KPMG DLT Report 2023

KPMG Switzerland

—

December 2023

Executive summary

The incorporation of Decentralized Ledger Technology (DLT) into the banking industry offers a plethora of advantages, enabling a more streamlined, protected, and customer-focused financial landscape.

By taking a proactive approach to embracing DLT, banks have the opportunity to take the helm in shaping the digital future of banking, providing innovative services that cater to the ever-evolving demands of their customers.

Our KPMG polling results regarding DLT in the Swiss and Liechtenstein banking sector indicate growing relevance of this topic in the current and future business strategy. While answers revealed increasing customer demand following a clear plan to launch DLT-based products and services, the impact of DLT on operating effectiveness is assessed as more important than additional sales.

In addition, banks surveyed are more likely to rely on third-party service providers than on in-house solutions to achieve the milestones they set for their DLT journey.

DLT is not merely a technological advancement, it is a transformative force that can inspire innovation within the banking sector. It drives banks to reassess their conventional methods and adopt a digital-first mindset. The banks that can successfully navigate this transition will be well positioned to become the market leaders of the future.

Interestingly, the regulatory developments have already caught up with the technological developments with various Swiss, EU, and global regulatory frameworks already in force and other regulatory proposals in the making.

Table of content

Executive summary ---- 02

Table of content ---- 03

Introduction ---- 04

DLT Polling Questions ---- 05

1.1 Demand and adoption
1.2 Roadmaps and development
1.3 Current trends and risks

Embracing the DLT Revolution: A New Era in Banking? ---- 14

2.1 DLT in banking
2.2 Opportunities for banking reinvention
2.3 Challenges and strategies

Clarity on Regulation ---- 19

3.1 Regulatory environment
3.2 International regulatory developments
3.3 Swiss regulatory developments

Swiss Tax Insights for Digital Asset Banks ---- 26

4.1 Swiss value-added tax (VAT)
4.2 Swiss stamp transfer tax (STT)
4.3 Swiss withholding tax (WHT)
4.4 Tax reporting requirements

Your Contacts ---- 33

Introduction

Decentralized ledger technology is a game-changer for the financial sector. By utilizing a distributed network of computers to record and verify transactions, DLT provides a level of security and transparency that is unmatched by traditional centralized systems. This technology enables secure, real-time transactions that can be traced and verified by all participants in the network, eliminating the need for intermediaries and reducing the risk of fraud and tampering.

Additionally, the decentralized nature of DLT allows for a more democratic and inclusive financial system, as all participants have equal access to the information and transactions recorded on the ledger. Overall, the implementation of DLT in the financial sector has the potential to bring about greater efficiency, security and transparency, transforming the industry in unprecedented ways. Most Swiss banks are currently planning to offer or increase their existing DLT product offering in the next 3-5 years.

Furthermore, DLT also offers several other advantages for the financial sector, which will become apparent in this report and the polling that KPMG conducted during 2023. For example, it has the potential to reduce transaction costs, speed up settlement times and improve regulatory compliance. It also creates new opportunities for financial innovation, enabling new products and services such as smart contracts, digital assets and decentralized applications (dApps).

Moreover, DLT's ability to track and verify transactions in real-time can help combat money laundering and other financial crimes. Finally, DLT's decentralized and transparent nature can improve public trust in the financial system, which is especially important in an era of increasing financial uncertainty and skepticism. The possibilities of DLT in finance are immense and will likely shape the future of the industry for years to come.

Moving on to another, yet connected topic, section 4 of this report provides some insights on the Swiss tax implications for digital asset banks. Given the recency of this matter, the tax treatment is subject to potential changes and should be monitored closely in the context of ongoing evolution of DLT in the financial sector.

01

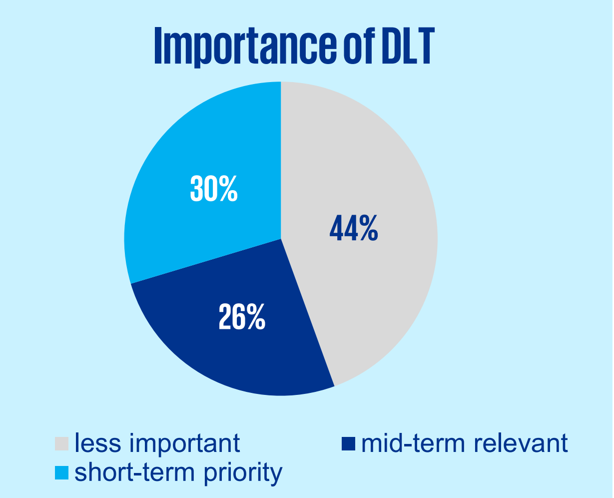
DLT Polling Questions

1.1 Demand and adoption

Acknowledgement of DLT in the banking sector

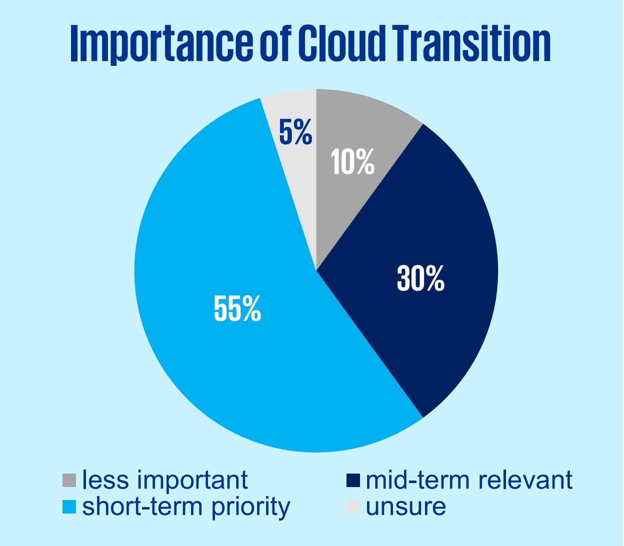
The topic of DLT has been around for several years with its own popularity hype cycles. However, the technology behind most popular blockchain projects remained interesting to many banks in Switzerland and globally.

In our survey of 20 banks domiciled in Switzerland and Liechtenstein, KPMG found that almost 60% of respondents indicated DLT as a short- to mid-term priority.



The most time-pressing topic for financial institutions that took part in the KPMG DLT Survey was the transition to the cloud.

However, it is worth noting that while most banks already use the cloud for their internal document storage, communication and daily collaboration among their employees, many banking processes are still managed by legacy systems that are not run from the cloud but on on-site servers. Due to many factors, not least because of the strict Swiss data protection and privacy laws regarding financial data, Swiss banks have apparently identified this transition to the cloud as a long overdue improvement to their operations.



