STROOCK
SPECIAL BULLETIN

Securities and Tax Classifications of Cryptocurrency Relating to ICOs

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Bitcoin's recent rise to fame and the growing role played by virtual currencies (*i.e.*, "cryptocurrencies") and distributed ledger technology (*e.g.*, the Blockchain) in a variety of areas, including global finance and e-commerce, have piqued legal and regulatory interest in these topics, which has given rise to a variety of legal issues. This *Stroock Special Bulletin* discusses the classification of cryptocurrencies for purposes of federal securities laws and U.S. federal income tax, particularly in the context of Initial Coin Offerings ("ICOs").

Cryptocurrencies and Securities Laws

Nascent companies looking to raise vital growth capital can find themselves stuck between a rock and a hard place. On the one hand, the complexity of and costs of compliance with securities laws can make traditional equity capital markets an unviable fundraising platform for small, start-up enterprises. On the other hand, the competition for venture capital backing can be fierce and, even if obtained, often delivers financing with significant "strings" attached (including loss of significant economics), which some start-ups may shy away from. Start-ups may attempt to raise funds in crowdfunding campaigns, such as Kickstarter, but these are subject to limited terms and are not conducive to raising significant amounts of capital.

ICOs could be the digital crowdfunding solution to the challenges facing start-ups in their fundraising endeavors. In basic terms, an ICO involves the issuance, by a company, organization, person or group, of a cryptocurrency (i.e., digital "tokens" or "coins") to investors in exchange for cash or other cryptocurrencies. Since securities laws apply to offers and sales of "securities," such as shares and bonds, and a digital token is, at least on its face, neither a share nor a bond, but rather a standalone, new type of asset class, early proponents of ICOs assumed that the offer and sale of digital token would fall outside the purview of the securities regime.

If this assumption were correct, ICOs could present a way for a start-up to fundraise on a widespread scale without having to comply with costly and burdensome securities laws and regulations, and, from the start-up's perspective, could become a viable alternative to traditional capital markets and venture capital financing. From an investor's perspective, the advent of ICOs would mean that smaller, non-institutional investors could finally see the types of returns that the start-up industry has been famed for but which have thus far been reserved for venture capitalists

and large institutional investors. While this sounds promising, the Securities and Exchange Commission's ("SEC") approach to ICOs to date is a strong indication that it may be too good to be true, at least with U.S. investors or a U.S. issuer. For a discussion of Bermuda as an alternative ICO jurisdiction, see https://www.stroock.com/siteFiles/Publications/BermudaJurisdictionOfChoiceDigitalAssets.pdf.

With its 2017 enforcement action against The Dao, involving one of the earliest ICOs in the U.S., the SEC indicated that, "depending on the facts and circumstances of each individual ICO, the virtual coins or tokens that are offered or sold may be securities"[1] and that offers and sales of digital assets by "virtual" organizations may be subject to the requirements of the federal securities laws. The SEC's analysis dealt a severe blow to ICOs, potentially undermining their appeal as simpler, cheaper alternatives to traditional securities offerings, and has given rise to significant debate over the last 12 months.

According to the SEC, a determination of whether digital tokens issued as part of an ICO constitute "securities" under Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 requires establishing whether the tokens display the hallmarks of an "investment contract." According to the Supreme Court's decision in *SEC v. W.J. Howey Co.*, an investment contract is "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[2]

In The Dao, an unincorporated, "decentralized" organization sold digital "Dao Tokens" to investors in return for the cryptocurrency Ethereum, which was then used by The Dao to finance projects sanctioned by a vote of Dao Token holders, who in turn stood to receive a portion of the profits from those projects. Holders of DAO Tokens had certain voting and ownership rights in The Dao, as well as a right to receive a return based on The Dao's performance. Applying the *Howey* test, the SEC concluded that Dao Tokens bore the hallmarks of an "investment contract" and, as such, The Dao's failure to comply with federal securities laws in selling Dao Tokens made its activities an illegal offering of securities.

Although The Dao was not a traditional corporation, and the tokens were not traditional shares or membership interests, it is not too difficult to draw parallels between The Dao's actions and those of a corporation issuing shares, with shareholders using their voting rights to influence the corporation's activities and reaping the profits of those activities through dividends declared on those shares.

