

## **INVESTMENT TREND IN DIGITAL CURRENCIES – THE CURRENT STATE OF FISCAL TREATMENT OF BITCOIN INVESTMENTS IN GERMANY**

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### **Abstract**

The article reviews the current trend of investments in digital currencies with its most famous representative, the bitcoin. The price explosion of bitcoins within the last year made the digital currency world-famous and a permanent topic in the media, causing greater awareness among investors regarding this investment opportunity. In addition, several financial instruments providing investors an opportunity to participate in digital currencies, particularly bitcoins investments, have been introduced recently, which can be traded at stock exchanges. This article seeks to highlight this asset class as well as discuss certain aspects of taxation for such investments according to the German Income Tax Act. In the first step, digital currencies are classified within the scope of traditional and alternative asset classes, and the current investment opportunities at the stock exchange will be described. Based on these findings, the article focusses on the several special aspects of German tax resulting from the many opportunities to structure the investment. Finally, the conclusion provides a synthesis of the essential points of the article and offers an outlook.

### **Keywords**

Digital Investments, Cryptocurrencies, Bitcoins, Asset Class, Fiscal Treatment

### **JEL Classification**

G11, G23, K34

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### **Introduction**

Digital currencies, also named as cryptocurrencies, are increasingly establishing themselves as an independent asset. The main representative of the asset class is the bitcoin which was made accessible to a broad public against the background of the performance and hype of bitcoins. On 11 December 2017, the first financial derivative (futures) was traded on the bitcoin on a major US stock exchange.

For a short time now, financial products that simulate the performance of cryptocurrencies have been available on the market. These products allow investors to participate in the performance of this investment by simply buying securities on the stock market without directly investing in bitcoins. For direct investment, investors need to register on relevant trading platforms and open a trading account. As a result, this development of new assets gives a broader group of investors an opportunity of (indirect) investment in cryptocurrencies, which then increases the attractiveness of this assets.

The article, on one hand, wants to review the current discussion on digital currencies as an own asset class. In addition, an overview of the several investment instruments involving

digital currencies shows the many possibilities available to investors. In the next step, the different methods of fiscal treatment related to the mode of investing in cryptocurrencies is explained. As currently observed, the market of such investments is occupied by private investors, while institutional investors have, so far, largely kept away from these investments (Doerner, 2018). However, there are some institutional investors interested in digital currency investments, who are also considering such investment opportunities (DWS, 2017; Kerschner, 2017). For this reason, the tax treatment of bitcoin investments will focus on private investors and the current available financial products.

## **2. Literature Review**

### **2.1 Digital Currencies as Own Asset Classes?**

The most traditional, common, and liquid asset is cash/money. There exists no general or legal definition of the notion of money in German civil or tax law (Eckert 2013). The classification of bitcoins and other digital currencies is excluded from the general notion of money, since there is no broad acceptance of bitcoins in economic life as means of payment (Eckert, 2013; Grueneberg, 2018).

Along with that understanding, the German regulatory authority (BaFin) and tax administration do not consider bitcoins as legal means of payment, which also comprises comprehension as electronic money in context of the EU-Directive 2009/110/EG (BaFin, 2017; FinMin HH, 2017). In addition, BaFin specifically states that as means of payment, only certain value units that are in return for real economic services, delivery of goods or services obtained or in the case of bitcoin without any remuneration in computer networks can be created as e-money (BaFin, 2017).

As a consequence, the authorities would not subsume digital currencies within an asset class comprising cash/ money in its general meaning. However, bitcoins and other digital currencies indisputably embody or carry a monetary value in themselves, because compared to the digital currencies' connected addresses (depending on the course) can have a high purchasing power. For this reason, the tax authority recognizes bitcoins as "substitute currency", independent of government and credit institutions (FinMin HH, 2017). In addition, the European Court of Justice decided that bitcoins have to be treated in the same way as legal means of payment according to the European Value Added Tax Directive (ECJ, 2015). The tax authority confirmed this understanding based on purposes of VAT that considered bitcoins as means of payment in case of such application (BMF, 2018).

As a result, the classification of digital currencies, such as bitcoins, is yet to be finalized in professional literature and jurisdiction. Up to now, bitcoins cannot practically be treated as means of payment. The future will show whether the classification needs to be adjusted, e.g. in case of broad acceptance of digital currencies in economic life. For this reason, digital currency investments, currently, cannot be subsumed under a traditional asset class, which typically comprises cash, stocks, and bonds according to the common conception (Bodio and Fasano, 2009; Farkas-Richling et al., 2012). As a modern financial instrument, digital currencies should represent an independent asset class within the group of the alternative asset class (for the classification of alternative asset class, Maftei et al., 2016).