1.1 Demand and adoption (Cont.)

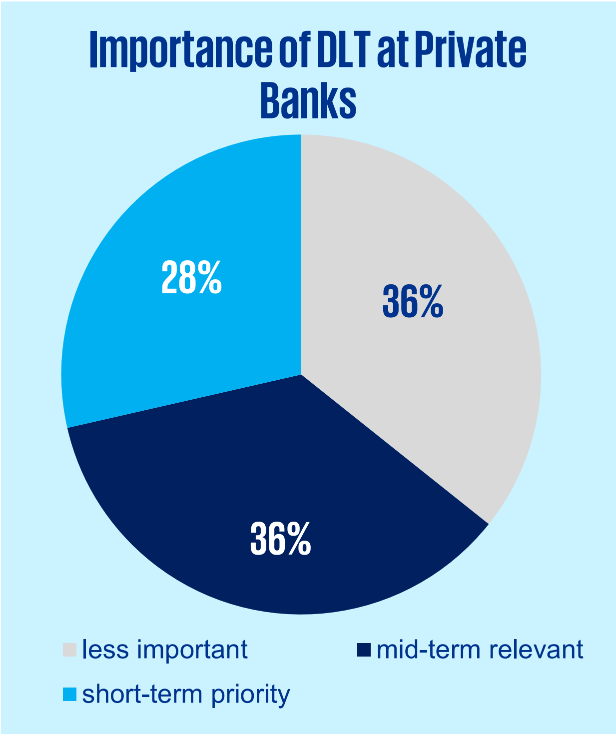
Private banks leading the banking sector in DLT

While a majority of banks see the potential of DLT, private banks in particular seem to be more active in this field.

Among the respondents, especially private banks are likely experiencing more demand from their clients compared to their retail counterparts, since crypto assets are evolving as a valid asset class in portfolio allocation strategies.

In addition to this trend observed in the private banking sector, retail banks may have seen a comparatively lower demand from their customers. In contrast, recent publications by cantonal banks in the second half of 2023, indicated an increased demand.

Many early adopters or traders of crypto assets may not have waited for retail banks to adapt to this trend. They have likely chosen to open accounts with the numerous crypto startups that already offered trading platforms, or have already established crypto wallets directly with decentralized exchanges.

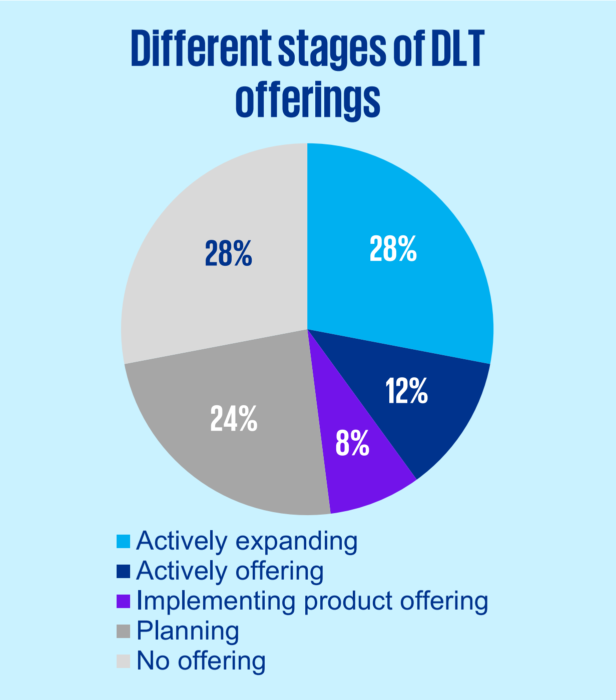


1.1 Demand and adoption (Cont.)

Different stages of DLT offerings

In addition, it is worth taking a closer look at the different stages of implementation, even though the demand is there and banks have mostly identified DLT for their future product offering.

Firstly, there are those banks that either do not see any value in DLT at all, those that merely plan to introduce some DLT products/services in future as well as those that are already implementing or even expanding their already existing product/service offering at the moment.



As banks indicated, almost one third of respondents are actively expanding their DLT offering and about half see DLT as an attractive opportunity that deserves active development and implementation of products/services.

Looking ahead, the survey revealed that 72% of participating banks will be actively offering DLT products/ services, subject to future regulatory developments and successful implementation efforts.

The 40% of respondents that are already actively offering or even actively expanding their DLT-related products and services, have a chance to improve their market positioning significantly and realize additional market share.

Conversely, for the 28% of respondents who do not plan to offer any DLT-related services, the risk of losing market share and a lack of expertise increases.

1.1 Demand and adoption (Cont.)

Specific demand for DLT-based products and services

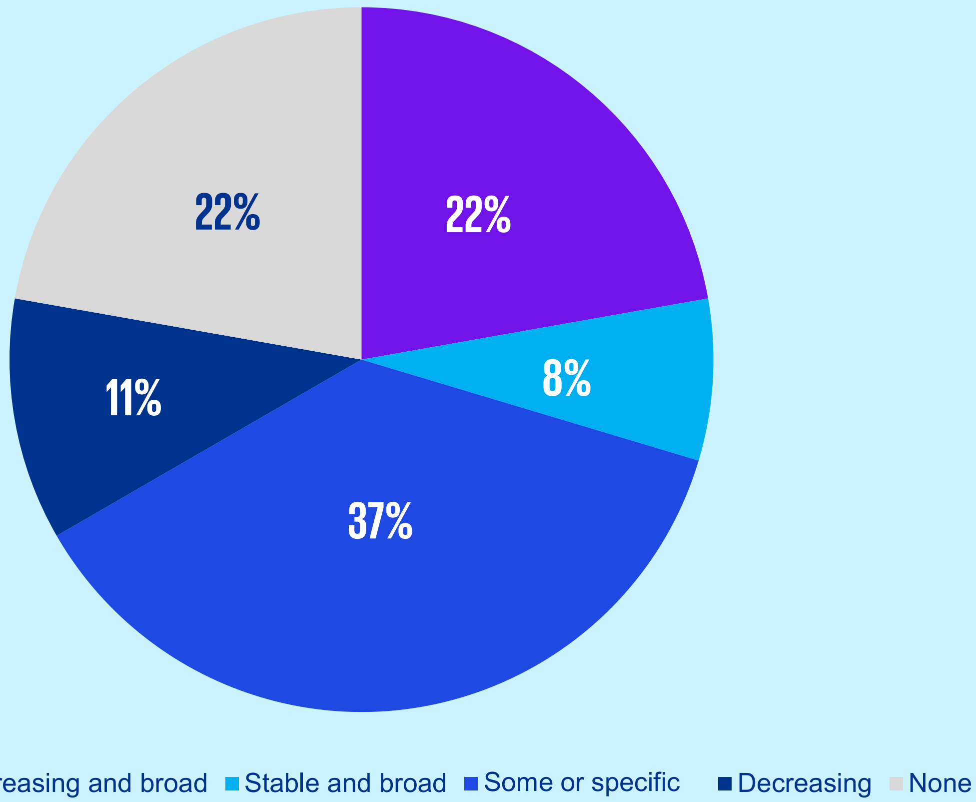
Moreover, there is a clear distinction between specific and broad demand for DLT-based products/services.

While about 70% of all respondents noted a certain level of demand from their clients for DLT-based products/services, most demand is actually driven by individual and specific client demands, according to 37% of respondents.

On the other hand a broader demand is noted by 30% of respondents showing either significantly increasing or stable demand for DLT-based product offerings.