The SEC's approach in The Dao clarifies that the uniqueness and novelty of cryptocurrencies and ICOs does not render them immune from traditional securities laws. When determining whether a particular ICO triggers the application of securities laws, the SEC may look beyond labels and focus instead on whether "the economic substance" of the transaction is akin to that of "a conventional securities offering," which will typically be the case where the token is being sold as part of an investment to develop a particular enterprise, "represents a set of rights that gives the holder a financial interest in [the] enterprise," and where the primary motivation for purchasing the digital asset is the potential investment return rather than the intent to use the digital asset to obtain goods or services.[3] Therefore, the absence of labels traditionally associated with securities offerings, such as "shares" or "Initial Public Offering/IPO," is not enough to take a transaction that otherwise bears the hallmarks of a securities

[1] *See* SEC Investor Bulletin: Initial Coin Offerings, July 25, 2017.

[2] 328 U.S. 293, 301 (1946).

[3] Digital Asset Transactions: When Howey Met Gary (Plastic), speech by William Hinman, Director of the SEC's Division of Corporate Finance, June 14, 2018.

transaction "out of the purview of the U.S. securities laws."[4]

According to a recent speech by William Hinman, Director of the SEC's Division of Corporate Finance, the token itself is "simply code" and not a security in and of itself; however, the manner in which the token is being sold and the reasonable expectations of its purchasers are central to the SEC's analysis, and "there are contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security."[5]

Since The Dao case, the SEC has been fleshing out its position on cryptocurrencies and its approach to analyzing transactions involving digital assets, with Hinman recognizing that "there are numerous implications under the federal securities laws of a particular asset being considered a security"[6] and SEC Chairman, Jay Clayton, indicating that the SEC seeks to "foster innovative and beneficial ways to raise capital, while ensuring – first and foremost – that investors and our markets are protected"[7] and that investors are able to make properly informed investment decisions. One important nuance articulated by Hinman, which may inform the SEC's thinking, is that "the analysis of whether something is a security is not static and does not strictly inhere to the instrument."[8] This suggests that the classification of a token as a security at the time of the token's initial offering in an ICO need not permanently seal its fate, and that the use and characteristics of that token may evolve in such a way as to take it outside of the realm of an investment contract at a future point in time, for example, because it no longer reflects the profits or "entrepreneurial efforts" of a particular group or person. These discussions imply that the SEC may be willing to recognize different types of tokens and that the application of securities laws may depend on that classification.

At one end of the token spectrum lie "equity" tokens, such as the Dao Token, which are typically issued by a single person, entity or a centralized group and whose value is linked to the activities of that person, entity or group and which are purchased with the goal of delivering performance-based returns, rather than a particular product, goods or services. At the other end of the spectrum lie "utility" tokens, which are typically issued on a decentralized network (*e.g.* the blockchain), whose value does not depend on the efforts or performance of a single or centralized entity, person or group and which can be exchanged for specific goods or services, or potentially used as a currency (e.g., the Bitcoin).

Hinman's recognition that "digital assets can represent an efficient way to reach a global audience"[9] and that the classification of tokens as securities is fluid may be an indication that the SEC may be leaving the door open for those wishing to build a blockchain-based enterprise, though insisting that the investor protections brought about by the securities regime be respected. In that vein, the SEC may be signaling a willingness to help companies analyze the regulatory landscape by providing "more formal interpretive or no-action guidance about the proper characterization of a digital asset in a proposed use."[10]

Tax Law and ICOs

For tax purposes, there are also important distinctions to be made. As noted in a previous *Stroock Special Bulletin*, the IRS takes the position that bitcoin is taxable when mined, even if not sold. See https://www.stroock.com/siteFiles/Publications/Three

4 *Id.*
5 *Id.*
6 *Id.*
7 *See* SEC press release 2017-131 "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities."
8 Digital Asset Transactions: When Howey Met Gary (Plastic), speech by William Hinman, Director of the SEC's Division of Corporate Finance, June 14, 2018.
9 *Id.*
10 *Id.*

FederalTaxIssuesRaisedByCryptocurrencies.pdf. It has not yet taken a position with respect to the issuance of digital tokens in an ICO.

