

Think ICO, think global

Manuel Meyer, Andrea Bolliger and Yves Mauchle of Baker McKenzie explain why the Swiss legal regime is attractive for initial coin offerings

Switzerland is currently in the midst of the global crypto-finance boom with Swiss-related initial coin offerings (ICOs) attracting worldwide attention. The abbreviation ICO refers to events during which investors transfer funds, generally in the form of cryptocurrency, to an ICO organiser. In return, investors receive a quantity of digital coins from the ICO organiser, also called tokens, which are tradeable on a blockchain.

In contrast to traditional fundraising means, ICOs allow global funds to be raised in a very convenient way through a web page, which is particularly attractive to start-ups. Imagine two founders of a Dutch sportswear start-up living in the Netherlands who would like to raise funds through an ICO in Switzerland in order to develop and market sportswear products in the Netherlands and produce them in China; such a cross-border undertaking will raise various legal and tax questions.

This article reveals some key legal, regulatory and tax insights you should consider in your ICO.

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Token classification

Swiss law does not define what a token is. Since there is no generally accepted classification of tokens, the Swiss Financial Market Supervisory Authority (Finma) has drawn up its own classification, taking into account the underlying economic function of the token. In this respect, Finma distinguishes the following categories:

- **Payment tokens** (synonymous with cryptocurrency): payment tokens are intended to be used as a means of payment for the acquisition of goods or services or as a means of transferring money or value. Payment tokens do not confer any claims against the ICO organiser.
- **Utility tokens**: utility tokens give access to a digital use or service based on a blockchain infrastructure.
- **Asset tokens**: asset tokens represent assets. Such tokens may in particular represent a claim within the meaning of the law of obligations towards the issuer or a membership right within the meaning of company law. In terms of the economic function, the token thus particularly represents a share, a bond or a derivative financial instrument.



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In the past year, Manuel was rewarded for his dedicated work with the Client Choice Award for M&A Switzerland 2017: "Manuel is a fierce negotiator; his knowledge is not limited to mergers and acquisitions, he has equal expertise in all fields of law." "He is fast, reliable and always delivers top-quality advice, which is a rare combination."



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Yves's practice focuses on debt and equity capital markets, regulatory issues, and corporate restructurings. He is admitted to practice law in Switzerland since 2013. Yves regularly advises on capital market transactions such as IPOs or bond issuances and represents financial institutions on regulatory matters. He also focuses on the particular regulatory challenges posed by fintech business models, such as crowdfunding and blockchain applications, including initial coin offerings.

- **Hybrid tokens:** the individual token classifications set out above are not mutually exclusive. For instance, asset and utility tokens can also include functions of a payment token.

This token classification is essential for the assessment of the applicable regulatory framework of an ICO in Switzerland. However, given that it is the first token classification that has ever been published by a Swiss authority, it may also become relevant for the tax assessment

of the competent Swiss tax authorities and may even have an impact on civil courts when assessing civil law questions in connection with tokens and ICOs.

Picking the right legal structure

The example of the Dutch sportswear start-up clearly demonstrates the complexity of selecting the appropriate legal structure, which

fundamentally consists of two layers. Firstly, the type of legal entity of the ICO organiser has to be carefully selected. In order for an ICO to qualify as a Swiss ICO, the ICO organiser must be located in Switzerland. Secondly, it is crucial to set the legal framework allowing the transfer of the ICO proceeds from the ICO organiser to the founders in the Netherlands for development and marketing purposes and in China for production.

The structure selected will have an impact on tax, which will affect the value of ICO proceeds that will remain for the undertaking. The selection of the legal framework along with

the transfer of ICO proceeds has to be made on a case-by-case basis and will trigger foreign laws as soon as a cross-border situation arises, as in the Dutch sportswear example. This article therefore focuses on the selection of the type of legal entity that the ICO organiser should adopt.

Swiss law provides for different types of legal entity and allows each of them to be adjusted largely to the needs of the case. In practice, however, the predominant legal entity type used for the ICO organiser is the Swiss foundation (*Stiftung*).

The foundation is basically a fund of assets with a value of at least CHF50,000 (approximately \$50,607) endowed to a special purpose. It has a legal personality but has no shareholders. The foundation's assets are administered by the foundation council in accordance with the foundation's purpose set out in the incorporation deed. The foundation council must be composed of at least three members, whereby at least one member with single signature authority or, alternatively, two members with joint signature authority must be Swiss or EU citizens residing in Switzerland. The foundation council is under state supervision with regards to the use of the foundation's assets. The state supervision is one of the major advantages of the foundation for ICO because this supervision warrants to the investors that the ICO proceeds will be administered in accordance with the foundation's purpose.

The foundation was also preferred in the past for regulatory purposes. However, nowadays Finma focuses on the type of token rather than on the legal entity type of the ICO organiser. Foundations, however, benefit from preferential income tax rate and may even be released from income tax if they perform non-profit objectives, which will not be the case if the founders have a financial interest in the foundation, as is the case for most ICOs like our Dutch sportswear start-up example. Moreover, foundations are not subject to Swiss withholding tax.

