YPOG Briefing:

Federal Ministry of Finance publishes circular on income tax treatment of virtual currencies and crypto tokens

Berlin, May 11, 2022 | Stefan Richter and Dr. Dajo Sanning

The German Federal Ministry of Finance (BMF) has published a circular on the income tax treatment of virtual currencies and crypto tokens. The circular provides the tax authorities with binding rules for all open tax assessments regarding the taxation of income from and in connection with virtual currencies and crypto tokens. It will significantly influence the development of blockchain-based business models in Germany. Particularly important topics are (1.) the holding periods for staking or lending, (2.) the distinction between trading and mere asset-managing income for staking, (3.) the acquisition of reward tokens and (4.) the timing of taxation for employee participation programs. We'll summarize these below.

1. No extension of holding period for staking or lending

The extension of the holding period for taxable disposals from one to ten years does not apply to virtual currencies. Staking and crypto lending, in particular, should therefore not extend the holding period to ten years.

In principle, the disposal of crypto tokens is taxable, even if the crypto tokens are held as private assets for tax purposes. However, disposals are only taxable if they occur within one year after the acquisition of the crypto tokens. According to the circular, this basic rule also applies crypto tokens that were staked before they were sold. The BMF thus follows the prevailing opinion in German tax literature and demands from German tax practitioners. In the draft version of circular, the BMF argued that staking would extend the period for taxable disposals to ten years. This was based on a specific anti-tax avoidance provision, which the BMF does generally not apply to virtual currencies. Apparently, the BMF particularly wants to provide for equal tax treatment of the more climate-friendly proof-of-stake consensus mechanism compared to the resource-intensive proof-of-work consensus mechanism. According to the circular, the staked crypto tokens as well as the reward crypto tokens can be sold tax-free after expiration of the one-year holding period. The same applies to crypto tokens that were used for lending before their disposal. Although the circular refers to virtual currencies, this should not imply a restriction to currency tokens. According to the BMF, utility tokens that are used as a means of payment (hybrid tokens) will be treated like currency tokens. Thus, if hybrid utility tokens are held as private assets and were staked or used for lending before they were sold, the holding period should not be extended to ten years for such crypto tokens.

The BMF's amended view on the holding period for staking or lending is appreciated. It recognizes that participation in the proof-of-stake consensus mechanism or crypto lending does not amount no tax avoidance. Thus, the dynamic development of innovative proof-of-stake algorithms will no longer be slowed down by German tax law. The same applies to crypto lending business models in the decentralized finance (DeFi) sector.

2. Distinction of trade or business and asset management regarding staking

The circular clarifies that participation in the proof-of-stake consensus mechanism does generally not constitute a trade or business. For German tax purposes, staking will be regarded as private asset management. Only in exceptional cases will staking be regarded as a trade or business activity. This may apply where users participate in the creation of new blocks for the blockchain, e.g., as a validator.

The distinction between trade or business and mere asset management is a central distinction within German tax law. If staking were a trade or business activity, the staked tokens and the staking rewards would be allocated to the taxpayer's business assets. A disposal of these tokens would then also be a taxable transaction, regardless of the holding period. In addition, the disposal would be subject to trade tax. The BMF rejects such a qualification for "passive" staking (e.g., as a delegator). Generally, staking will be regarded as mere asset management. The staking rewards are therefore allocated to the private assets for tax purposes. At the time of their allocation (entry in wallet), they are taxable as other income, irrespective of whether the staking rewards have been exchanged into fiat currency (dry income taxation). The fiat exchange rate at the time of their entry in the staker's wallet will be decisive for taxation.

A disposal of the staking rewards is generally only taxable within one year after receipt (whether staking rewards are taxable at all upon disposal, c.f. below under 3). However, the BMF considers income from trade or business in connection with staking to be possible if users participate the creation of new blocks for the blockchain. According to the BMF, the block creation may be qualified as a service (provision of computing power) rendered to other users. Under German tax law, the provision of services will generally be qualified as a trade or business. The tax treatment of staking thus depends on further circumstances of the individual case and the specific design of the staking algorithm.

The clarification is appreciated. It is consistent with the existing tax system and takes into account that "passive" staking is not a trade or business activity. Rather, from an economic perspective, staking is comparable to the provision of a collateral for the block creation process. According to the well-established case law of the German Federal Fiscal Court, the provision of collateral against consideration does not constitute a trade or business. Going forward, the technical details of the staking algorithm will become much more relevant to the taxation of participants in proof-of-stake consensus mechanisms. As a general rule, "active" staking is likely to remain limited to individual cases. As long as taxpayers do not operate a node or otherwise actively participate in block creation, it is unlikely to qualify as a trade or business activity.