Traditional securities, such as shares of stock in a corporation, typically may be sold to investors without recognition of taxable gain by the company; they are treated in effect as "contributions to capital."[11] However, it is unclear whether this treatment would extend to the "equity" tokens issued in security token offerings, as the IRS has taken the position that tokens are intangible personal property, but has not opined on their possible treatment as stock or securities. This is also the subject of significant debate, and it has been suggested that the IRS should consider treating tokens differently in varying situations. Various steps can be taken to increase the likelihood that an equity token will be treated as stock for nonrecognition purposes.

For the moment, it would seem that, for tax purposes, there is a significant risk that all tokens will be treated like "utility" tokens – which treatment, like that of crowdfunded pre-sales generally, requires recognition of gain at the time the cash for the pre-sold item (in this case, by proxy through the digital token) is constructively received. The IRS set forth its informal view (which may not be cited as precedent) on the topic of crowdfunded pre-sales in Information Letter 2016-0036, which noted that the income tax consequences of such pre-sales do depend on the facts and circumstances, but that in general, once money is paid and not, for example, held in a third-party escrow, it is recognized as (potentially taxable) income at that time, and a self-imposed restriction on the availability of such income does not legally defer such recognition. Accordingly, until and unless further guidance is issued, it would seem that tokens must conform with the requirements of securities laws with a significant risk of not having the tax-free treatment of an issuance of typical securities, at least if the issuer of the tokens is deemed to be in the United States.

Foreign issuers present a new and interesting question, however. U.S. tax law generally respects the jurisdiction in which an entity is incorporated, but contains sets of rules (in Subpart F) to address the taxation of foreign corporations controlled by U.S. shareholders, often requiring such shareholders to include in their income the earnings of the foreign corporations, even if such foreign corporations are not themselves subject to U.S. corporate tax and even if the earnings remain, undistributed, at the corporate level.[12]

As an initial matter, it should be noted that an ICO may be accomplished in the U.S. or in a foreign jurisdiction, by a corporate entity organized in the U.S. or elsewhere, or by a group of individuals without any corporate or other entity status. If an entity doing an ICO is a corporate entity formed under the laws of a foreign jurisdiction, the existing CFC rules and framework would likely apply. But what if the ICO is done by a group of individuals?

One possibility is that, for tax purposes, a deemed entity would be created based on where the ICO is registered. For example, as discussed above, Bermuda is a notable jurisdiction possessing laws by which an ICO may be registered and conducted. Would the IRS impute a corporate entity in that jurisdiction and apply the CFC rules? Absent guidance, difficult to say, but it seems like a possibility. If the U.S. has a tax treaty with the foreign jurisdiction, would those terms apply? What steps can potential coin issuers take to ensure tax certainty, regardless of the consequences? Unfortunately, without IRS guidance, there are more questions than answers.

[11] *See* Internal Revenue Code ("Code") Section 1032.

[12] *See* especially the new GILTI rules of Code section 951A (which generally may subject to tax the current U.S. tax in the hands of 10% U.S. shareholders income of the controlled foreign corporation (a "CCFC") at a 10.5% rate income that is not "subpart F income"). *See also* the passive foreign investment company ("PFIC") rules of Code sections 1291 et seq.

For a group of individuals in the U.S., it would seem reasonable for the IRS to characterize an ICO as creating a partnership among the sponsors. The question then is what is being sold by the sponsors – interests in a partnership? If so, the rules of Subchapter K might permit the investments to be treated as tax-free contributions to the capital of the partnership. However, in light of the lack of previous IRS positions on tokens as stock or securities, as noted above, there is a significant risk that the sale of tokens would be treated as sales by the partnership of other intangible personal property (or possibly services), which would be subject to tax. In this event, a corporate form might be more beneficial given the lower (21%) corporate tax rate under recent legislation.

In any event, a number of tax issues are raised not only by the treatment of the tokens as property but potentially not stock or partnership interests, but also by the nuances of whether an entity (and if so what type) is created and where. Investors in the digital currency space will continue to look forward to further guidance.

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For More Information

The issues discussed in this *Stroock Special Bulletin* remain at the forefront of cryptocurrency taxation, and Stroock intends to provide updates on developments in this area. If you have questions, or would like additional information, please contact:

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