are also used to validate smart contract transactions built on the Ethereum blockchain and do therefore have a wider purpose than just serving as a virtual currency. The value of such tokens is simply based on expectation that a third party will exchange the acquired tokens for the same or a higher value of money, goods

or services. The more people which have debt payable in Bitcoins, the more likely Bitcoins may be exchanged for good value. These intrinsic tokens are very much like any money established by law or governmental regulation (i.e., fiat money). The exchange of Swiss Francs into Bitcoins should therefore be subject to the same rules and regulation as an exchange of Swiss Francs into Euros or Dollars (see below).

Asset-backed tokens on the other hand represent a claim of a specific holder on an underlying asset or service or a right of the holder against the issuer or a related company, such as participation in profits similar to the dividend right of a shareholder. Such asset or right may first have to be created by a start-up (e.g., the asset may be the right to store data on a platform or the simple access or use of a platform yet to be developed) or may first have to be stored by the acquirer of the token (e.g., the user transfers the equivalent of CHF 100 to the address of the token issuer in exchange for a token, he or she may at a later stage reclaim the investment while redeeming the token). Such token is sometimes described as "I owe you" (IOU) token, because it is like a receipt, or a utility or application token.

An asset-backed token may be deemed as the digital equivalent of an intermediated security with the differences that (i) the underlying is not limited to personal or corporate rights of a fungible nature and that (ii) such token may be created by anybody not only by certain financial intermediaries as set out in Swiss law. The creation of asset-backed tokens is recorded on a blockchain (whether it's coloured coins on the Bitcoin blockchain, or a smart contract on Ethereum). The holder of the asset-backed token may either transfer it to a third party or, if permitted, request pay out or use the services embedded in the token from the creator of the token or from the respective debtor.

Qualification of tokens and regulatory consequences

Issuance of intrinsic tokens

The Swiss Federal Council confirmed various years ago that intrinsic tokens should be deemed as virtual currency. Virtual currency has to be treated as any other currency. The long standing practice of FINMA reflects this understanding. As a consequence, the exchange of fiat money, Bitcoin, Ether or any other intrinsic token into a newly issued intrinsic token in the course of an ICO would be subject to the same laws as the exchange of any currency. Any Swiss entity offering currency exchange has to comply with the Swiss anti money laundering (AML) rules in the event such entity is acting on a professional basis. In the course of any ICO, the required threshold to act on professional basis is being reached if the value of the accepted Bitcoins or Ethers in exchange of the issuance of new intrinsic tokens exceeds CHF 2 million. In such event, the Swiss entity issuing new intrinsic tokens has either to join a self-regulatory organization for AML purposes or submit itself to the respective supervision of FINMA. Any investor (whether foreign or Swiss) investing more than an equivalent of CHF 5,000 of intrinsic tokens into the newly created tokens is subject to the required know your customer due diligence of the Swiss entity conducting the offering.

Issuance of asset-backed tokens

The analysis is slightly more complex in the event asset-based tokens will be generated in the course of an ICO. Apart from the FINMA Guidance 04/2017 of 29 September 2017 (see below), neither FINMA nor the lawmaker has provided any guidance on the qualification of asset-backed tokens under Swiss law.

First of all, an asset-backed token might qualify as a *security (Effekte)* under Swiss law. Securities are *standardized certificated and uncertificated securities, derivatives* and *intermediated securities,* which are suitable for mass trading. Standardized and suitable for mass trading means that the standardized securities, derivatives and intermediated securities must be made publicly available in the same structure and denomination with more than 20 investors as long as they have not been created for individual counterparties only. This would certainly be the case in respect of an ICO.

The qualification of asset-backed tokens as securities would have important consequences: A Swiss entity which collects funds for an underlying company while issuing securities generally requires a securities dealer license in Switzerland. A platform allowing for multilateral trading of securities (i.e., a platform which allows multilateral trading, non-discretionary conclusion of contracts or trading in securities) may only be offered by regulated banks or securities dealers. The issuance of debt or equity securities to more than 20 investors requires a prospectus. The issuance of certain derivatives (i.e., structured products) requires a simplified prospectus and the derivatives have to be issued, guaranteed or secured by a regulated bank or securities dealer.

Without fulfilment of the above mentioned regulatory requirements or obtaining a non-action letter from FINMA, it is therefore crucial that the asset-backed tokens generated by the Swiss entity *will not show elements of a security*, i.e., do not qualify as uncertificated securities, derivatives or intermediated securities (tokens are clearly not certificated securities because they are not represented in a physical deed).

In the event one token equals one or more shares or a percentage of a share in a company, one could simply disregard the token and take it as a security. A token shall therefore not represent a fraction of, one or a multiple of equity right in an underlying company in the event no prospectus compliant with Swiss law would be available.

Asset-backed tokens *may also resemble structured products or other derivatives.* A structured product is an investment instrument where the redemption value is linked to the performance of one or more underlying assets. Underlying assets are investments such as shares, interest, foreign currency or commodities. Typically, the underlying has a market value which allows pricing of the structured product (this requirement has lately been challenged, though). Asset-based tokens generated in Swiss ICOs should lack such structuring on an underlying asset if not generated in compliance with regulatory requirements. Rather, such asset-based tokens should be unstructured (option) rights in the participation or use of a yet to be developed platform. Different to structured products, such mere options may be issued by a Swiss entity without prospectus or other documentation requirement. The sale of an option right against fiat money, Bitcoin, Ether or other established third party cryptocurrency should further not be subject to AML regulation.

