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# Cryptocurrencies:

## A Tax and Securities Law Primer

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# Part I

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# Current Tax Guidance

- Notice 2014-21
  - “Convertible Virtual Currencies” are treated as property for tax purposes
  - Not considered foreign currency
  - Virtual currency received as payment for goods and services must be included in income at fair market value (FMV)
  - Subject to information reporting and backup withholding to the same extent as any other payment in property
  - A taxpayer who successfully mines virtual currency must include FMV of virtual currency on the date of receipt in income
  - Exchange of virtual currency for other type of property or money is taxable

# AICPA Suggested Guidance

- May 30, 2018 letter suggesting additional guidance
- 2014 notice treats mining more like a service than the production of property, so AICPA suggest deductions for costs be treated like deductions related to provision of services, i.e., all costs, except those for equipment, should be immediately deductible rather than being capitalized
- To determine FMV, taxpayers should be able to (1) use average price across exchanges, (2) use average daily prices or (3) use price indexes for determining FMV, so long as method is reasonable and consistently applied
- Donations should not require appraisal
- Taxpayer should be able to choose between specific identification or first-in-first-out accounting
- De minimis rule for small exchanges

# IRS Enforcement Efforts

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- Over the period 2013 – 2015 more than 14,000 Coinbase users bought, sold, sent or received at least \$20,000 worth of bitcoin
- Over the same period, only 800 to 900 taxpayers reported gains related to bitcoin

# IRS Enforcement Efforts

- Coinbase John Doe Summons
  - November 17, 2016: DOJ seeks all Coinbase customer records from 2013 – 2015
  - November 30, 2016: Court order authorized the service of summons on Coinbase
  - November 29, 2017: US District Court Judge orders Coinbase to turn over information on accounts with at least \$20,000
  - February 23, 2018: Coinbase notified approximately 13,000 customers that it will be providing information to the IRS

# 1031 Like Kind Exchange

- The 2017 Tax Cuts and Jobs Act restricts like kind exchanges to real property beginning in 2018
- With respect to pre-2018 periods, there was some question as to whether exchanges of virtual currency could qualify as a like kind exchange
- Analogous authorities
  - RR 76-214: swap of bullion for bullion qualified
  - RR 79-143: swap of bullion for numismatic-type coin does not qualify because bullion is valued solely on the basis of gold content and numismatic-type coins are valued based on age, number minted, history, condition and metal content
- Few attempted swaps transacted on an exchange likely complied with qualified intermediary requirements



# Bitcoin Forks

- Bitcoin → Bitcoin Cash, Bitcoin Gold, Bitcoin Diamond...
- Is a fork taxable?
  - Stock splits or stock dividends
  - RR 86-24: buying a pregnant cow
    - Buyer knew cow was pregnant and purchase price allocated between cow and calf
  - General Windfalls: income is realized when there is (1) undeniable accessions to wealth, (2) clear realization and (3) taxpayer having complete dominion and control over the property



# Bitcoin Forks

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- If taxable, when?
  - When is free and unrestricted control achieved?
    - Date of fork?
    - Date new token may be traded or exchanged?
    - Date of trade or exchange (see pregnant cow ruling)?

