A Token Gesture: Tax Considerations for Cryptocurrencies and Utility Tokens

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What is a Token?

- Tokens are a representation of a digital record that entitles the holder to specified assets or utility that is maintained using blockchain technology.
- The rights inherent in each token are described in the project's whitepaper.
- The functionality of a token is made possible through the use of smart contracts: self-executing programmable computer code.
- An Initial Coin Offering (ICO) can be a means used to fund a blockchain project.

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Token Categories

- Cryptocurrencies or "Convertible virtual currencies," that represent a medium for transmission of value.
  - Bitcoin, Bitcoin Cash, Litecoin, etc.
- Security (or Equity) tokens.
  - Provide interest in profits, vote, liquidation rights, etc.
- Utility tokens.
  - Access to goods or services.
  - Pre-functional or fully functional at time of sale.
- Other digital assets.

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Federal Tax Characterization

- Potential Tax Characterization:
  - Prepaid Services
  - Property
  - Equity
    - Derivative
    - Commodity
- Securities law guidance NOT determinative for tax characterization.
- A token's federal income tax treatment depends on the rights and powers associated with the token.

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Federal Tax Characterization (cont.)

- Token Functionality/Utility:
  - Does the token represent only the right to obtain a service in the future?
  - Does the token offer profit sharing or voting rights in entity management?
  - Is the token exchangeable for a product – *e.g.* utilization of intellectual property?

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Tax Characterization

Prepaid Services:

- Possible if a token has only a right to receive future services from the issuer and no power to compel the issuer to repurchase the token (and no profit sharing function).
- Prepayments for services are generally taxable upon receipt unless "advance payment" tax accounting election is made which enables deferral for one year.
  - See *Schlude v. Commissioner*, 372 U.S. 128 (1963); Rev. Proc. 2004-34 (codified by the Tax Cuts and Jobs Act in IRC Section 451(c)).

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Tax Characterization (cont.)

- If token proceeds (or payments received pursuant to a contract to deliver tokens in the future) are treated as payments for prepaid services, proceeds are subject to tax by the issuer when received.
  - Forward contract treatment is NOT available

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Tax Characterization (cont.)

Property (not equity):

- Proceeds received on the sale or exchange of property are taxable.
- Because tokens are self-generated by the issuer, the tax basis will be zero. Thus, 100% of the proceeds are subject to US federal income tax.
- However, to the extent proceeds are received pursuant to an arrangement to deliver tokens at a future date, (*e.g.* SAFT) the arrangement may be treated as a "prepaid forward contract".
- Proceeds received under a prepaid forward contract are not subject to US federal income tax until the underlying property is delivered to the contract holder.

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Tax Characterization (cont.)

Equity:

- Limited distribution rights likely insufficient to become equity.
  - But dividend or other profit sharing coupled with voting rights and liquidation rights (residual return of capital) may create an equity interest.
- The issuance and redemption of stock by the issuer have no tax consequences to the issuer.

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Tax Characterization (cont.)

- Numerous tax rules applicable to stock: distributions, redemptions. In addition, if a holder utilizes the token's utility (*i.e.* for services), the services may be taxable to the holder. Issuers must withhold on dividend distributions and FATCA reporting may apply.
- Additional considerations if issuer is a partnership for tax purposes. See Treas. Reg. § 307.7701-1(a)(2) (contractual arrangement may create a separate entity for Federal tax purposes).

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Virtual Currency: IRS Notice 2014-21

- IRS's position on tax treatment of "convertible" "virtual currencies" that have an equivalent value in real currency, or that acts as a substitute for real currency; *i.e.*, may be used to pay for goods or services, or held for investment.
- Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.
- For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.
- Virtual currency is not considered foreign currency.

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Virtual Currency: IRS Guidance (cont.)

- If the FMV of property or services received in exchange for virtual currency exceeds the taxpayer's adjusted basis, the taxpayer has taxable gain (character depends on whether the currency is a capital asset in the hands of the taxpayer.
- Payments made with virtual currency are subject to information reporting to the same extent as any other payment made in property.
  - Form W-2 (wages)
  - Form 1099-MISC (compensation for independent contractors)
  - Form 1099-K
- Notice 2014-21 does not address the tax treatment of tokens that are not virtual currencies, forks, barter reporting, and issuers of tokens.