A fundamental disadvantage of the foundation for our sportswear start-up example is that the founders may encounter issues with the foundation council regarding the use of the ICO proceeds in the Netherlands for the development and marketing activities and in China for the production. The founders do not control the foundation council. The latter in collaboration with the state supervisory authority will determine, at their own discretion, whether or not the use of ICO proceeds is in line with the foundation's

purpose. There are examples in the past where the proceeds of successful ICOs were blocked in the foundation because the foundation council and the founders could not agree on the use of the ICO proceeds. The intended use of ICO proceeds should thus be accurately described in the foundation's purpose. However, given that the purpose of a foundation must not be changed for a 10-year term, the more accurate this description is, the less flexibility the founders have in view of a potential future game changer.

As opposed to the foundation, the company limited by shares (*Aktiengesellschaft*) and the limited liability company (LLC) (*Gesellschaft mit beschränkter Haftung*) are much more flexible. These legal entity types also have legal personality and are managed by a board. The board may consist of one member only and board members do not need to be Swiss or EU citizens. However, at least one board member with single signature authority or, alternatively, two members with joint signature authority each must reside in Switzerland. Companies limited by shares and LLCs are held by shareholders and are not under state supervision. The minimum share capital of a company limited by shares amounts to CHF100,000 and CHF20,000 for an LLC. As opposed to the foundation, the shareholders keep control over the ICO proceeds. Furthermore, and in contrast to a foundation, these legal entity types can issue asset tokens conferring rights to their equity, which is by far more interesting for investors.

How to clear the regulatory hurdles

While ICOs are not regulated as such, they are met by a variety of Swiss financial market regulations. Given the wide variety of types of token and ICO set-ups, the specific circumstances of each individual case must be assessed based on the underlying economic purpose and the specific characteristics of the issued tokens.

One possible regulatory hurdle is the Banking Act. A business conducting an ICO that accepts or advertises to the public that it will accept more than 20 deposits from the public may trigger banking licensing requirements. If the participants receive their invested capital back by handing over the tokens, the issuance is – with few exceptions – within the scope of banking regulation. However, as the issuance of tokens is in most cases not associated with claims for repayment

against the ICO organiser, token sales can usually be conducted by non-banks.

Furthermore, tokens may qualify as securities under the Financial Market Infrastructure Act (FMIA). This can have various consequences. While the distribution of self-issued uncertificated securities is mostly unregulated, the creation and issuance of derivative products on the primary market is subject to a broker-dealer licence. The same holds true for underwriting tokens and offering them to the public. Finally, trading platforms for tokens could be within the scope of the FMIA, in particular if a non-discretionary matching of orders is used.

Whether or not a token qualifies as a security under Swiss law depends on its economic function. As mentioned, Finma distinguishes between payment tokens, utility tokens and asset tokens. Payment tokens are not treated as securities. Likewise, if the sole purpose of a utility token is to confer digital access rights to an application or service (access token) and if the token can actually be used in this way at the point of issue, Finma will not treat the utility token as a security. Conversely, Finma treats asset tokens as securities if they are standardised and suitable for mass trading. Rights to acquire tokens sold in pre-sale phases of an ICO may also be considered securities.

If shares or bonds are offered for public subscription, a prospectus within the meaning of the Swiss Code of Obligations (CO) must be published. This rule will also apply if equity or bond issuances are conducted in the form of a token sale. The prospectus liability set out in the CO must above all be considered for ICOs. If rights similar to shares or bonds are offered, it is possible that a court would apply the prospectus liability rules to white papers describing ICOs. As a result, any person involved in the preparation of a white paper (including consultants) would be potentially liable for incorrect or misleading information contained in the white paper. This means, among other things, that the risks associated with the token should be thoroughly described.

Apart from prudential regulation, ICO organisers and other parties conducting business with crypto assets may be subject to anti-money-laundering (AML) rules. According to the practice of Finma, the sale of payment tokens constitutes the issuing of a means of payment and is subject to the Anti-Money-Laundering Act (AMLA), as long as the tokens can be transferred on a blockchain infrastructure. In the case of utility tokens, AML regulation is not applicable as long as the main reason for issuing the tokens is to provide access

rights to a non-financial application of blockchain technology. While the question about whether or not an activity is subject to the AMLA can be answered with relative ease, the AML duties and obligations can be a significant administrative burden for ICO organisers, and many practical questions remain open. ICO organisers will often choose to work with third-party service providers to cover AML duties.

To summarise, Switzerland can be considered a jurisdiction with a rather liberal regulatory environment. Although Finma is accommodating to blockchain applications and fintech in general, it needs to apply the law as set out in the various financial market acts. Whether an ICO falls within the scope of Swiss financial market regulation has to be determined carefully in each individual case, as the answer to this question strongly depends on the functionalities and rights of the token.

In addition to the Swiss regulatory environment, it is indispensable to consider foreign regulations. In particular, US securities law should be observed, not only on account of its rather extensive scope of application, but also due to the severe civil and criminal sanctions associated with its violation.