Interestingly, retail banks seem to have the lowest demand for DLT offerings. This may also be due to their less institutionalized customer base, which does not drive the demand for DLT-based products in general.

Demand for DLT-based products and services



1.2 Roadmaps and development

Business functions most affected by DLT

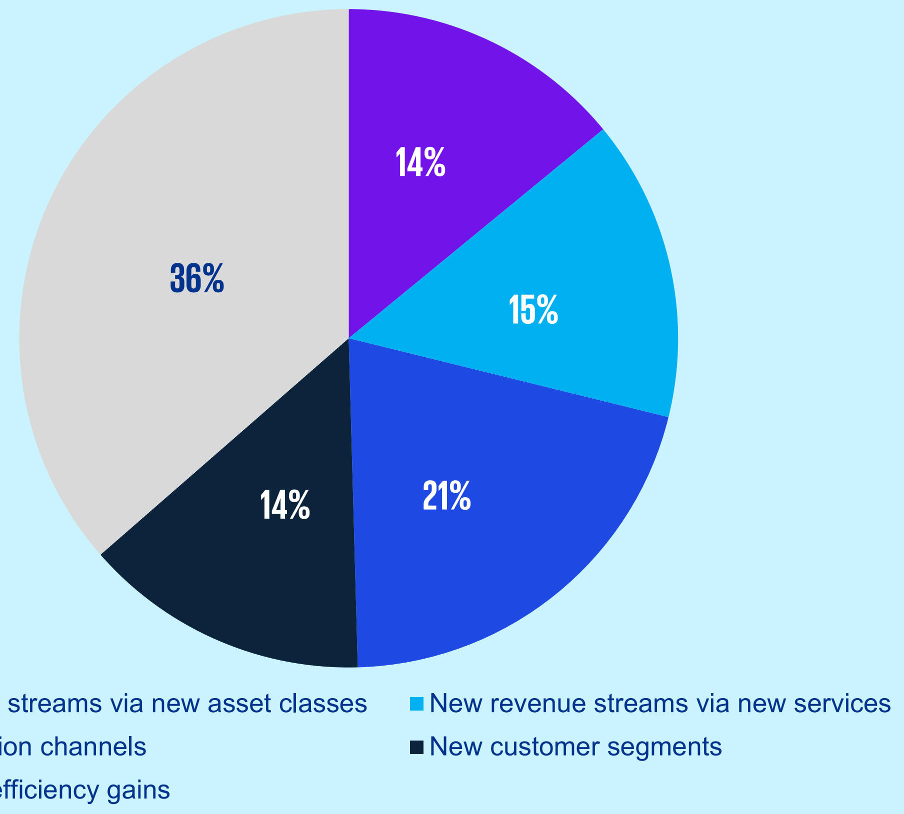
In the survey, respondents were also asked for their opinion on the most prominent DLT use cases.

Looking ahead, most respondents across all banking segments named operational efficiency as the most attractive use case for DLT. Despite these answers in the polling, and although DLT-related services and offerings exist as discussed before, actual DLT solutions for achieving operational efficiency gains are still rarely seen in banking infrastructures today.

It was also reported by all banking segments that the functions most affected will be in the areas of Trading, Payment, and Custody. Not surprisingly, respondents see DLT's greatest potential impacting these three functions.

However, such potential impact will strongly depend on other developments, such as central banks' digital currency initiatives and regulatory developments.

Most potential for DLT use cases in 3-5 years

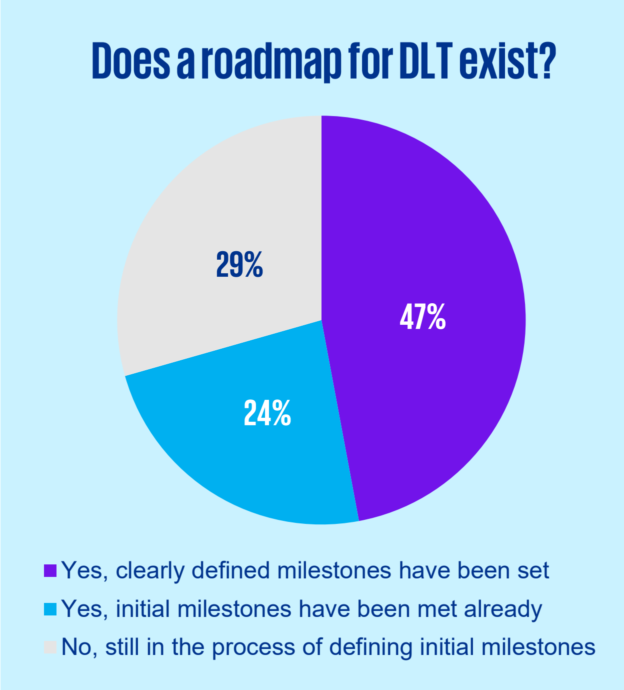


1.2 Roadmaps and development (Cont.)

Roadmaps for DLT implementation

Furthermore, regarding the existence of detailed roadmaps for the DLT product/service offering, a clear majority of banks state that they have clearly defined milestones in place and about one quarter of respondents say that initial milestones have already been met. This means that over 70% of banks have actively engaged in milestone setting for DLT and are likely going to adapt and update their roadmaps accordingly in future. This is congruent with the product and service offering as discussed on page 8 earlier.

Yet, there also seems to be a group of banks accounting for almost 30% of banks, which are still defining their initial milestones (or it is still unclear).



1.2 Roadmaps and development

Development strategies for DLT products and services

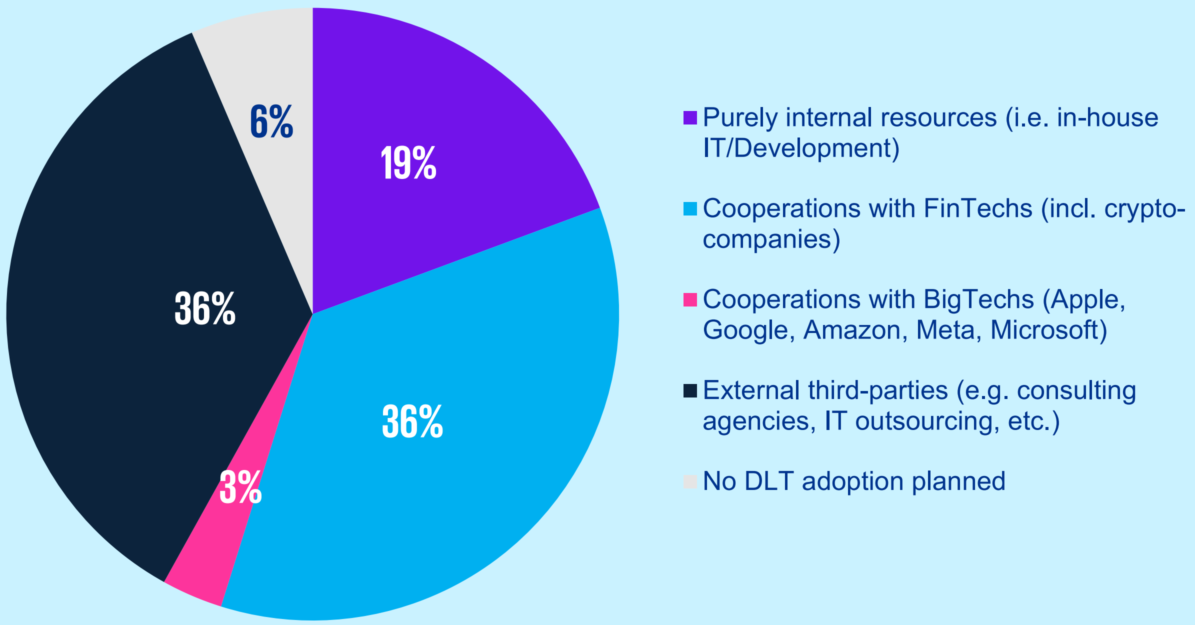
Having clearly defined roadmaps and milestones in place is one thing but actually implementing them is the more crucial part. To that end, the survey asked banks to indicate their current development strategies for DLT in general.

