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Ministry of Finance (MOF):

Draft of a letter on individual questions relating to the income tax treatment of virtual currencies and tokens in Germany[1]

The German Ministry of Finance (MOF) published the long waited for draft decree[2] on taxation of crypto currencies on 17 June 2021. In the following we are providing a first assessment of the content.

The letter is intended to provide practitioners in administration and business and individual taxpayer with a guide to the income tax treatment of tokens and virtual currencies. So far there was no clear administrative approach to the income tax treatment of activities in this area. The detailed MOF draft comprises 24 pages and contains introductory explanations on virtual currencies, tokens, blockchain, acquisition of units of a virtual currency by mining, acquisition of units a virtual currency through exchange, wallet, initial coin offering (ICO), staking, fork, lending and air-drop.

The MOF clarifies also certain accounting topics. Units of a virtual currency are non-depreciable assets. Within the framework of Section 15 of the Income Tax Act (commercial activity), the allocated units of a virtual currency and the transaction fee paid in units of a virtual currency are acquired (swap process). The acquisition costs correspond to the market rate at the time the units of a virtual currency were acquired (derived from Section 6 (6) EStG). Each swap results into a new holding period. Within the framework of Section 22 No. 3 EStG, the units acquired are to be valued at the market rate at the time of acquisition in accordance with Section 8 (2) sentence 1 EStG.

The MOF draft explains then in detail the income tax assessment of various activities in connection with units of a virtual currency and with tokens. Income from these activities can, depending on the circumstances of the individual case, be income from commercial operations (Section 15 EStG), income from employment (Section 19 EStG ie when paid to an employee), income from capital yields (Section 20 EStG), income from private sales transactions (Section 22 No. 2 EStG in conjunction with Section 23 EstG > speculation) or other income (Section 22 No. 3 EStG). So-called mining can generate income from

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[2] https://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Steuerarten/Einkommensteuer/2021-06-17-est-kryptowaehrungen.pdf?__blob=publicationFile&v=2

commercial operations (Section 15 EStG) or income from (other) services within the meaning of Section 22 No. 3 EStG in case it is not part of a commercial activity.

Generally, it should be noted that income from commercial activities are generally taxable regardless of the holding period of the tokens while private sales transactions are only taxable if the holding period is less than one year (or 10 years see below). Consequently, the MOF letter distinguishes the taxation of tokens depended if the virtual currencies or tokens are hold by (or are part of) a commercial activity (business) or privately as private investor.

In so-called mining cases (the creation of virtual currencies), according to the administrative opinion, commercial income is rebuttably supposed. If the requirements for commercial income can be refuted, then there is income from other services due to the typical economic behavior of the miners. While the tax authorities do not completely rule out mining in the context of private asset management, which is generally to be welcomed, it remains unclear where exactly the boundaries between “hobby mining”, commercial activity and private asset management run. The tax authorities refer here to case law which however has hardly be done in case of crypto assets but other cases from the past. The MOF is also addressing mining pools.

> *“Section 28: In the case of **mining**, regardless of the amount of hardware and electricity expenses, it is rebuttably presumed that there is a commercial activity. In the case of high costs for the acquisition of hardware and / or high energy costs for the operation of the hardware, however, the intention to make a profit must be checked. In the long term, mining must be suitable for generating a profit from this activity (see H 15.3 (total profit) EStH 2019).*
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> Section 29: The mere management of one's own assets is generally not a commercial activity. A mere asset management is to be assumed if the activity still presents itself as the use of assets in the sense of a fruiting from assets to be preserved and if the exploitation of substantial assets through reallocation of tokens does not come to the fore. **When the area of private asset management is left depends on the circumstances of the individual case** (see R 15.7 (1) EStR 2012).
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> Section 30: The above statements also apply if several miners join forces in a **mining pool** and contribute proportionally to the overall computing power. If units of a virtual currency are generated in a mining pool, these are distributed to the miners involved in accordance with a defined key. The operator of the mining pool only takes on a coordinating role. The miners collectively bear the entrepreneurial risk of their work. Depending on the contractual structure of the individual case, a mining pool can represent a co-entrepreneurship. The general principles for accepting co-entrepreneurship apply (see H 15.8 (1) (General) EStR 2012). There is no co-entrepreneurship if the operator of the mining pool is only provided with computing power by the individual miner for a fee as part of a service relationship.
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> Section 38: If units of a virtual currency are repeatedly bought and sold (including exchanging them for units of other virtual currencies), such trading in units of a virtual currency can constitute a commercial activity. To distinguish it from private asset management, the criteria for commercial securities and foreign exchange trading can be used.