Asset-based tokens *should further not represent a right to request repayment of the underlying asset* to the investor. Otherwise the issuance of the token could be deemed as deposit taking by the Swiss entity conducting the token offering. The acceptance of deposits from the public triggers the application of banking regulation. Swiss regulated banks only are permitted to accept deposits. A Swiss foundation or company would, therefore, not be permitted to accept fiat money, Bitcoins, Ethers or other intrinsic tokens from investors in exchange for a token which allows the holder of such token to request payout of the underlying assets.

Four important exemptions from the said application of the Swiss Banking Act are noteworthy. First, payments from investors based on a prospectus subject to Swiss law do not qualify as deposit under the Swiss Banking Act. Even though the disclosure requirements of a Swiss prospectus are currently rather low, the white papers used in an ICO do generally not cope with the legal requirements for a Swiss prospectus. However, it would take limited effort to amend a white paper in order to scope with the prospectus requirements. Secondly, payments to a charitable foundation would generally not be deemed as deposit. We believe that Swiss foundations engaging in an ICO do not have a charitable purpose and may therefore not benefit from this exception. Third, accepting deposits from an unlimited number of third parties below the aggregate value of CHF 1 million would not trigger banking license requirements (regulatory sandbox). Fourth, the acceptance of (virtual or fiat) money not exceeding a value of CHF 3,000 by a payment system for future services or goods fall out of scope of the term deposit (provided that no interest is being paid to the investor). Even though the last two exceptions may be relied upon in an ICO, they would limit the acceptable ticket sizes and scale. Mid-size and large investments would be excluded.

Finally, if the assets raised from investors in the course of an ICO are for the purpose of collective investments, and such assets are managed for the account of such investors on an equal basis, the provisions of the collective investment scheme legislation need to be considered.

Latest guidelines of FINMA on ICOs

On 29 September 2017 FINMA has issued guidance on the regulatory treatment of ICOs in Switzerland. FINMA recognises the innovative potential of distributed ledger technology and takes a technology neutral approach. FINMA shows the interdependencies and links to the existing regulatory framework and financial market laws as further detailed above. FINMA urges issuers to receive a ruling prior to the launch of the ICO and warns investors about fraudulent behaviour.

More specifically FINMA states that:

- AML regulation would apply where the creation of a token by an ICO vendor involves issuing a payment instrument. If this were the case, other regulation may apply for third parties, especially for professional cryptobrokers or trading platforms which carry out exchange transactions or transfers with tokens (secondary trading with tokens);
- Accepting public deposits where an obligation towards participants arises for the ICO operator because of the ICO generally would require a banking licence;
- A licensing requirement to operate as a securities dealer may be required where the tokens issued would qualify as securities (e.g., as derivatives); and
- Where assets collected as part of the ICO would be managed externally, the structure may qualify as collective investment fund, again subject to licensing requirements.

Our analysis above reflects the concerns raised by FINMA in its recent ICO guidance. However, it should also be observed that in contrast to the proclamation by the regulator that ICOs remain welcome in Switzerland, the criteria set forth in the guidance are exorbitantly broad in some circumstances. For instance, not every obligation of the ICO operator towards a token holder necessitates a banking license; rather, this is only the case if the token holder is entitled to redeem the token value, but not if the obligation of the token issuer consists in granting access to a certain platform functionality, or a profit share (in which case, however, the token might be deemed a security).

Tax treatment on ICOs

Income tax treatment of companies raising funds through ICOs

Currently, there are no established guidelines with regard to the income tax treatment of companies collectively raising funds through ICOs. The tax treatment should be reviewed on a case-by-case basis.

Depending on the specific circumstances and the structuring of the tokens, the Swiss entity conducting the offering of the tokens may be obliged to reflect the proceeds of the ICO as taxable income. In said cases, it should be justifiable to neutralize the income out of the ICO by accounting for a provision in the amount of the ICO proceeds due to the fact that the income is linked to the liability for future payments/services by the Swiss entity issuing the tokens.

VAT treatment of companies raising funds through ICOs

Currently, there are no established guidelines with regard to the VAT treatment of ICOs. Depending on the specific circumstances and the structuring of the tokens, the ICO may be regarded as falling outside the scope of VAT or as a VAT-exempt financial transaction. In other cases, the ICO may be qualified as a taxable supply provided that the investors are located in Switzerland.

Conclusion

We believe that Switzerland remains an attractive jurisdiction for initial coin offerings. However, structures where tokens are generated which resemble securities, as well as structures where funds are being collected to finance foreign entities by Swiss foundations without any prior tax ruling confirmation and non-action letter from FINMA may be challenged by the regulator and the tax authorities. Whether an ICO launched in Switzerland is compliant with Swiss regulation very much depends on the structuring of the token and the right embedded in it. We, therefore, advise to pre-discuss any potential ICO with the competent authorities.

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