What to expect from tax rules

Current Swiss tax laws do not yet fully address the challenges of the new economy. It is thus not surprising that no legislation regarding the taxation of ICOs has been enacted yet and that related administrative guidance is still scarce. ICOs are rather assessed on a case-by-case basis by the competent Swiss tax authorities; they look for analogies in traditional forms of fundraising and more or less follow Finma's categorisation of the different kinds of tokens.

ICOs may affect the tax position on the level of the ICO organiser, its related entities responsible for the development, marketing and production, and the investor. As Swiss tax laws do not specifically address the taxation of ICOs and the competent Swiss tax authorities have yet to establish a visible practice, the well-established practice of the Swiss tax authorities of issuing private letter rulings proves very ICO-friendly. In the light of the significance of tax consequences in connection with ICOs, it is advisable to obtain a binding ruling from the competent Swiss tax authorities in advance.

The sportswear start-up example referred to at the beginning of this article gives ground for a good overview of the possible tax consequences of an ICO. Assuming the ICO organiser of the sportswear start-up would issue asset tokens

granting the right to a portion of the ICO organiser's profits but excluding any claim for being repaid the investment, the possible tax consequences would be the following.

Any consideration received (whether in a traditional currency or cryptocurrency) by the ICO organiser has to be duly recorded in its profit and loss statement and is perceived as taxable income. To the extent that there is a contractual obligation to invest the ICO proceeds in the development of a specific profit-generating product, the competent Swiss tax authorities should approve recording a corresponding provision, which may neutralise the taxable income derived from the ICO. Further, the issuance of tokens should not trigger Swiss issuance stamp duty. Following the ICO, the proceeds have to be transferred to the related entities in the Netherlands and in China which bear the development, marketing and production costs. In practice, such costs will be recharged to the ICO organiser. From a tax (as well as from a legal) perspective, it is essential that any intercompany payment is at arm's length to avoid any undesired tax effects. In the current scenario, three different jurisdictions are involved and therefore a comprehensive transfer price study may be required. Once the developed product generates profits, payments to the investors should be fully deductible as a business expense from the ICO organiser's taxable income. On the other hand, to the extent that the development provisions were not entirely offset against development costs, they have to be dissolved and thus would increase the ICO organiser's taxable income.

For the investor, the acquisition of asset tokens should be a tax neutral exchange of assets. Yet, Swiss resident investors have to declare the fair market value of their tokens for wealth tax purposes. Once the investor starts receiving profit participation payments from the ICO organiser, such payments are subject to income tax as 'compensation payments'. Since the ICO organiser has no obligation to repay the investment, not only payments exceeding the investment amount but all payments may qualify as taxable income. However, the Swiss federal tax administration (SFTA) is of the opinion that such asset token-derived payments to investors should not be subject to Swiss withholding tax. On the other hand, a Swiss resident investor holding the tokens as part of his private assets should realise a tax-free capital gain upon the sale of the tokens. The SFTA is of the view that asset tokens, which grant a right to participate in the issuer's profits, could qualify as sub-participation in the shares issued by a company. Consequently, the transfer of such

asset tokens against consideration may be subject to Swiss turnover stamp duty if one of the involved parties (or intermediary) qualifies as Swiss securities dealer within the meaning of the Swiss stamp duty act. Following the reasoning of the SFTA, no Swiss turnover stamp duty is due if the tokens are issued by a foundation and not by a company.

The aforementioned tax considerations are based on the issuance of an asset token in the sportswear start-up example. The tax consequences of ICOs depend substantially on the characteristics of bundle of rights which are conferred by the token. Consequently, additional taxes, in particular Swiss value-added tax (Swiss VAT), could be triggered. For instance, the issuance of utility tokens may be subject to Swiss VAT if a Swiss resident investor has acquired a right for the delivery of services in exchange for its investment. Furthermore, as ICOs are often not limited to a specific jurisdiction, international tax aspects should be considered. ICO organisers are therefore well advised to conduct a comprehensive analysis of the tax consequences of the ICO not only in Switzerland but in all jurisdictions involved.

An ICO-welcoming market

Switzerland is an ICO-friendly jurisdiction. It proposes an unlimited range of legal structuring possibilities that allow the design of a legal framework to perfectly fit the needs of an ICO project.

The regulation applicable to ICOs strongly depends on the economic function of the tokens. However, it is possible to structure an ICO in a way that does not require an authorisation. This having been said, the economic assessment of an ICO heavily depends on the rights the tokens confer. The question of whether an ICO falls under Swiss financial market regulation must therefore be carefully assessed in each individual case with Finma.

ICOs in Switzerland may be structured in a tax-effective way. The ruling practice of the Swiss tax authorities proves very ICO-friendly since the tax consequences on the level of the involved entities as well as on the level of the investors may be agreed in advance with the competent Swiss tax authorities.

Eventually, given that tokens are offered over the world wide web, an ICO may have an impact in various countries. This is why foreign laws must also be taken into account when carrying out an ICO, even if the ICO is carried out from Switzerland. The prudent token issuer will have to think global!