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Bitcoin

- Bitcoin is software that tracks and validates the transfer of digital assets called "bitcoins".
- Each bitcoin transaction (from bitcoin's inception) is encrypted and recorded in a public ledger (see, *e.g.*, https://blockchain.info/).
- Transactions are added to the ledger in "blocks," each of which is cryptographically-linked to the prior block in the chain (hence, the moniker, "blockchain").
- The cryptography used in bitcoin ensures that each block can be linked to only one particular "parent" block, which permanently fixes the order of transactions and prevents "double spending" of bitcoins.

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Mining

- Users, or "nodes," broadcast transactions to the network.
- Each miner (a specialized node) collects such transactions into a candidate block and then attempts to validate its candidate by solving a complex cryptographic problem.
- The first miner to solve the problem and validate its candidate broadcasts its validated block to the network, which adds it to the ledger as the next block in the chain.

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Mining (cont.)

- The "winning" miner automatically receives a "block reward" (newly-issued bitcoins) and transaction fees as payment for expending the significant energy required to update the blockchain.
  - Block rewards are the only source of "new" bitcoins.
  - After 21 million bitcoins have been mined, no new bitcoins will be issued.
  - Block rewards are taxable as ordinary income to the miner.

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The Blockchain Ledger and Consensus

- The ledger, or blockchain, is not centrally maintained.
- Instead, each node downloads and updates its own local copy with new blocks as miners broadcast them.
- Occasionally, two miners broadcast valid blocks for the same parent, which causes the blockchain to become inconsistent across nodes (*i.e.*, each node updates its copy of the blockchain with the first block it receives).

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The Blockchain Ledger and Consensus (cont.)

- Such inconsistencies are resolved by consensus, which is determined based on which of the two versions of the blockchain is extended by the next valid block.
- All nodes will always consider the longest blockchain the authoritative blockchain and work to lengthen it.
  - The tremendous energy required to create a chain longer than the "honest" chain limits both its feasibility and its appeal, diminishing the risk that the blockchain will be hacked.

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Development

- Rules governing creation of transactions and blocks are programmed into the bitcoin software.
- Because the bitcoin software is open-source, no single constituency has control over its development.
  - Literally anyone can download the underlying code and develop and release a new version of the software.
- Thus, development occurs by consensus.
  - Each node that implements the new version of the software is "voting" in favor of the rules it imposes, while each node that fails to implement the new version of the software is voting against the rules it imposes.
  - Typically, consensus emerges when one version of the software or the other becomes dominant.

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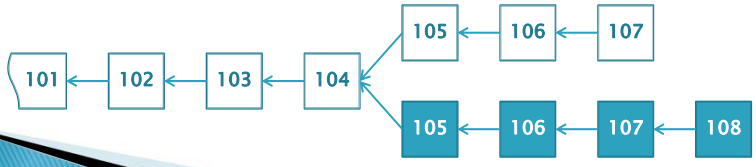
Forks

- A "fork" is a new version of the bitcoin software
  - A "soft fork" is more restrictive regarding validity requirements for transactions and blocks.
  - A "hard fork" is less restrictive regarding validity requirements for transactions and blocks.
- A fork of the bitcoin software may or may not cause the blockchain to permanently diverge, or split, into separate chains depending on.
  - the compatibility of the fork with the existing software and
  - the consensus of nodes (or lack thereof)



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Forks (cont.)

- Compatibility determines whether nodes using one version of the software will accept transactions and blocks created using the other version of the software.
  - In the case of a soft fork, a node that does not upgrade will accept transactions and blocks created using the new version of the software, but not vice versa.
  - In the case of a "compatible" hard fork, a node that does upgrade will accept transactions and blocks created using the existing version of the software, but not vice versa.
  - In the case of a "bilateral" hard fork, nodes using one version of the software will not accept transactions and blocks created using the other version of the software.
- Consensus generally determines whether one version of the software prevails as preferred over the other.