Interestingly, the answers from respondents show a clear lack of in-house capabilities when it comes to developing DLT solutions. Likewise, there seems to be little cooperation between banks and Big Tech players such as Apple, Google or Microsoft for DLT application. This implies a strategic decision towards fintechs and third-parties, (i.e. consulting firms and IT providers).

Hence, this means that banks will likely become close partners and develop strong dependencies with selected fintech startups and third parties to help them develop their DLT solutions as they increase their collaboration.

However, these dependencies bear a third-party risk that requires a thorough due diligence and a strong and ongoing third-party supervision.

Development strategies for DLT



1.2 Roadmaps and development (Cont.)

Development strategies for DLT products and services

Therefore, especially looking at the lack of in-house capabilities of banks, it may be prudent to develop in-house expertise addressing third-party risks and effectively deal with any future developments.

In particular, adequately developed in-house competencies support the assessment of the right third-party service provider to work with.

Additionally, when speaking of future developments one should not forget the challenging regulatory and legal environment that DLT finds itself in globally.

Banks were also asked about their current understanding and awareness of the relevant national and international laws, regulations, and standards currently being discussed, especially throughout Europe and the US. Close to two thirds of respondents indicated that these issues are on the agenda of their regulatory change committees and that they are fully aware of these changes, while a further 20% are at least somewhat aware of them.

In the long-term, the current competition could increase when fintech partners enter the market as a regulated financial intermediary.

02

Embracing the DLT Revolution: A New Era in Banking?

DLT potential for cost-cutting and operational efficiency

For many years, banks have largely adhered to traditional business models, often lagging behind other industries in terms of continuous innovation and improvement. However, the emergence of DLTs presents an unprecedented opportunity for a significant overhaul of these traditional banking paradigms. While the potential for new revenue streams is a compelling reason for banks to venture into this novel domain, it's far from the sole motivator.

The integration of DLT opens up a myriad of strategic advantages. One such benefit is the ability to engage in cross-selling, which could attract diverse and previously untapped customer segments. This not only expands the customer base but also diversifies the bank's service offerings. Additionally, adopting DLT signifies a move towards the modernization of the banking sector, aligning it more closely with the digital and fast-paced nature of contemporary finance.

Equally important is the considerable potential for cost reduction that DLT enables. By streamlining processes, enhancing transactional efficiency and reducing the need for intermediaries, banks can achieve significant operational savings. This aspect of DLT is crucial, as it can lead to more competitive pricing models and improved profitability in the long run.

In summary, while revenue generation is a key driver for exploring new business avenues such as DLT, the broader strategic implications, including customer base expansion, modernization and cost efficiency, are equally pivotal for the banking sector's evolution and sustainability.

Banking Sector: A Slow Starter in the DLT Race

Despite the rapid growth of DLT and cryptocurrencies, banks have been relatively slow to enter the space. This cautious approach is partly due to regulatory uncertainties and the nascent nature of the technology. However, the potential of DLTs in transforming banking services is immense, presenting opportunities many banks don’t ignore.

2.2 Opportunities for Banking Reinvention

DLT use cases in the banking sector

DLT presents several opportunities for banks to reinvent their services and operations (examples, not conclusive):

Payment Settlement and Clearance

DLT can drastically reduce the time and cost involved in settlement and clearance processes. By utilizing DLT's real-time processing capabilities, banks can offer faster and more efficient transaction services, both domestically and internationally. There is also significant potential for use cases such as collateral management and repurchase agreements.

Tokenization of Assets

Tokenization — converting rights to an asset into a digital token — could revolutionize asset trading and management. Banks can play a key role in bridging traditional finance with DLT-based systems, providing customers with new ways to invest and manage assets

Custody, Brokerage, Staking Services

As digital assets become more mainstream, the demand for secure custody services grows. Banks, with their established trust and security protocols, are well-positioned to provide custody for digital assets. Additionally, extending brokerage services to include cryptocurrencies and tokenized assets or staking services could attract a new customer base seeking to explore digital asset investments.

Decentralized Finance (DeFi) and Traditional Finance (TradFi)

DeFi offers an alternative to traditional banking services, operating without central authorities using smart contracts on DLT. Banks can integrate DeFi solutions into DeFi offers as an alternative to traditional banking services, operating without central authorities using smart contracts on DLT. By integrating DeFi solutions into their offerings, particularly in lending and borrowing, banks can provide customers with more flexible and efficient financial services. As trusted counterparts, banks are in a position to combine traditional financial services with DeFi and can for instance act as oracle or broker for hybrid structured products.

Trade Financing

DLT are going to revolutionize trade finance in banking by enhancing transparency, increasing efficiency and ensuring secure transactions. Its decentralized ledger provides real-time access to data, reducing fraud risks and errors. By digitalizing processes with smart contracts, DLTs significantly shorten transaction times and cut costs by eliminating intermediaries. Additionally, its cryptographic security is ideal for handling sensitive financial data. This technology also facilitates smoother cross-border transactions and helps banks comply with regulatory requirements more effectively.

2.2 Opportunities for Banking Reinvention

Intermediary and Advisory Roles in Crypto Transactions

With their expertise in financial transactions, banks can act as intermediaries and advisors in the complex world of crypto transactions, offering added security, reliability to customers navigating the crypto market and industry with in-depth know-how regarding the financial services and regulatory landscape.

DLT Use Case for Corporate Payments

A Dax40 global corporate recently collaborated with a global transaction bank to pioneer a revolutionary blockchain system, foreseeing the transformative impact of emerging digital business models. By leveraging the blockchain technology, the corporate seeks to proactively address the challenges posed by digital business model disruptions (i.e. pay-per-use) and ensuring a more accurate and flexible approach to cash forecasting and intra-group funding. The system's key features include the introduction of programmable payments beyond conventional models such as zero-balanced cash pooling. The corporate plans to extend the system to include USD and EUR transactions in the coming year. This initiative aligns with broader industry trends where major banks are actively integrating blockchain technology into their infrastructures. With this pilot, the corporate positions itself at the forefront of financial innovation, anticipating a future marked by streamlined, transparent and secure payment processes.