> **According to the case law of the Federal Tax Court** (judgment of December 20, 2000 - X R 1/97 BStBl II 2001, p. 706), **frequent purchases and sales alone do not justify a commercial activity, even if a larger scope is reached.** When it comes to investing in securities, there are numerous options for the investor to take. There are income-free securities (e.g. checks, bills of exchange), interest-bearing paper (e.g. bearer bonds, federal treasury notes) and equity securities (e.g. shares, profit participation certificates). According to the Federal Tax Court, this diversity means that bad securities are replaced by good securities or interest-bearing securities by equity securities. **A commercial activity, on the other hand, presupposes that the taxpayer behaves "like a trader" or "typical of a bank" and uses a commercially set up business.** Against the background that in the case of virtual currencies, numerous business models enable the generation of additional units of virtual currency by holding the transfer of use, these criteria must also be transferred to the circumstances at hand and checked in each individual case (compare section No. 29)."

For income from the sale of units in a virtual currency, a distinction is made between commercial and private assets. In private assets, units of a virtual currency are viewed as "other economic goods" within the meaning of Section 23 (1) sentence 1 No. 2 EStG. Profits from the sale of units of a virtual currency that are held as private assets therefore represent income from private sales transactions (Section 22 No. 2 EStG in conjunction with Section 23 EStG) if the period between acquisition and sale is no more than one year. An exchange of a token into another token or currency is resulting into a new holding period (Section 39). In contrast tokens being part of a commercial activity are always taxable regardless of the holding period.

This sale period is extended to ten years in accordance with Section 23 (1) sentence 1 number 2 sentence 4 EStG if units of a virtual currency or token are used as a source of income and income has been generated from them in at least one calendar year of the holding period. According to the MOF draft, it can be used as a source of income, for example, if units of a virtual currency are made available for a fee by way of so-called lending. However, it can also be used as a source of income for so-called staking. The prolongation of the holding period to 10 years applies however only insofar as the tokens have been used for staking, for the remaining tokens the one year period applies (also if they are part of the same wallet).

> "Section 47: According to Section 23 (1) sentence 1 number 2 sentence 4 EStG, the **holding period is extended to ten years** if units of a virtual currency or token are used as a source of income and income has been generated from them in at least one calendar year. It is used as a source of income, for example, when units of a virtual currency are made available for a fee by way of so-called lending (compare Section No. 21 and 77).
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> Section 48: Use as a source of income within the meaning of Section 23 Paragraph 1 Clause 1 Number 2 Clause 4 EStG can also be given for **staking.** This applies in any case if the staking is operated as so-called cold staking or in connection with a masternode. In both cases, holding units of a virtual currency leads to the allocation of further units of the virtual currency.
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> Section 49: The use of units of a virtual currency for the purpose of **proof of stake** represents a use as a source of income within the meaning

of Section 23 Paragraph 1 Clause 1 Number 2 Clause 4 EStG, if holding the units of a virtual currency leads to the participant receiving the next Block created, thereby generating additional units of a virtual currency. In this case, the units of a virtual currency are used as a source of income."

