Tokens and DeFi energizing the funds industry, from issuance to taxation

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2021 was a record-breaking year for cryptocurrencies, with many, including Bitcoin and Ethereum, reaching new market price highs. The total crypto market capitalization in 2021 reached a record US$3 trillion before dipping below US$1 trillion in June 2022.

According to a survey led by The Block*, roughly US$25.1 billion has been allocated in venture funding across 1,703 crypto deals. M&A transactions for the digital assets also broke a record in 2021 with dollar volume increasing by 730% to US$6.1 billion year on year.

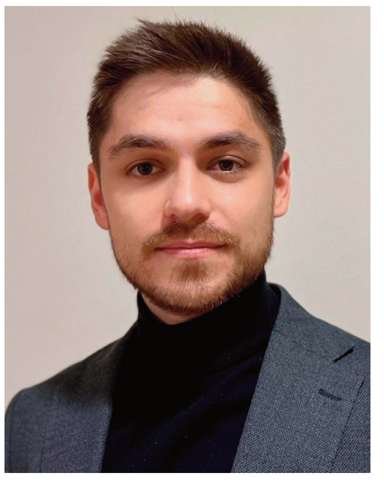
2021 was also a good year for the non-fungible tokens (NFT) sector which recorded a trading volume of US$8.8 billion with Art and Collectibles contributing 59% and gaming NFTs comprising 41% of the volume.

Deloitte's metaverse month in May showed a huge appetite for these topics. Now we continue the web 3.0 journey through the review of decentralized finance (DeFi), token issuance and the taxation of these new assets.

The Institutional transition phase to crypto assets

Beside the skyrocketing growth and recent fall in market capitalization of crypto-currencies, innovative funding methods have risen over the past few years. Among those, DeFi is seen as a driver. DeFi combines decentralized applications (dapps) using blockchain to provide a wide range of financial services such as market-making, savings, trading, insurance, lending and derivatives custody. DeFi allows executes transactions in a secure and verifiable way with little need for intermediaries such as central clearing houses or escrow services.

As crypto and digital assets that rapidly evolve, organizations also have now the opportunity to harness these technologies and redefine their own business strategies for the future. For many asset managers starting to consider crypto as an asset class to diversify their portfolios, fintech companies based on this technology are still under the radar. As noted by Block, one of the significant M&A deals of the year was J.C. Flowers & Co.'s acquisition of a 30% stake (at $300 million) in LMAX Digital, the institutional cryptocurrency exchange operated by LMAX Group. The most recent bear market downturn may reduce the appetite for those investments; however, strong fintechs will still remain viable investments.



For financial institutions to fully embrace DeFi, it is imperative that platforms continue to keep investor confidence and meet regulatory requirements by demonstrating compliance, security, and market integrity. As DeFi presents the same type of risks as other capital markets, financial institutions can thus capitalize on their knowledge and experience of the capital markets to promote the use of DeFi.

Security token offerings: a powerful distribution methods for investment funds

Blockchain has allowed the development of a new form of fund distribution: security token offering (STO). STO's primary purpose is to facilitate investment and broaden distribution through security and transparency – a whole new paradigm at the frontier of technology, law and finance.

Concretely, the fund issues financial instruments in the form of tokens, called "security tokens," recorded on a blockchain. Like financial securities, those tokens represent securities that are purchased by investors, recorded on a distributed ledger and subject to European financial regulation such as Prospectus, MIFID II and Market Abuse Regulation. Once acquired, these tokens may provide political and financial rights (right to vote, right to dividends, etc.) to their holders.

Security tokens embody the digitalization of financial assets based on a blockchain. Now it is possible to acquire part of a company's capital with cryptocurrencies. Tokenization can be applied to financial instruments such as shares and bonds as well as tangible assets such as real estate, revenue streams and intellectual property. Tokens that represent traditional assets such as a fund's shares, debt, or units can therefore be issued through an STO.

Although a wide range of tokens can be qualified as securities (including NFTs and asset-referenced tokens), the following token types are likely to be prioritized by asset managers:
- Equity tokens, which are quasi-similar to shares resulting from traditional fundraising
- Debt tokens, which are similar to bonds issued by companies when they wish to raise funds through debt

In addition, tokens can include political and/or financial rights that can be regrouped with the concept of "smart agreement." Key characteristics of tokens are the synthetization, digitalization and automatization of transaction execution after an order/agreement between two parties. Smart agreements are reduced to a coding presentation, designed to ensure a quick, certain and easy execution of the consensus between the parties.

Practically, smart agreements are extremely well adapted to the velocity of blockchain and crypto. We may note that the standard concepts of contractual law (such as negotiation, materialization of consent, or even existence of written provisions) are strictly limited and replaced by coding lines focused on the conditions to execute a transaction. The materialization of the consent, which becomes instantly immutable, is limited to the most simple digital acceptance (the click). Thus, those instruments should be carefully used by investors, which should accept a certain degree of risk on their transactions.

The tax environment behind blockchain and crypto evangelists

Needless to say, tax payers and tax authorities must navigate the complex instruments resulting from the practice. The tax treatment of various instruments therefore depends on their qualification as quasi-equity or quasi-debt and obviously must be analyzed on a case-by-case basis. To that end, the analysis should focus on the rights attached to the token (participation in the capital of the issuer, voting rights, type of returns, ranking, existence of stapling, maturity, rights to liquidation proceeds, convertibility, etc.). In the he future, we will most likely see the rise of "digital" substance over form. Following the qualification of instruments, the returns should then be subject to the related treatment, as dividend or quasi-dividend vs. interest and similar income.