From an investor's point of view, the legal and commercial comprehension of digital currencies is not as important as its broad acceptance as means of payments, which indirectly implies the value. Thus, an investor would rather consider digital currencies as assets than means of payment. For this reason, asset managers developed opportunities to invest in such digital currencies. The digital currencies, thus, are a kind of "hybrid asset class", which can currently be considered as a new asset class in the investor's context.

**2.2. Financial Products of Digital Currencies Investments for Investors**

As already mentioned in the introduction, bitcoins (and other digital currencies) can be purchased directly. In case of bitcoins, the investor is required to have an electronic wallet in order to transact and directly invest. For this reason, the dominant form for investors in digital currencies is indirect investment because such investments are easily tradable at stock exchanges enabling simple handling and operation. The participation in performance of digital currencies can be placed through several instruments. The indirect instruments available to the investor include forward contracts and options, certificates, exchange-traded funds (ETFs) as well as open- and closed-end investment funds.

**Table No. 1: Simplified Classification of Standard Products**

<b>Investment Instrument</b>	<b>Accounting and Tax Classification</b>
Forward contract (Future)	Unconditional Forward Contract
Option	Contingent Forward Contract
Certificate	Debt Security
ETF	Investment Fund (UCITS)
(Closed-end/ Special) Investment Fund	Alternative Investment Funds (AIF)

*Source: Schmidt, 2018*

These financial products, currently, provide appropriate opportunities to indirectly invest in digital currencies. The legal and economic design of these products are comparable to investment instruments of other asset classes (Maftai et al., 2016). Financial products, mainly those designed as certificates, ETFs, or AIFs will typically invest in baskets of such digital currencies. An asset basket of digital currencies diversifies the investment portfolio within that type of asset. From a risk aspect, an asset basket reduces (but does not eliminate) the dependency on one cryptocurrency.

**3. Research Methodology**

Research on investments in digital or crypto currencies is a very current topic. For this reason, it was not appropriate to focus on statistical studies based on the complexity and risk aspects of digital currencies, since these need to be considered over a period covering several years to reach reliable statements (see approaches Wislon-Nunn and Zenil, 2014; Cocco et. al., 2014). Instead, we concentrated on tradable digital currency assets relevant for capital investors since the design of such assets is decisive for their fiscal treatment. Thus, this article focuses on the financial products currently applied at the European and US stock exchanges.

Within the research, it should be stated, that there already exist several investment instruments that have been applied at stock exchanges. These instruments provide an opportunity to participate in an indirect bitcoin / digital currency investment. The first financial derivative or bitcoin futures was traded on a US stock exchange on 11 December 2017. In addition, by the end of 2017 participation certificates for bitcoins were applied at the German stock exchange. Furthermore, the Financial Market Authority (FMA) of Principality of Liechtenstein, which is the national regulatory authority, approved investment funds involving cryptocurrency, according to the list on 26 February 2018. These funds are designed as alternative investment fund (AIF) in accordance with European law (Bussian et al., 2016).

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## **4. Statements - Taxation of Bitcoins Investments in Germany**

### **4.1 Introductory Remarks**

In this section, the current fiscal treatment of bitcoin investments will be considered; this means paid purchase of bitcoins investments with “old” money, typically listed USD or EUR as a capital investment.

The paid purchase needs to be differentiated from “mining” of bitcoins. Here, the miner provides various services in the bitcoin network through transaction confirmation or provision of computer capacity etc. and in return the miner receives bitcoins. This way of acquiring bitcoins with the intention of making profits with mining is considered as commercial activity resulting in commercial income for the miner. Such income is also subject to German’s trade tax (in case of exceeding a free allowance in the amount of kEUR 24.5).

### **4.2 Direct Investment**

Investors, who intend to directly buy the bitcoins, require an electronic wallet. Through this wallet, bitcoins can be received and transferred (transaction or encashment of bitcoins can be made). From a tax perspective, bitcoins are ordinary intangible assets or so-called foreign currency (consider ECJ, 2015 according to the VAT Directive).

The transfer of bitcoins, if they do not exceed the limits of commercial trading transaction principles, which would also lead to commercial income, sales transactions with bitcoins are only taxable as so-called private sale transactions pursuant to Sec. 23 para. 1 no. 2 ITA. This taxable event is only relevant in cases where the period between the acquisition and the disposal of the bitcoins is not more than one year. The meaning of disposal in this context is, e.g. the sale / exchange of bitcoins against USD or EUR via a trading platform, but also the use of bitcoins as a means of payment, i.e. if the bitcoin holder pays for the purchase of goods or services with bitcoins.

The sale proceeds therefore result from (i) the performance of the bitcoin and (ii) the currency development of the currency exchanged. In determining of the acquisition date, the identification of the sold bitcoins is of central importance. In our opinion, if all the bitcoins are kept in a wallet, the first-in-first-out principle (“FIFO”) can be used in accordance with Sec 23 (1) no. 2 sentence 3 ITA; firstly, the sequence of consumption is necessary to determine the date of acquisition and thus, by this method, it seeks to both indicate whether the decisive one-year period has expired as well as determine the capital gain.