In the case of units held as private assets, the administration concludes that there is a sale both when exchanging virtual currencies for state currencies (such as Euro, USD etc. > Fiat Currency) and when exchanging them for other virtual currencies. The holding period in accordance with Section 23 Paragraph 1 Clause 1 No. 2 EStG should start anew after each exchange. When determining the capital gain, the **first in first out (FiFo)** method should be permitted. The holding period is to be extended to ten years through so-called lending (transfer of the virtual currency in exchange for additional units).

"Section 44: For determination of the holding period each asset/ token needs to be **considered separately** (compare Section No. 37). For reasons of simplification, the application of the **first in first out (FiFo)** method to the units of a virtual currency is permitted. This means that it is to be assumed that the units of a virtual currency acquired first were sold first.

Section 45: The method which is chosen – ie. FiFo method or individual consideration - must be applied to each individual wallet and retained in this wallet until the units of a virtual currency have been sold in full. After a complete sale of the units of a virtual currency in this wallet and subsequent new acquisition of units of this virtual currency, the method can be changed. When holding crypto units in multiple virtual currencies, there is a separate option for each virtual currency in a wallet."

In the case of so-called **forks** (splitting of a currency, like a share split), the original acquisition costs should be divided if possible. The time of acquisition of the old units should also be the time of acquisition of the new units in case of a fork.

"Section 56: With the purchase of units of a virtual currency, the taxpayer acquires the possibility of receiving units of a new virtual currency in the course of a **fork**. As a result, the taxpayer purchases units of a new virtual currency for consideration as part of the units of the virtual currency that existed before the fork. The acquisition costs of the units of the existing virtual currency are generally to be allocated in relation to the market rates of the units of the respective virtual currencies at the time of the fork (cf. margin no. 32 for determining the market rate). As far as the virtual currencies acquired with the fork have no value, the acquisition costs remain with the units of the virtual currency existing before the fork. **The time of acquisition of the units of the new virtual currency corresponds to the time of acquisition of the units of the existing virtual currency.**

If the units of a new virtual currency that have arisen as a result of a fork are sold, the profit generated is taxable as income from private sales transactions according to § 22 number 2 in conjunction with § 23 paragraph 1 sentence 1 number 2 EStG if the period between the acquisition and disposal is not more than one year. This also applies if the taxpayer has gained access to the units of a virtual currency that existed before the fork by means of mining. Regarding the extension of

> the sale period to ten years, please refer to the explanations under margin no. 47 referenced."

The MOF draft also contains a placeholder at this point for the obligations of the taxpayer and his documentation and to keep records.

Valuation of crypto assets: In many places it is crucial for the income tax treatment of crypto assets that the market value is determined at a certain point in time. For this purpose, the BMF wants to use an average rate of three exchanges (e.g. Coinbase, Kraken and Binance) or web-based lists (e.g. Coinmarketcap).

> "Section 32: The market rate can be based on the average value from the exchange rate of three different trading platforms (e.g. Kraken, Coinbase and Bitpanda) or web-based lists (e.g. https://coinmarketcap.com/de). If a stock exchange price is available, this must be used as a basis.
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> If claims are settled with units of a virtual currency, these are to be recorded at the market rate at the time the claim is settled.
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> Section 39: Units of a virtual currency are to be regarded as "other economic goods" within the meaning of Section 23 Paragraph 1 Clause 1 Number 2 EStG. Virtual currencies are asset-value advantages, the acquisition of which can be of a value for the acquirer. They are accessible for an independent evaluation by means of a market price that can be determined via stock exchanges (e.g. Boerse Stuttgart Digital Exchange), trading platforms (e.g. Kraken, Coinbase and Bitpanda) and lists (e.g. coinmarketcap)."

The coins received in case of proof of stake are taxable as other income (§ 22 Nummer 3 EStG) if they do not being part of a commercial activity in which case they are always taxable as such. Same applies to lending (Section 77) and Airdrops (see below).