Complexity in the qualification of the tokens is also dependent on the level of information provided by the issuer. Investors should therefore make sure to have access to a minimum set of information on their certificates.

In parallel, the concept of "staking" has recently been developed and consists of the immobilization of security tokens, in order to generate passive income or reward for the long-term liquidity in the blockchain. Despite the fact that the underlying token would be a quasi-debt or quasi-equity certificate, the key characteristics of the staking would tend to qualify the transaction as a lending transaction, thus triggering recognition of (quasi-)interest income.

From an operational tax perspective, the above qualification of instruments will be key for an investment to become an issuer (as a fund or corporate vehicle). The impacts include withholding tax on payments, VAT, application of double tax treaties and also recent tax developments in the fund industry (such as ATAD) which focus and subordinate tax deduction to the income recognition at the investor level. There is therefore a strong need for appropriate qualification and assessment and, to some extent, merit in some harmonization.

From a Luxembourg perspective, tax authorities have merely focused on the interpretation of cryptocurrencies, foreseeing that they constitute intangible assets and that the income taxation is in relation to their trading or from the Proof of Work (PoW). As a practical consequence, Luxembourg entities should not be allowed to draw up their financial statements or to file their tax returns in a specific cryptocurrency.

Luxembourg investors may look for additional interpretations on other types of tokens, income recognition or type of deductible expenses. This is particularly the case where security token yield would be paid in crypto assets (such as stablecoins or in the same token as the investment). The Luxembourg tax authority circular dated 26 July 2018 stated that the nature of the income will not be affected by the payment method. As an example, where interest is paid in virtual currency like Stablecoin, it does not affect the nature of the interest income. However, all tokens are not equivalent, and their value might be subject to high volatility.

In a nutshell, while the technical solutions and opportunities are robust and efficient, the adhesion of the market and the clarifications of the taxation will still be needed in order to bring the industry to a new golden age. Deloitte Tax & Consulting has set a team of experts to help clients in developing their strategy or technical support.

* The Block - 2022 Digital Asset Outlook Report (theblockcrypto.com)

Sources:
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LuxSE named Stock Exchange of the Year by Environmental Finance

The Luxembourg Stock Exchange (LuxSE) has been granted the 'Stock Exchange of the Year' award by Environmental Finance as part of the Sustainable Investment Awards 2022 on June 26th, with the winners of the different categories officially unveiled earlier today.

The Environmental Finance Sustainable Investment Awards 2022 are global and recognise financial institutions and other companies which strive to incorporate ESG across all asset classes, contribute to making sustainability an integral part of investment decisions and support projects that mitigate climate change or make a positive impact in the world.

"This award is an important recognition of the positive environmental and social impact that the Luxembourg Stock Exchange contributes to by facilitating sustainable investment towards the global goals. Every day, we strive to make sustainable investment more accessible not just to established players in developed markets but also in emerging markets, where the funding is needed the most. This recognition by Environmental Finance further strengthens our conviction that exchanges can and must drive the transition to a more sustainable and inclusive economy," said Julie Becker, CEO of LuxSE.

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Recognising efforts in data, education and transparency

The jury at this year's Sustainable Investment Awards chose LuxSE, home to the world's leading platform for sustainable securities the Luxembourg Green Exchange (LGX), as the winner in the 'Stock Exchange of the Year' category for its pioneering work in three key areas: expanding the scope of sustainable investment opportunities featured on the platform, bringing structured sustainability data to the market with the LGX DataHub and fostering sustainable finance knowledge and awareness through the LGX Academy. The Environmental Finance Sustainable Investment Awards, now in its fourth year, considers the efforts and achievements made by contenders in the period from 1 March 2021 to 1 April 2022. A judging panel consisting of over 40 investors and industry experts reviewed and scored the submissions.

This year marks the first time LuxSE is awarded at the Sustainable Investment Awards. LuxSE was granted the 'Exchange of the Year' award for five consecutive years from 2017 – 2021 in Environmental Finance's Bond Awards, which is the other major annual award competition organised by the sustainable finance-focused news outlet.

Accelerating sustainable finance

In 2021, LuxSE continued to develop the LGX platform to reflect and foster new market trends, with the overarching objective to accelerate sustainable investment. The LGX fund window was revamped to reflect the Article 8 and Article 9 fund classification under the Sustainable Finance Disclosure Regulation, providing more transparency to investors around funds' SFDR classification.

To highlight the wider sustainable investment universe beyond labelled bonds and expand sustainable investment opportunities for impact-conscious investors while demand for green bonds exceeds the supply, LuxSE also added a new section featuring Climate-Aligned Issuers, showcasing companies that derive at least 75% of their revenues from environmentally friendly activities.

To address the main hurdles to sustainable finance, LuxSE further developed the LGX DataHub and LGX Academy in 2021. The scope of the LGX DataHub was expanded to include sustainability-linked bonds (SLBs) in addition to green, social and sustainability bonds, and now offers structured sustainability data on more than 7,000 of the world's listed sustainable debt instruments.

LuxSE also brought the LGX Academy courses to a number of additional countries, including Rwanda, Cabo Verde and Vietnam as part of the exchange's focus on sustainable finance capacity building in emerging markets.

As of 31 May 2022, LGX encompasses a total of 2,800 sustainable securities, including 1,400 green, social, sustainability and sustainability-linked bonds from 240 issuers in 50 countries, raising a total of EUR 736 billion for green and social investment and sustainable development across the world.