How we can assist you in the Reinvention of Banking

- Support regarding blockchain-related transaction structuring and integration in operations
- Strategic implementation of crypto service offerings
- Design and implementation of processes
- Definition of target operating models
- Financial accounting advisory considering unique characteristics of blockchain transactions
- Assessment of transactions and reporting framework compliant reporting
- Assistance with accurate financial reporting, including balance sheets, income statements and cash flow statements that account for cryptocurrency holdings

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2.3 Implementing DLT in Banking: Challenges and Strategies

DLT adoption in the banking sector

While the opportunities are significant, implementing DLT in banking is not without challenges. Banks must navigate the technical complexities of DLT and align it with their existing services. They also need to address regulatory concerns and ensure customer trust and security.

Developing a Strategic Approach

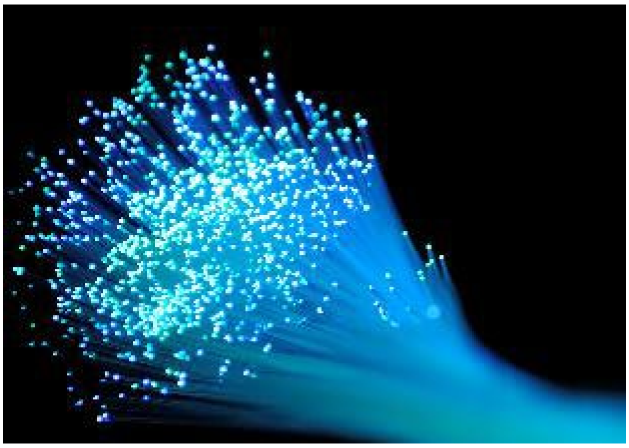
- **Understanding DLT Technology::** banks must invest in understanding the nuances of DLT, including its strengths and limitations.
- **Partnerships and Collaborations:** collaborating with fintechs and DLT experts can accelerate the adoption process and provide the necessary expertise.
- **Regulatory Compliance:** navigating the evolving regulatory landscape is crucial for the successful integration of DLT in banking services.
- **Investing in Security:** ensuring that robust security measures are in place is vital, given the sensitivity of financial data and transactions.

The Future of Banking with DLT

The integration of DLT in banking holds the promise of a more efficient, secure and customer-centric financial world. Banks that proactively adopt DLT can lead the way in the new era of digital banking, offering innovative services that meet the evolving needs of their customers.

A Catalyst for Innovation

DLT is more than just a technology; it's a catalyst for innovation in the banking sector. It encourages banks to rethink their traditional operations and embrace digital transformation. The banks that succeed in this transformation will likely become the market leaders of tomorrow.



03

Clarity on Regulation

DLT regulation and international standards

With the increasing popularity of cryptocurrencies, DLT is on the rise. While DLT serves as the underlying technology, its potential applications extend far beyond just cryptocurrencies. Nevertheless, use cases related to cryptocurrency service offerings are driving current regulatory developments worldwide and setting the stage for the adoption of the technology and future use cases built upon it.

Given the global reach of cryptocurrencies, existing regulations have been established at the local level by different jurisdictions, varying in maturity. Therefore, the need for global international standards is greater than ever. In the following we aim to highlight current key regulatory developments from a global perspective down to the local jurisdiction in Switzerland.

Financial Action Task Force (FATF)

In 2019 the FATF, as the global money laundering and terrorist financing watchdog, extended its measures to combat money laundering (AML) and the financing of terrorism to virtual assets and virtual asset service providers (VASP). The extension focused on the following key areas:

- Clarification of the definitions of virtual assets (cryptocurrencies, stablecoins, non-fungible tokes, etc.) and VASPs,
- FATF standards applicable to stablecoins,
- Money laundering and terrorist financing risks in peer-to-peer transactions,
- Licensing, registration and supervision of VASPs,
- Travel rule requirements, and.
- Information-sharing and cooperation amongst VASP Supervisors.

Since 2019 the FATF has been in a constant dialog with countries and relevant stakeholders to further develop its measures in this sector.

Basel Committee on Banking Supervision

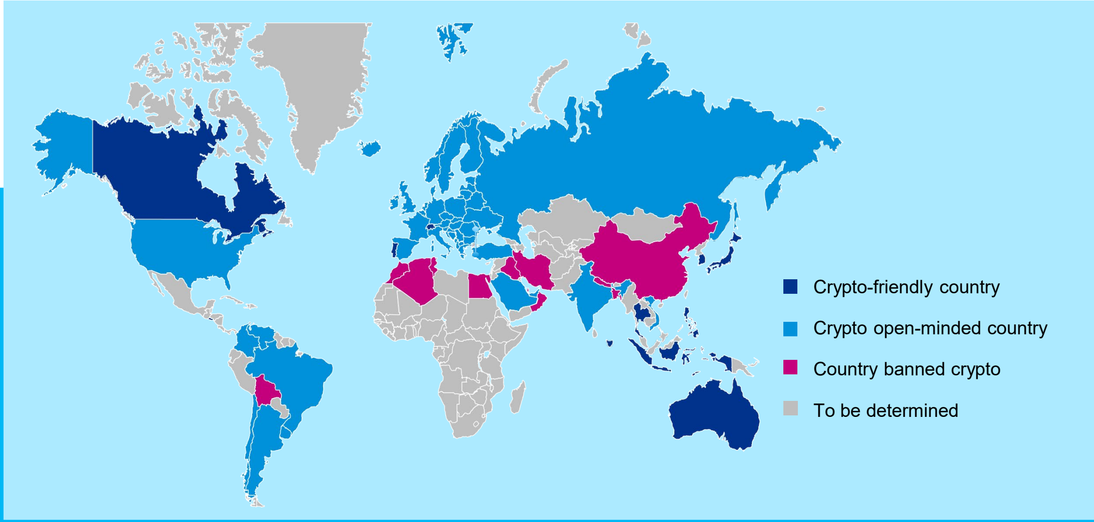
In December 2022, the Bank for International Settlement (BIS) through its Basel Committee on Banking supervision published its final global prudential standards for banks' exposure to crypto assets. These standards are expected to be implemented by 1 January 2025.

According to the published standards, banks are required to classify crypto assets and reassess them on an ongoing basis. It is the banks' responsibility to ensure that the crypto assets to which they are exposed are compliant with the classification criteria. Furthermore, banks are required to adhere to minimum capital requirements depending on the classification of crypto assets as well as capital requirements for operational risks and requirements to address liquidity risks.

Bank for International Settlement (BIS)

In October 2023, the BIS issued a public consultation on banks' disclosure of crypto asset exposure, which is based on the disclosures contained in the final prudential standard published in December 2022. The standard will be finalized after the consultation by 31 January 2024 with a proposed implementation date as of 1 January 2025.