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Chain Splits

- If, upon a fork, there is consensus such that all nodes upgrade or no nodes upgrade, there will be no chain split.
- A soft fork causes a chain split if and for as long as there is no consensus and the blockchain created using the existing software has more support (*i.e.*, is longer).
- A compatible hard fork will cause a chain split if and for as long as there is no consensus and the blockchain created using the new software has more support (*i.e.*, is longer).
- A bilateral hard fork will always cause a permanent chain split — developers of a bilateral hard fork generally lack sufficient support to gain consensus.
  - Bitcoin Cash and Bitcoin Gold are bilateral hard forks

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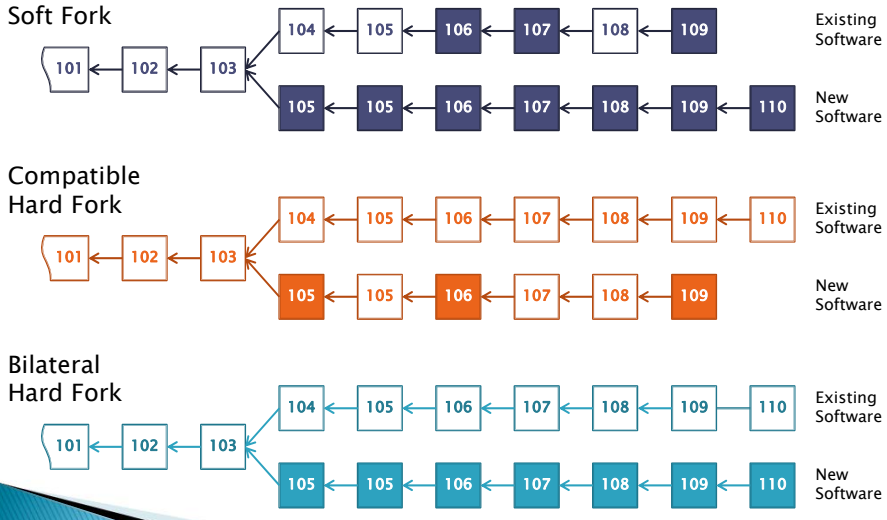
Forks



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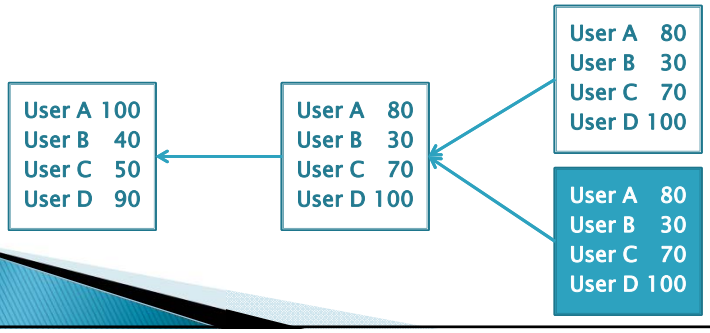
Consequences of a Chain Split

- Immediately after a chain split, a user that upgrades will automatically own (and can spend) the same number of "coins" on the new chain as on the old chain because the two chains have an identical transaction history through the point of the split.
  - The existing ledger is, in effect, "copied" into the new chain and the record of the user's existing coins is reflected on both the old ledger and the new.



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Tax Treatment of a Fork

- There is no guidance addressing the treatment of forks.
- A fork is potentially analogous to a number of different kinds of transactions.
  - Stock dividends/stock splits.
  - Dividend of property.
  - 1031 exchange.
  - Purchasing the pregnant cow or racehorse.
  - Partition of tenancy in common, division of trust, partial sale of property.
  - Division of trust.
  - Found property.
  - General windfalls (Glenshaw Glass).
  - Free samples.

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Tax Treatment of a Fork (cont.)

- If treated analogously to a stock split, stock dividend, pregnant livestock, or partitions of property, the taxpayer has (i) no immediate recognition of income, (ii) the taxpayer bifurcates it's pre-fork tax basis between post-fork tokens in proportion to FMV, and (iii) the taxpayer's holding period tacks.
- If treated analogously to found property, free samples, or Glenshaw Glass, the taxpayer will (i) recognize ordinary income equal to the FMV of the new token when the taxpayer exercises dominion and control, and (ii) no tacking of the taxpayer's holding period.