3. Acquisition process

The BMF advocates for a broad concept of "acquisition". This indirectly expands the scope of taxable disposals of crypto tokens held as private assets.

According to the BMF, crypto tokens are deemed to be acquired against consideration if they were acquired from third parties in exchange for other crypto tokens or fiat currency. Reward crypto tokens from mining or staking as well as crypto tokens allocated to the taxpayer in connection with crypto lending, airdrops or ICOs are also deemed to be acquired against consideration. An acquisition against consideration is a prerequisite (in the case of assets held as private assets for tax purposes) for a subsequent disposal of the crypto tokens to be taxable if disposed of within one year of the

acquisition. If, for example, there was no acquisition against consideration in the case of staking rewards, staking rewards could be disposed of tax-free within one year of receipt.

The BMF's interpretation is questionable. The well-established case law defines an 'acquisition' as an acquisition from a third party against consideration. In the case of airdrops, there should regularly be no consideration paid for the allocated crypto tokens. In the case of reward crypto tokens from mining or staking, there is likely to no third party (seller) from whom the miner or staker acquires the rewards. After all, the rewards are automatically allocated by the blockchain network itself. The BMF's interpretation amounts to a mere fiction that is not prescribed by law.

4. Taxation date for employee token programs

If crypto tokens are transferred to employees at a reduced price or free of charge, the crypto tokens are deemed to be a taxable benefit in kind that may be subject to wage tax. The taxable accrual to the employee generally occurs when the crypto tokens are transferred into the employee's wallet provided that the crypto tokens are tradable at that time. Taxation may occur earlier if the employee assigned the claim to the crypto tokens to a third party against consideration.

In a draft for the circular, the BMF additionally demanded that the crypto tokens are listed on a crypto exchange or can be used as a means of payment before a taxable accrual could occur. However, this view contradicted the well-established case law of the Federal Fiscal Court for taxable accruals under employee stock option plans. It created considerable legal uncertainty for both employee and employer, the latter being obligated to withhold wage tax. However, legal uncertainties remain regarding the criterion of tradability. Based on well-established case law, it should be sufficient that the crypto tokens are transferable and that the employee bears the economic risks and opportunities of the future performance of the crypto tokens. Due to the decentralized nature of the blockchain, crypto tokens may be transferred directly between wallets without the need for the crypto tokens to be listed on a crypto exchange. In this respect, tradability should be interpreted as transferability or usability of the crypto tokens.

The BMF's amended view is appreciated as it applies general taxation principles and well-established case law of the Federal Fiscal Court on the allocation of shares to employees under stock option plans to crypto tokens. Shares from employee stock option plans are generally taxed at the time they are transferred into a securities account of the employee. Accordingly, the point in time at which crypto tokens are transferred into the employee's wallet should generally be decisive in a crypto context. From that point on, the employee is able to transfer the crypto tokens to other users without the need for a listing on a crypto exchange. Nevertheless, the criterion of tradability creates additional legal uncertainty. It would be desirable for the BMF to add a reference to the general case law of the Federal Fiscal Court on employee stock option plans for clarification.

5. Outlook

The circular is a long-awaited contribution to legal certainty regarding the taxation of crypto tokens in Germany. Essential activities are covered in a convincing manner, both technically and in terms of their tax consequences. It is appreciated that the BMF no longer adheres to the extension of the holding period for staking and lending and applies general taxation principles for taxable accruals in the case of employee token programs. In other areas, however, general taxation principles are deviated from without convincing justification to the detriment of taxpayers. This concerns in particular the interpretation of the acquisition concept. In addition, the circular does not cover some important issues. This concerns, among other things, the cooperation requirements of taxpayers. The previous draft included a placeholder, which was deleted without comment. Newer business

areas such as DeFi business models also remain unmentioned. A detailed examination of the circular also shows some remaining ambiguities – for example, regarding the determination of the market price of crypto tokens.

The circular will have an impact beyond its actual scope. It will also affect institutional investors such as crypto funds or VC funds that invest part of their capital commitments in crypto tokens. According to the circular, an investment in crypto tokens or a participation in "passive" staking or lending should generally not requalify such fund's income as income from trade or business.

Overall, the circular is an important milestone for the taxation of blockchain-based business models. However, the development is by no means complete. YPOG's Fintech + DLT practice group will continue to closely accompany and shape the development going forward.

Your contact at YPOG:

Stefan Richter
Partner, Hamburg

+49 40 607728192
+49 151 40228692
stefan.richter@ypog.law

Dr. Dajo Sanning
Associate, Hamburg

+49 40 6077281 107
+49 151 40228779
dajo.sanning@ypog.law