3.2 International regulatory developments



United States

The US is at the forefront in terms of crypto currency trading volumes, but it lags behind in regulating cryptocurrencies when compared to global regulatory developments. While other countries established a dedicated regulation for crypto currencies (i.e. MiCAR in the EU) the US intends to subordinate crypto currencies under existing regulations and existing supervisory bodies such as the Security Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC is addressing the current legal ambiguity surrounding cryptocurrency classification through legal proceedings against Ripple, Coinbase, Binance, and Kraken.

Furthermore, in July 2023 the House Financial Services Committee submitted its bill "Clarity for Payment Stablecoins Act 2023" to address community demands for legal clarity over stablecoins. Following this, Paypal published its intention to launch its own stablecoin.

European Union

The European Union has taken significant steps in regulating crypto assets with the Digital Finance Package published in September 2020. This package includes the Markets in Crypto Assets Regulation (MiCAR), the Digital Operational Resilience Act (DORA), and the pilot regime for market infrastructures based on DLT. MiCAR aims to establish a unified framework for crypto assets in the EU, covering anti-money laundering measures, investor protection and market integrity. DORA sets rules for security and Responsiveness in Information and communication technology (ICT)-related incidents. The DLT Pilot Regime allows controlled testing of DLT market infrastructures.

While the Digital Finance Package will strengthen the regulation of crypto assets and DLT in the EU, uncertainties persist regarding the regulation of Non-Fungible Tokens (NFT).

3.3 Swiss regulatory developments

Swiss DLT Regulation

The Federal Act on the Adaptation of Federal Law to Developments in Distributed Ledger Technology (DLT bill), adopted by the Swiss Parliament, entered into force as of 1 February 2021. The DLT Act included amendments to:

- Financial Services Act (FinSA);
- National Banking Act (NBA);
- Code of Obligations (CO);
- Federal Intermediated Securities Act (FISA);
- Federal Act on International Private Law (PILA);
- Banking Act (BA);
- Financial Institutions Act (FinIA);
- Anti-Money Laundering Act (AMLA);
- Financial Market Infrastructure Act (FMIA); and
- Debt Enforcement and Bankruptcy Act (DEBA), incl. accompanying blanket ordinance.

Custody and storage for crypto assets

With the DLT bill clarification within the DEBA addresses the segregation of digital assets in case of bankruptcy as well as access to data and personal information. Rules addressing the segregation of digital assets grants the right to reclaim digital assets held by the custodian under certain circumstances. These rules allow banks and other supervised financial institutions to hold crypto assets off-balance sheet more easily, thereby benefiting from stricter capital requirements as issued by the FINMA and reiterated by the Basel Committee in its publication ‘Prudential treatment of crypto exposures’ issued in December 2022. Along with the segregation of digital assets included in the DEBA, the safekeeping of crypto assets was specified in the BA.

3.3 Swiss regulatory developments (Cont.)

Swiss DLT Regulation

Specifically, crypto assets that serve as means of payment (i.e. payment tokens) held in omnibus accounts (i.e. one wallet for multiple clients) qualify as custodial assets under Article 16 BA. As a result, licensing requirements were introduced for the safekeeping of such crypto assets necessitating a fintech or a banking license. Conversely, if such crypto assets are held in separate custody no license is r equired. However other requirements such as anti-money laundering, must still be taken into consideration.

The licensing requirements have become a focal point of recent discussions among various stakeholders in the crypto industry and the FINMA.

With its publication in early September 2023, the Swiss Blockchain Federation (SBF) outlined the change in practice by the FINMA regarding the application of licensing requirements for providers of staking services.

According to the SBF's circular, FINMA implies the need for a banking license referencing applicable rules under the DLT Act when offering staking services. This conclusion is primarily driven by concerns related to the temporary locking of assets by various staking protocols (lockup periods) and the risk of losing assets in case of wrongdoing during the staking process (slashing). The SBF emphasizes that this change of practice could significantly hinder Switzerland's innovative strength. As a result, non-bank staking providers may be unable to continue their operations without a banking license and banks offering staking services are required to account for such deposits on balance sheet, leading to higher capital requirements.

Taking industry concerns into consideration, FINMA indicated that it will open a public consultation in the near future

3.3 Swiss regulatory developments (Cont.)

Swiss DLT Regulation

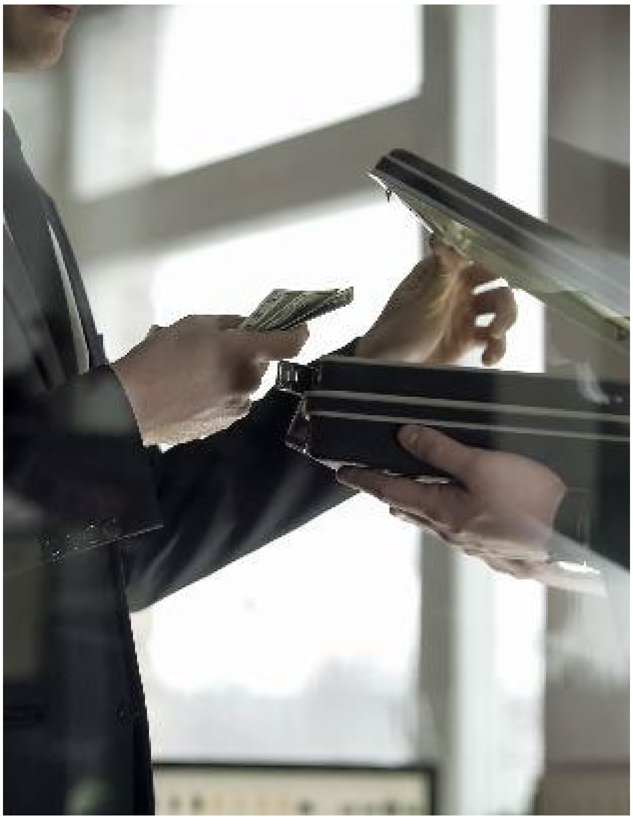
AML rules for crypto services

The AMLA's scope has been expanded in two key ways: First, DLT trading facilities are now considered financial intermediaries subject to AML rules. Second, qualification as a financial intermediary no longer solely depends on fund control but also on maintaining a permanent business relationship and providing an essential service for the technical solution. This broadens the range of virtual currency activities subject to AML rules.

DLT securities and trading facilities

The Swiss Code of Obligations has introduced a new type of securities called 'registered uncertificated securities' (DLT securities). These securities must be registered in a DLT protocol and can only be transferred within this protocol. DLT securities simplify the process of legally binding transfers and eliminate the need for a central securities depository.
These new securities are expected to make it easier and more cost-effective for companies to issue equity or debt instruments, thereby improving liquidity and accessibility for secondary trading. To facilitate multilateral trading of DLT securities, a specific license called DLT trading facility is introduced under FMIA. Unlike traditional trading facilities, DLT trading facilities can grant access to both qualified participants and private individuals directly and can offer custody, clearing and settlement services without an additional license. However, they cannot centrally clear certain DLT securities to mitigate risk concentration.