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Tax Characterization – Bitcoin Fork

- For U.S. federal income tax purposes, virtual currencies like bitcoin are considered property (see Notice 2014-2).
  - For the CFTC and at least one federal court they are considered commodities (see *CFTC v. McDonnell*, Case No. 18-CV-361 (E.D.N.Y. 2018)).
- As property, bitcoin likely represents mere co-ownership for U.S. federal income tax purposes, and not an interest in a partnership or a corporation
  - Users of bitcoin (the software and the digital asset) are not associates jointly carrying on a business and dividing the gains therefrom (see Treas. Regs. 1.7701-2(a)(2))
  - Instead, the software serves as an autonomous, anonymous, peer-to-peer payment verification system – all transactions occur, and all gains are derived, outside the bitcoin software

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Tax Characterization - Chain Splits

- Although the "receipt" of "new" coins upon a chain split may be an accession to wealth, it is not a realization event
  - No exchange of property
    - *Cottage Savings Ass'n. v. Comm'r*, 499 U.S. 554 (1991)
  - No change in user's legal relationship to its bitcoins
    - *Helvering v. Bruun,* 309 U.S. 461 (1940); section 109
  - Users already own the "new" coins
    - *Eisner v. Macomber*, 252 U.S. 189 (1920)
  - No assurance of viability; new coins may be transitory
    - *M.E. Blatt Co. v. United States*, 305 U.S. 267 (1938)
    - *Hewitt Realty v. Comm'r*, 76 F.2d 880 (2nd Cir. 1935)
  - May be difficult to establish value of new coins at the time of the chain split

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Tax Characterization - Chain Splits

- Similar accessions to wealth are not realization events, notwithstanding readily ascertainable value
  - Birth of livestock, harvested crops, discovery of oil or gas
  - Receipt of welfare or child support payments
  - Modification of a patent to create a new patent
  - Software upgrades under a "shrink-wrap" license
  - Rezoning of one's land in a manner that increases its value
  - Entry into executory contracts (Rev. Rul. 57-29, modifying I.T. 3721, 1945-1 C.B. 164)
  - Receipt by shareholders of rights to purchase debentures in another corporation (Rev. Rul. 63-225)
  - Employer's payment of employees' business travel expenses (*United States v. Gotcher,* 401 F.2d 118 (5th Cir. 1968))
  - Courtesy discounts granted to employees (section 132)
  - Imputed royalties that, under foreign law, may not be paid (*The Proctor and Gamble Company v. Comm'r*, 95 T.C. 23 (1990), aff'd, 961 F.2d 1255 (6th Cir. 1992

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Tax Characterization - Chain Splits

- Counterarguments
  - Accession to wealth, clearly realized, over which the user has complete dominion
    - *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), rehearing denied 349 U.S. 925 (1955)
    - *Haverly v. United States*, 513 F.2d 244 (7th Cir. 1975)
  - Treasure trove
    - Rev. Rul. 61, 1953-1 C.B. 17
    - Treas. Regs. § 1.61-14(a)
    - *Cesarini v. United States*, 296, F. Supp. 3d 3 (N.S. Ohio 1969), aff'd per curiam, 428 F.2d 812 (6th Cir. 1970)
- In these cases, however, the taxpayer's accession to wealth did not arise from, nor was it embedded in, its prior ownership of an asset

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Tax Characterization - Chain Splits

- If the receipt of new coins upon a chain split is not a realization event, a user's basis in its new coins will depend on whether the receipt of new coins is a capital transaction or the nontaxable receipt of income
- Basis in a new asset derived from capital is generally determined by apportioning the taxpayer's original basis between the original asset and the new pro rata based on their relative fair market values at the time of receipt
  - *Eisner v. Macomber*, 252 U.S. 189 (1920)
  - *Miles v. Safe Deposit & Trust Co. of Baltimore*, 259 U.S. 247 (1921)
- Basis in a new asset received in a nontaxable, non-capital transaction is generally zero
  - *Koshland v. Helvering*, 298 U.S. 767 (1936)
  - Rev. Rul. 79-431, 1979-2 C.B. 108
  - Treas. Regs. § 1.167(a)-6

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Token Presales and SAFTs

- Presale of token prior to its becoming functional.
- SAFT – "Simple Agreement for Future Token".
- Echo of SAFE ("Simple Agreement for Future Equity"), a form created by Y Combinator for startups in 2013 as convertible debt alternative.
  - Terms
    - No maturity date; no interest.
    - Liquidation preference.
    - Automatically converts into preferred stock upon equity financing, generally at favorable terms compared with new investors.
    - May have right to repayment on certain events, *e.g.* acquisition.
  - Tax Treatment?