# Compensating Service Providers with Tokens

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Type	Economics	Taxation	Comments
<b>Unrestricted Token Grant</b>	Immediate grant of tokens; not subject to vesting.	The FMV of the token is ordinary income to the service provider in the year the token is received by the employee. Also subject to payroll taxes, reporting and withholding obligations.	
<b>Restricted Token Grant</b>	Grant of tokens subject to vesting based on length of service or performance metrics. Vesting can be accelerated based on pre-determined triggers, such as change in control or termination of employee without cause or achievement of milestone for token platform.	No 83(b) election: the FMV of the token is ordinary income to the employee in the year when the restrictions on the token lapse. 83(b) election: FMV of token is ordinary income to employee in year of grant and further appreciation is taxed at capital gain rates when token is disposed. The ordinary income piece is subject to payroll taxes, reporting and withholding obligations.	The risk of the 83(b) election is that if the value of the token goes down after grant, employee will pay tax on the higher value at grant and will not get an offsetting loss when the token is disposed.
<b>Token Options</b>	The right, but not the obligation, to purchase a pre-determined number of tokens at a set price. Can be subject to vesting.	Not taxable upon grant, but on exercise, the difference between the amount paid and the FMV of the token is ordinary income. Also subject to payroll taxes, reporting and withholding obligations.	Treatment under 409A is unclear. Best practice is to assume 409A applies and that the options comply with 409A.  Determining exercise price can be difficult prior to an ICO or other token generation event so this may not be a great option for compensation prior to these events.
<b>Restricted Token Units</b>	A promise to grant tokens to recipient in the future, usually after time or performance based vesting conditions are met. Could be settled in tokens or cash.	Not taxable at grant. When the underlying tokens are paid, the FMV is ordinary income to the employee in the year the tokens are received. Also subject to payroll taxes, reporting and withholding obligations.	Restricted token units issued prior to an ICO or other token generation event and then settled after such event can have 409A issues. Best practice is to assume 409A applies and the restricted token units comply with 409A.

# Simple Agreement for Future Tokens (SAFT)

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- Used to raise funds in advance of a token offering
- Based on the Simple Agreement for Future Equity (SAFE) released by Y Combinator
- Intended tax treatment is, often, to defer recognition of income on amounts paid to SAFT issuer until the token offering
  - Questionable position – depends of individual facts and circumstances
  - Other potential avenues for deferral should be explored

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# Part II

# Cryptocurrency Offerings and Securities Law

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# Roadmap

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- Cryptocurrency Basics
- Regulatory Framework – Multiple Agencies Claiming Authority
- Securities Law Basics
- Review of ICO Approaches
- SEC Guidance and The Questions an Offering Must Answer
- “Utility Tokens” Probably Are Not the Answer
- Placing ICOs into Traditional Securities Frameworks, For Now



# Cryptocurrency Basics

- Cryptocurrency offerings and the derivatives are exploding.
- These take traditional and nontraditional forms.
- Initial coin offerings seek payments, frequently in other cryptocurrencies such as Ether, in exchange for coins or tokens.
- Initial coin offerings frequently are used in place of more traditional fundraising, likely due to the fact that unlike in traditional fundraising, the investors do not “own” the issuer – they simply obtain rights in the coin or token.
- Some offerings are more traditional, such as funds that invest solely in cryptocurrency.



# Regulatory Framework

The state and federal regulatory framework is evolving each day, with multiple federal agencies claiming authority

- IRS with respect to the taxation of cryptocurrencies – initial rule is that cryptocurrency is property for tax purposes
- Commodity Futures Trading Commission (CFTC) – has held that Bitcoin and other cryptocurrencies are commodities, and has begun to license regulated clearing houses for the trading of swaps and derivatives
- Securities and Exchange Commission (SEC) – has reviewed ICOs through the lens of securities offerings, and has found that securities laws apply
- States getting involved as well – Wyoming passed crypto-friendly law



# Securities Law Basics – Securities Generally

- What is a security?
- One test, frequently applied by the SEC in this context, is the *Howey* test for investment contracts. Investment contracts involve:
  - An investment of money
  - Into a common enterprise
  - With the expectation of profits
  - Solely from the efforts of the promoter or a third party
- Common non-cryptocurrency examples of securities
  - Equity securities – stock, membership interests, partnership interests
  - Debt securities – bonds, notes, derivatives (securitization of notes)



# Securities Law Basics—Registration/Exemption

- The primary rule: if you are selling or offering for sale a security, the security must either be registered with both federal (SEC) and state agencies, or it must qualify for an exemption from registration
- Formal registration typically is reserved for initial public offerings or other very large raises; time consuming and expensive
- There are many types of exemptions that are available – availability is based on characteristics of the issuer, the offering, and the purchasers
- The requirements of the exemptions vary wildly; the largest variations have to do with whether purchasers are “accredited investors”
- Remember that you must comply with both state and federal laws