If there is no more than one year between sale and purchase, the capital gain is taxed at a disfavored rate to the progressive income tax rate of up to 47.48%. If the one-year holding period has expired, the bitcoin sales transactions are completely tax-free.

### **4.3 Derivatives and Forward Contracts**

The investor can invest in derivatives, e.g. calls, puts, contracts for difference (CFDs) that are linked to the performance of bitcoins. These financial products could provide the investor with a proportional compensation in cash, thus the investor earns income from futures transactions according to Art. 20 (2) no. 3 ITA, which corresponds to the standard withholding tax rate in the amount of 25% (26.375% including the solidarity surcharge).

In particular, for a long time the fiscal allowance of losses by forfeiting of these products was disputed (Heinicke and Krüger, 2016; Jansen, 2016). The Federal Fiscal Court (BFH, 2016) has solved that case by decision, which was contrary to the tax authorities’ opinion. As a result, forfeitures of options are taxable expenses for investors.

#### **4.4 Securities**

Yields of debt securities, in general, represents interests or interest-like capital claims (Art. 20 (1) No. 7 ITA), such as securities or certificates where the repayment amount depends on the performance of the bitcoins and which promise or provide the investor with a repayment in cash when due, depending on the bitcoin price. They can also be comparable to derivatives (so-called "full risk certificates"). According to German Income Tax Act, these instruments are referred to as so-called other (interest-like) capital claims according to Art. 20 para. 1 no. 7 ITA. Income from the redemption / repayment of such securities is also subject to the withholding tax rate, i.e. 26.375% for a national private investor. For international investors, in particular, withholding taxes are not applicable and hence pose no problems with regard to the refund of these taxes.

If the security or certificate is linked to the performance of bitcoins and securitizes a physical delivery claim whereby the investor has (exclusive) right to physical delivery of bitcoins (transfer of actual bitcoins into his electronic purse) instead of repayment in cash, the decisions of the highest fiscal court on XETRA-Gold (BFH, 2015, BFH 2015a; BFH, 2018; FG Thuringen, 2017) should be applicable in our opinion. As a result of the delivery claim, the investor is treated as if he were investing directly in bitcoins. The income from such financial instruments is therefore also tax-exempt outside of the one-year period of Art. 23 ITA.

#### **4.5 Investment Funds**

As already mentioned above, it will not take long until the first (alternative) investment fund is authorized by its regulatory authority, thus entering the capital markets. For these financial products, the new German Investment Tax Act (Stiegler et al., 2016) will be applicable on such investments.

The means, distributions from the fund, profits from the sale of the fund units, as well as the annual accumulation tax (so-called taxable pre-flat rate) will be taxed at the level of national private investors in the amount of 26.375% as a definite withholding tax. For these kind of investments funds, there will be no partial exemptions applicable (Stiegler et al., 2016). Thus, not only is the entire profit taxable in the hands of the investor, but furthermore, there will not be any taxation at the level of investment fund.

#### **Conclusions**

There is no general valid or legal definition of digital currencies. From an economic perspective, digital currency is money in the form of digital means of payment, and is not based on any intrinsic value when compared to central bank money. The transactions and balances of these digital currencies are mainly managed in a decentralized, bank-independent network.

The classification of sole assets in traditional and alternative asset classes can be rather difficult. Within the group of the alternative assets, further subcategories constitute detailed subdivisions. In fact, there is no generally accepted definition of alternative investments (Dönges, 2008).

In the current perspective, digital currencies such as bitcoins lack the functional properties of money. Thus, currently digital currencies cannot be classified as money or cash. However, in some areas bitcoins are already being accepted as means of payment. The digital currencies can be considered as "hybrid asset classes" because investments in digital currencies is an investment trend and certain characteristic features of money are already in place. Several types of assets represent short-term realizable securities.

Investments in bitcoins and other cryptocurrencies can be divided into direct and indirect types. Investors typically will indirectly participate in digital investments rather than directly because financial products, representing an indirect investment, can be freely traded at stock

exchanges. The range of different digital currencies in the amount of circa 1,500 will also lead to investment in asset baskets.

Investors can participate in digital currencies by way of investing in futures, derivatives, certificates, or alternative investment funds. Typically, investment funds will provide a broad variety of cryptocurrencies in the managed fund assets. Depending on the (i) way of participation, (ii) design of the investment instruments, and (iii) holding period of the digital currency investment, the tax rate on the capital gain will vary from 0% to 47.78% according to German tax law.

Future development and use of cryptocurrencies like bitcoins is open but characterized by setbacks and declines of older digital currencies (e.g. Mt. Gox, Flexcoin). Contrary to these setbacks, there are the expectations, particularly of e-businesses, aiming at recognition of cryptocurrencies as means of payment.

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