In the case of so-called airdrops (free distribution of virtual currencies or tokens) in the private sector, the administration believes that there should usually be income from a service within the meaning of Section 22 No. 3 EStG. A service should be assumed if the taxpayer is obliged or has to agree to provide the issuer with personal data in return for the units of a virtual currency or token (basically any activity lead to income). If there is no consideration, a donation can be considered which may be taxable as such. In case of tokens received which are taxable income under Section 22 No. 3 EStG a new holding period of one year applies to them. The MOF refers to Section 47 in Section 81. In my opinion this referral means that Airdrops shall also prolong the holding period from one to 10 years for the tokens for which Airdrops are granted.

With the **Initial Coin Offering**, tokens are issued by the issuer himself. The MOF explain that the tax treatment is depending from the features of the tokens and if they are used in commercial activities or privately. Utility tokens which are granted for the right of a product or service shall not lead to income if they are just used for this purpose. If they are sold to a third party they are taxable within the one year holding period.

Special explanations are made for **Equity/ Security or Debt Tokens**. If the right conveyed by the token is a bond in nature, the income tax classification of the resulting income or profits applies it depends on whether a capital claim within the meaning of Section 20 (1) number 7 EStG or a mere claim in kind is justified. The latter is seemingly no capital yield while capital yields fall in this income category and are taxed as such.

> "Section 61: So-called **utility tokens** give the owner future access to a product or service. If such tokens are redeemed, this is irrelevant for income tax purposes (Federal Tax Court judgment of February 6, 2018, IX R 33/17, BStBl II p. 525). There is no sale because there is no transfer to a third party in return for payment if the holder of the token merely redeems the claims to a product or service embodied in the token and receives the goods or service using the tokens."
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> Section 62: If utility tokens are sold, the profit/loss from the sale leads to income from private sales transactions according to § 22 number 2 in conjunction with § 23 paragraph 1 sentence 1 number 2 EStG, if the period between the acquisition and the sale does not exceed one year, unless the requirements of Section No. 47 are met.
> A sale within the meaning of Section 22 Number 2 in conjunction with Section 23 Paragraph 1 Clause 1 Number 2 EStG also applies if utility tokens are used as a means of payment (hybrid tokens).
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> Section 63: **Equity / Security / Debt Token**: Depending on the design, tokens can also be viewed as securities or other financial instruments.
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> Section 66: If the right conveyed by the token is a bond, the income tax classification of the resulting income or profits applies it depends on whether a capital claim within the meaning of Section 20 (1) number 7 EStG or a mere claim in kind is justified.
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> Section 67: If the bond gives the holder only a right to delivery of a fixed amount of a virtual currency deposited with the issuer or a claim to payment of the proceeds from the sale of the virtual currency by the issuer, there is no capital claim within the meaning of Section 20 (1) number 7 EStG, but a **claim in kind**." Note: Reference is made to several Federal Tax Court decision such as Xetra Gold > not taxable sale > differently probably if sold to a third party.
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> "Section 69: If, on the other hand, the bond represents a capital claim within the meaning of Section 20 Paragraph 1 Number 7 EStG, income received during the holding period leads to income from capital assets (current investment income). A sale of the bond falls within the scope of Section 20 (2) sentence 1 number 7 EStG (no holding period). In the case of income not received in Euros, Section 20 Paragraph 3 and Section 20 Paragraph 4 Clause 1 Clause 2 EStG must be observed."

The associations are invited to comment the draft until July 19, 2021. In addition, a video conference with the associations is planned for August 19, 2021. A federal-state working group should deal with the topic regularly even after the final MOF letter has been published so that it can be expected that more details are issued in due turn.

It should be noted that the MOF decree is only binding for the tax administration. It is no law but interpretation of law from the point of view from the tax administration. It is also no

surprise that the tax administration usually takes a view which extends its taxation rights. It is expected that only several court cases in the future will allow a final assessment of whether in all situations tax needs to be paid for crypto transactions as outlined in this paper. This probably will require a couple of years. Tax payers are currently best advised if they disclose all relevant facts in their tax returns and keep the tax assessments open as far as possible and were it is for their advantage.

RU, 27 June 2021