Requirements for obtaining a DLT trading facility authorization are similar to those for stock exchanges and multilateral trading facilities, with the stipulation that the operation must be conducted by a Swiss entity, making entirely decentralized platforms generally ineligible for such authorization in Switzerland. The FMIO provides additional details on DLT trading facility requirements, including provisions for correcting or cancelling executed trades and restrictions on trading certain financial instruments to comply with anti-money laundering rules. Simplifications for smaller DLT trading facilities are also introduced based on a risk-based approach, aligning with requirements for other trading facilities.



3.3 Swiss regulatory developments (Cont.)

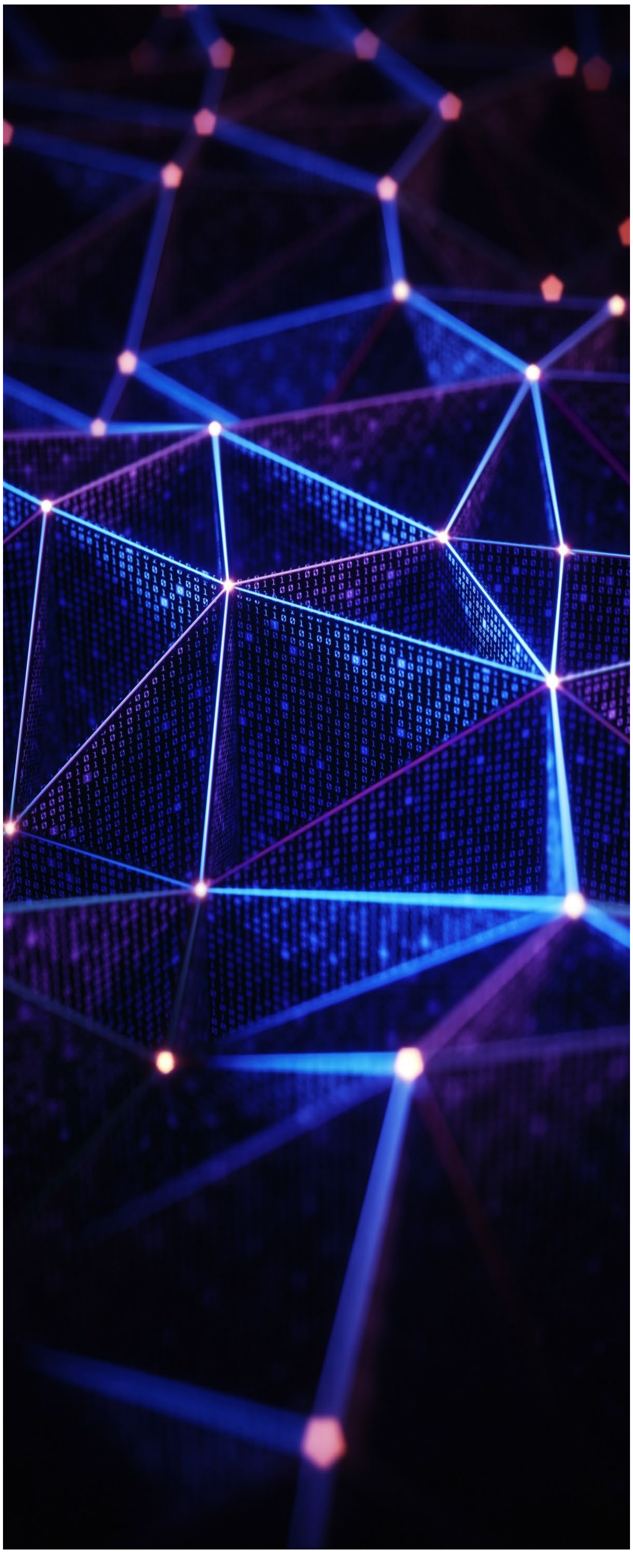
Swiss DLT Regulation

DLT for collective investment schemes

In September 2021, FINMA approved the first Swiss crypto fund structure as “other fund for alternative investments” investing in crypto assets. These collective investment schemes are managed by regulated asset managers, administrated by regulated management companies and custody is provided by regulated custody banks.

However, the Federal State Secretary for International Finance (SIF) noted in its federal council report "Digital finance: areas for action 2022+” issued in February 2022 that there is untapped potential for the use of DLT in the area of the Collective Investment Scheme Act (CISA).

Although it is already possible to issue funds in the form of tokens, the CISA does not yet provide for the use of DLT for the custody and management of digital assets, which limits the potential for innovative new products and efficiency gains. Therefore, the federal council instructed the federal department of finance as well as the SIF, in cooperation with the regulator FINMA and the industry, to adapt the legal framework and strengthen the use of DLT in the fund industry.



3.3 Swiss regulatory developments (Cont.)

Swiss DLT Regulation

Conclusion

As highlighted in this report, regulators worldwide acknowledge the growing significance of DLT by implementing regulations to govern its use. While certain jurisdictions like the European Union and Switzerland have already enacted specific DLT regulations, others such as the United States are currently working towards establishing legal clarity.

Upon closer examination of Swiss legislation related to DLT, a degree of legal uncertainty persists. The interpretation of existing DLT rules, particularly concerning staking, remains a topic of discussion between regulators and industry stakeholders, with other legal aspects yet to be addressed. Notably, the Collective Investment Scheme Act does not fully accommodate the innovative potential of DLT. Additionally, we closely monitor the European Union's approach to regulating stablecoins and its potential impact on Swiss legislation, along with anticipated regulations regarding NFTs.

Given the dynamic nature of evolving regulatory requirements, it is imperative for companies engaged in the DLT industry to vigilantly track and adapt to future developments.

How we can assist you in DLT Regulations

- Assessment of planned activity with regards to applicable laws/regulations
- Support during the license application process with the regulator from an advisory or license application audit perspective
- Financial statement and regulatory audit
- Assessment of tokens under applicable regulations (i.e. FINMA ICO Guideline)
- Advice on trends/developments in the regulatory landscape important for strategic decision-making
- Support regarding adherence to DLT-specific regulatory requirements
- Support in the selection, instruction and oversight of specific DLT service providers
- Education of Board, Management and/or other staff in DLT regulations

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04

Swiss Tax Insights for Digital Asset Banks

4.1 Swiss value-added tax (VAT)

Introduction to Swiss taxation in the DLT sector

The Swiss tax authorities have early on adapted their practices concerning DLT businesses, and due to the significant growth of this industry in Switzerland, they have already accumulated a wealth of experience compared to other countries. The challenge here is that the Swiss tax authorities have not made all of its applied practices public.

In the following we explore some of the **officially published and (non-published)** tax implications and challenges that lie ahead for banks and other financial institutions that are interested in incorporating digital assets into their services.

Swiss value-added tax

The Swiss Federal Tax Administration (FTA) has issued a general guidance on the VAT treatment of digital asset services. However, this guidance is still evolving as the nature of digital assets and the corresponding services offered continue to develop. In its guidance, the FTA distinguishes between:

(i) payment tokens,

(ii) utility tokens, and

(iii) asset tokens.

Separate rules exist for hybrid tokens, which are tokens that consist of multiple functions.