# Securities Law Basics – Types of Exemptions

## *“Simple” Exemptions – Purely Intrastate Offering*

- In this scenario, the issuer and all purchasers are in the same state
- *One* out-of-state purchaser destroys the exemption
- Federal: Intrastate exemption – self-executing (no filing), no fee
- State: Texas and other states have numerical thresholds where, as long as they are not passed, self-executing exemption available (in Texas, no more than 15 sales per year, or 35 security holders)
- Very useful, very widely used; most “friends and family” offerings fall into this category
- No specific requirements for offering or information provided



# Securities Law Basics – Types of Exemptions

*“Moderate” exemptions – out-of-state purchasers, but accredited investors*

- Most common exemptions in this category referred to as Regulation D
- Consisted of Rules 504, 505, 506 (now just 504 and 506)
- All have different ceilings and requirements
- Different ceilings on offering – 504, \$5MM; 506, unlimited
- Most relevant for this discussion is Rule 506 (more info later)
- Federal: Requires filing of a Form D, payment of a fee
- State: Most states have companion Form D-type filings and fees
- Forms are relatively simple; file, then proceed with offering
- For accredited investor-only sales, no specific information requirements



# Securities Law Basics – Types of Exemptions

*“Difficult” exemptions – nonaccredited investors in multiple states*

- Can similarly use Regulation D, but information requirements are vastly different (there also are other exemptions available)
- If nonaccredited investors involved, must be provided information roughly equivalent to what would be submitted in a full registration
- Typically is presented in a “prospectus” or “offering memorandum”
- Among other requirements, must list exhaustively risk factors
- Document is expensive and time-consuming to generate (\$25-50K+)
- Still does not involve direct SEC review



# Securities Law Basics – Types of Exemptions

## *Beyond “Notice” Filings*

- Some exemptions are more involved than a “notice” type of filing, like those for Form D exemptions
- The most relevant for this discussion is Regulation A+
- Regulation A changed to permit public offerings of securities of up to \$50 million in a 12-month period, leading to “A+”
- Regulation A+ permits public offerings to nonaccredited investors without transfer restrictions
- Regulation A+ offerings must be filed with *and reviewed by* SEC; in some instances states must review as well; may also have ongoing public reporting requirements



# Review of Current ICO Approaches – The Wild West

- Hundreds of millions of dollars have been raised in questionable ICO offerings, swaps and other transactions
- Common approaches:
  - Everyone else is doing it, so why can't we?
  - They can't come after *everyone*. Right?
  - It's not a sale, it's a swap.
  - We have a utility token. It has value in our system. Well, someday it will.
  - NIMBY – see you in Switzerland (or some other foreign country)
- Except for the last one, the SEC has made it very clear they are extremely skeptical about ICO practices thus far



# SEC Review – Increased Activity and Concern

- March 2017: SEC rejection of ETF-based bitcoin offering (Bats BZX Exchange)
- July 2017: Investor Bulletin – Initial Coin Offerings
- July 2017: “DAO Report” – SEC concludes traditional securities laws apply
- August 2017: Investor Alert – Public Companies Making ICO-Related Claims
- November 2017: Investor Alert – Celebrity Endorsements
- December 2017: Statement on Cryptocurrencies and Initial Coin Offerings
  - Includes “Questions for Investors Considering a Cryptocurrency or ICO
  - Investment Opportunity”
- December 2017: SEC shuts down Munchee Inc. ICO “utility” offering
- March 2018: Statement on Potentially Unlawful Online Platforms for Trading Digital Assets
- April 2018: SEC halts fraudulent Centra Tech “CTR” Token

# SEC Guidance – Questions to Ask and Answer

- Who exactly am I contracting with?
  - Who is issuing and sponsoring the product, what are their backgrounds, and have they provided a full and complete description of the product? Do they have a clear written business plan that I understand?
  - Who is promoting or marketing the product, what are their backgrounds, and are they licensed to sell the product? Have they been paid to promote the product?
  - Where is the enterprise located?
- Where is my money going and what will it be used for? Is my money going to be used to “cash out” others?
- What specific rights come with my investment?
- Are there financial statements? If so, are they audited, and by whom?
- Is there trading data? If so, is there some way to verify it?