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Token Presales and SAFTs (cont.)

- SAFT – developed in 2017 by the SAFT Project.
- Terms.
  - Purchase price paid upfront.
  - Upon a network launch (sale of tokens to general public in product launch), holder receives a number of tokens equal to the purchase amount divided by a price that is set at a specified discount from the token sale.
  - On certain events, repayment of purchase amount at a discount.
  - Purchase amount may be denominated and/or paid in cryptocurrency.

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Token Presales and SAFTs (cont.)

- Intended tax treatment:
  - SAFT whitepaper indicates that it is intended to be treated as a forward contract and taxed under an "open transaction" approach.
  - Taxable event to issuer when tokens delivered.
- Holder treatment?
  - Intent to align timing of income with startup expenses.

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Token Presales and SAFTs (cont.)

- Forward contract authorities: Rev. Rul.2003-7 concludes that entry into prepaid forward does not result in disposition of stock.
  - Retention of rights in stock, control over stock; could settle in cash.
  - Distinguishable?
- Analogy to when-issued securities?
- Relevance of token trading on exchange.
- Potential effect of Section 451(b)?
- Other agreements: SAFTE (tokens or equity), RATE (real agreement for tokens and equity), etc.

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Structuring Considerations

- ICOs occur in different jurisdictions: Different tax laws re how and when proceeds must be reported in income.
- Financial accounting and tax reporting rules may differ.
- Launching token sale from outside the US does not automatically escape US Tax.
- Foreign Non-Profit Foundation may not be tax exempt for US tax purposes.

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Considerations For Non-U.S. Issuer

- Where was intellectual property created?
- If IP was or will be created in the US, consider taxability of IP transfer outside the US.
- Will the foreign entity be engaged in substantive business activities?
- Will the foreign entity be engaged in business in the United States as a result of actions by its officers, directors, contractors or other parties in the United States? How do you determine effectively connected income?
- Is it possible to structure the affairs using multiple entities where services are provided between entities taking "transfer pricing" into account?

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Considerations For Non-US Issuer (cont.)

- Will the foreign entity be considered a controlled foreign corporation ("CFC") for U.S. tax purposes subject to anti-deferral rules under Subpart F?
- Will the U.S. officers or directors have to report their relationship to the foreign entity and its assets on their personal U.S. income tax returns?
- Consideration of issues before, during and after an ICO, may prepare companies for future IRS and regulatory guidance and may mitigate the consequences of future regulatory problems if reasonable positions were taken.

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Structuring Considerations

- US Issuer v. Non-US Issuer:
- Old Law:
  - US Issuer: 35% current taxation upon issuance.
  - Non-US Issuer: assuming structuring possible, potential deferral of tax until repatriation.
- Tax Reform Changed Things: GILTI & FDII.
- New Law:
  - US Issuer: 21% current tax upon issuance but a portion of proceeds may be subject to lower tax rate (13.125%) if FDII ("Foreign Derived Intangible Income") rules apply (if tokens are sold to and used by foreign holders).
  - Non-US Issuer: Assuming structuring possible, 10.5% tax on proceeds ("Global Intangible Low-Taxed Income").

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Considerations For Non-US Investors

- US Trade or Business
  - Traditional investor, trader, dealer analysis.
- Eligibility for Stock-Securities Trading Safe Harbor
  - Are tokens debt or equity for tax purposes?
- Eligibility for Commodities Trading Safe Harbor
  - May apply to cryptocurrencies because derivatives in the currency may be available.
- Chapter 4 Withholding
  - Contract Right to Payment
  - Dividend Rights

Other Issues

- Method of Accounting
  - Multiple lots of the same token
  - Inventory accounting
- Reporting and withholding.
  - Barter rules.
  - Payroll taxes for tokens used as compensation.
- FBAR Reporting
  - Tokens probably not interests in a foreign account
- FATCA
  - Issuers of tokens that pay distributions may be subject to FATCA
  - How does an issuer comply when tokens are traded?
- Bounties.
- Token airdrops.
- IRS Summons