As the function of tokens can change over time and applications expand, it is difficult to classify tokens for VAT purposes under the appropriate categories of the FTA. It is further important to note that these categories do not necessarily correspond to those set by the Swiss Financial Market Supervisory Authority (FINMA).

According to the practice of the FTA, a utility token is only considered taxable for VAT purposes if a specific service or at least a clearly determinable future service is linked to the token and no exemption applies. For example, if a token is linked to a specific electronic service, it would be considered a taxable utility token.

Swiss value-added tax

However, if there is no clearly determinable (future) service linked to the token, it may not be considered a supply at all for VAT purposes. Further important – **not officially published** – news is that the FTA recently changed its practice regarding native tokens with a governance function. The governance function as such is not considered as a taxable service. In addition, a native token with a governance function may be qualified as payment token if this is the primary function.

The VAT treatment of token custody, trading and issuance can vary widely depending on the type of token, so it's crucial to classify tokens correctly. Token qualification for financial institutions can be overwhelming, depending on the scope of the digital asset offering. There is no official publication or tool on VAT qualification of tokens, which is why banks need to develop their own internal approach. Based on our experience the FTA is willing to provide some relief for the relevant processes and qualifications where appropriate. Banking services for digital assets also include a variety of electronic services, which can be billed to customers individually or as a package. VAT treatments for these services may vary depending on their nature.

Based on a recent decision from the Swiss Federal Administrative Court, block rewards for validation and verification activities provided to a decentralized blockchain network are considered as non-remuneration if there is no identifiable service recipient and no clear service relationship in a VAT sense.

However, when offering such services to clients/investors (via delegated/nominated Proof-of-Stake) rewards are shared between the pool operator and pool delegators. As such, there are further factors to consider.

Another complexity is the fact that the VAT treatment and/or token qualification of digital asset services may differ from country to country. This can make it difficult for banks to comply with VAT laws in multiple jurisdictions.

As the digital asset market continues to grow, it is likely that the VAT treatment of digital asset services will become even more complex. Banks that offer these services should therefore carefully consider the VAT implications of their activities.

4.2 Swiss stamp transfer tax (STT)

Swiss stamp transfer tax

An STT liability arises if **(1)** a securities dealer (according to STT provisions) acts as an intermediary or counterparty in **(2)** the transfer **(3)** of taxable securities **(4)** against consideration and **(5)** no exemption applies.

Banks are securities dealers for STT purposes by default. As such they must account for and pay STT on transactions against consideration that involve tokens qualifying as taxable securities for STT purposes, unless a special exemption applies (e.g. a transaction for an exempt investor for STT purposes).

The FTA has issued guidance on the application of STT to digital assets. The guidance clarifies that certain types of digital assets, such as debt tokens that qualify as bonds as well as investment tokens with participation rights, or those with reference to taxable securities such as shares or bonds, qualify as taxable securities for the purposes of STT. The FTA's practice is, however, not as clear as it seems. In particular the qualification of a token that represents a share as a taxable security is controversial.

As a result, banks that are dealing in digital assets must carefully evaluate each token on a case-by-case basis to determine whether it is likely to be considered a taxable security for STT purposes. This is a new internal process that must be integrated into the systems and processes for the preparation of the STT register.

The FTA has been keeping a closer eye on crypto exchanges since the release of its working paper on cryptocurrencies and it is likely that this will also be the case for banks with a digital asset offering.

4.3 Swiss withholding tax (WHT)

Swiss withholding tax

In Switzerland, WHT is a tax levied on certain types of income such as interest on Swiss bonds and dividends on Swiss stocks. The standard rate of WHT is 35%. However, there are several exemptions available.

The FTA has also issued guidance on the application of WHT to digital assets. Based on this, interest payments on debt tokens issued in Switzerland and dividend payments on investment tokens with participation rights that are issued in Switzerland are subject to WHT at a rate of 35%.

The WHT is deducted from the interest / dividend payment by the payer (issuer) and remitted to the FTA. *Example: A bank issues debt tokens to raise capital. The interest payments on the debt tokens are subject to withholding tax at a rate of 35%.* In contrast to this, staking rewards should not be subject to WHT. However, to obtain certainty on this matter, a bank may want to consider submitting a tax ruling request to the FTA. This is especially important if the amounts involved are material.

How we can assist you in DLT taxation topics

- Clarifying the correct VAT treatment and data requirements for all banking services around digital assets (wallet services, custody, trading, staking etc.)
- Supporting the issuance of tokens (Profit tax, Withholding tax, Stamp transfer tax, VAT)
- Assisting with the qualification of tokens for Swiss tax purposes
- Assessing whether transactions involving digital assets are subject to Stamp transfer tax or Withholding tax
- Providing solutions around digital assets / transactions tax reporting & account statements
- Evaluating the tax treatment of investments in crypto assets by individuals
- Providing support regarding the readiness for information exchanges on digital assets
- Providing tax advice with establishing crypto funds

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4.4 Tax Reporting Requirements

Crypto-asset reporting framework (CARF)

With the planned introduction of the CARF by the OECD, extensive reporting and due diligence requirements will become applicable in the future for crypto assets. CARF is a global standard for the automatic exchange of information (AEOI) on crypto assets. Under CARF, Crypto-Asset Service Providers such as banks will be required to annually report information about their clients' crypto-asset holdings to the tax authorities.

The implementation of CARF is a significant development in the taxation of crypto assets. The exact timeline for the implementation of the CARF across OECD member jurisdictions is currently unclear. **In Switzerland, the Federal Department of Finance will prepare a consultation draft to implement the revision of the CRS and CARF by the end of June 2024.**

For banks offering digital assets, these revisions will mean that they will need to:

- Collect and report information on all accounts held with crypto-asset service providers, regardless of whether the account holder is a resident or non-resident of the bank's jurisdiction.
- Update their CRS self-certification forms to account for the new status of crypto-asset service providers.
- Report any crypto assets they currently hold on behalf of clients.
- Include the value of any digital currencies in the account balance of any depositary account.

Overall Swiss tax implications

The tax implications of banks offering digital assets are complex and far-reaching. Banks that are considering offering digital assets should carefully evaluate the potential tax consequences of their activities.

Guidance on the tax implications of digital assets can be found in various publications and leaflets from the tax authorities and various advisors. However – as not all of the currently applied practice is officially published it is recommended to consult with an experienced advisor or the tax authorities directly so as to make informed decisions about how to best position your bank for the future.

Whilst the exact future of digital assets is uncertain, what is clear is that they are here to stay. Banks that are able to navigate the complex tax landscape of digital assets will be well-positioned to succeed in the digital age.

Your challenges for tax compliance

...what you have to keep in mind when offering digital asset services

Swiss value-added tax

Navigating the VAT qualification of the tokens that underlie your digital asset services

Crypto-asset reporting framework

Fulfilling the reporting and due-diligence obligations on your digital asset offering

Swiss stamp transfer tax

Determine whether your traded digital assets qualify as securities for STT purposes

Swiss withholding tax

Declare and pay the right amount of withholding tax on your digital assets issued

Your Contacts

Our Swiss team of DLT experts is always at your service

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