# SEC Guidance – Questions to Ask and Answer

- How, when, and at what cost can I sell my investment? For example, do I have a right to give the token or coin back to the company or to receive a refund? Can I resell the coin or token, and if so, are there any limitations on my ability to resell?
- If a digital wallet is involved, what happens if I lose the key? Will I still have access to my investment?
- If a blockchain is used, is the blockchain open and public? Has the code been published, and has there been an independent cybersecurity audit?
- Has the offering been structured to comply with the securities laws and, if not, what implications will that have for the stability of the enterprise and the value of my investment?
- What legal protections may or may not be available in the event of fraud, a hack, malware, or a downturn in business prospects? Who will be responsible for refunding my investment if something goes wrong?
- If I do have legal rights, can I effectively enforce them and will there be adequate funds to compensate me if my rights are violated?



# SEC Guidance – Crypto Transactions and ICOs Frequently are Securities

- July 25, 2017 – “DAO Report”
  - SEC considered “distributed autonomous organizations”
  - “DAO Token” sold to raise funds to support cryptocurrency-related companies
  - SEC determined securities laws apply to cryptocurrencies, applying *Howey* test
- December 12, 2017 – *In the Matter of Munchee Inc.*
  - Munchee sought ICO to raise funds to support development of mobile application relating to restaurants
  - Token was to provide users with “utility” functions in app
  - ICO launched October 31
  - SEC called next day, ICO shut down voluntarily
  - Very common approach – white paper, publicized online, pre-sale with discounts
  - SEC applied *Howey* test to determine that tokens were securities
  - Since ICO shut down voluntarily, no civil penalty; cease and desist issued



# “Utility Tokens” Probably Are Not the Answer

- Why did the white paper and “utility” approach in *Munchee* not satisfy the SEC?
- SEC order: “Determining whether a transaction involves a security does not turn on labeling – such as characterizing an ICO as involving a ‘utility token’ – but instead requires an assessment of ‘the economic realities underlying a transaction’.”
- There were utility aspects to the token – services, purchase/sale of goods
- But an expectation was created that the value of the token would rise due to the development of the ecosystem and application, and that at some point, a profit was to be expected
- This expectation brings the token back into the *Howey* test
- This expectation appears to be extremely common among ICOs, regardless of form
- A late arriving “utility” also does not seem to help (where token originally has no utility, but once the related business or application reaches maturity, then “utility” appears)



# Potential Reckoning on “Utility Tokens”

- Wyoming sought to change its laws to permit “utility tokens,” and passed a set of five pieces of legislation designed to invite utility token ICOs into Wyoming
- Most importantly, the legislation exempts *certain* utility tokens from state securities laws
  - Tokens must be exchangeable for goods and services and not marketed as investments
- Entirely unclear how many utility tokens actually would qualify
- At some point we would expect the SEC to weigh in



# ICOs in Traditional Securities Frameworks

- SEC guidance makes clear that it is possible to have a compliant ICO using existing methods of registration and exemption. Most believe there are two primary methods that would work.
- Rule 506
  - If limited to accredited investors, very few requirements
    - No formal SEC or state review
    - No specific information delivery requirements
    - No limit on amount raised
    - Public solicitation permitted
  - Tokens likely would be “restricted,” limiting resale for some time
- Regulation A+
  - Permits \$50 million raise in 12 month period in public offering
  - Not limited to accredited investors, and securities not restricted
  - Offering must be filed with and reviewed by SEC; may also be state review



# Words of Caution

- Although Rule 506 and Regulation A+ offerings would seem to provide a viable framework for many ICOs, they have not been utilized extensively to date
- Be wary of anyone saying that they have done many offerings in this fashion – *no one has*
- Be wary of anyone saying that they know how a particular offering will turn out, particularly on “utility tokens” – as of now, *no one does*
- A note on SAFTs – a SAFT is an *instrument*, based on the SAFE (which is a form of warrant) – it is not an exemption in and of itself, and the offering still must fall under an available exemption



# Questions

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