FOREIGN TOKENS – U.S. TAX CHARACTERIZATION: QUESTIONS AND DISCUSSION

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INTRODUCTION

Initial coin offerings ("I.C.O.'s") offer blockchain-based[1] companies a new way to raise capital.[2] Companies, both in the U.S. and outside the U.S., have been raising capital using blockchain technology since 2016. For example, in 2016 Overstock raised $2 million through the sale of digital preferred stock on a blockchain platform, as part of a larger capital raise.

Some issuers use I.C.O. proceeds to fund the development of a service on a blockchain (*e.g.*, a crypto-asset exchange), others to purchase a property (*e.g.*, real property or even stock in a corporation). In 2019, investors were offered the opportunity to invest in Elon Musk's SpaceX venture via a new token product — USPX. A special purpose vehicle ("S.P.V."), Unicorn Tokenization Corp., was formed for this purpose. It bought shares of SpaceX on a secondary market and offered investors to purchase tokens representing shares in the S.P.V. Token holders were granted economic rights proportionally equivalent to the underlying SpaceX shares.

As these means of raising funds gained popularity around the world, questions arose. The S.E.C. ruled that some tokens are securities, so that an offer to the public in the U.S. is subject to Federal securities laws.[3] Tax questions also arose, but not all questions have been answered. Specifically, no guidance exists with respect to the proper characterization of a token, and U.S. investors are not assured of the tax consequences of their investments. Nor are they advised on how they should be reported.

No "one answer fits all" can exist in these circumstances, as each token is different. The rights and powers embedded in each token are specific to the offered token and are described in the I.C.O. documentation. Some tokens are sold as an equivalent of a stock (*e.g.*, USPX tokens, which were therefore not offered to U.S. investors), making them an instrument that is relatively clear for most U.S. tax purposes, although some uncertainties remain. For example, is a token holder considered a "shareholder" for purposes of meeting the requirements to be treated as a

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1 "Blockchain" refers to the technology that allows decentralized ledger. See our Blockchain 101 article.

2 While many refer to coins and token interchangeably, in fact, they are different. A coin is native to its blockchain (Bitcoin, Litecoin, Ether, Neo, to name a few) and can be used as a (crypto)currency outside its native blockchain, while a token is generally created on an existing blockchain. For example, a token can be built on the Ethereum platform. This token is known as the ERC-20 token.

3 S.E.C. Release No. 81207 in relation to their investigation of The DAO token offering.

real estate investment trust ("R.E.I.T.")?[4] Others tokens are not clearly presented to buyers as an equivalent of stock, and those raise more questions when it comes to determining their U.S. tax characterization.

TOKENS ARE PROPERTY. BUT ARE THEY EQUITY?

It seems that tokens are a type of cryptocurrency. The I.R.S. ruled that Bitcoin and other virtual currencies are treated like property and that a transaction using such property is a taxable event.[5] However, the I.R.S. has not addressed when certain tokens that hold equity-like characteristics (*e.g.*, voting rights, rights to participation payments, or redemption rights) will be treated as equity for tax purposes. Not all tokens offer such equity-like characteristics. Some tokens offer merely the future right to participate in a service, or receive a product, developed by the issuer. The I.R.S. has not addressed the U.S. tax treatment of these tokens.

"I.R.S. has amended Form 1040, **U.S. Individual Tax Return***, to include a question as to whether the taxpayer received, sold, sent, exchanged, or otherwise acquired a financial interest in any virtual currency."*

If certain non-U.S. issued tokens were viewed as representing an equity interest in the issuer, their ownership may affect the status of the issuing corporation as a controlled foreign corporation ("C.F.C.") or a passive foreign investment company ("P.F.I.C."). As a result, this would affect an individual holder's U.S. reporting obligations – and potentially those of other holders as well as the holders of the common stock of the issuer. This could also affect their income calculation under Subpart F rules, G.I.L.T.I. rules, and P.F.I.C. rules. And noncompliance, especially on international matters, is harshly penalized.

Additionally, this could affect the issuing company. Will the I.C.O. proceeds be taxable to the issuer? Will payments, if any, made to token holders be a deductible expense or could it be viewed as a dividend payment? How will the Foreign Account Tax Compliance Act ("F.A.T.C.A.") apply to the issuing entity?

The classification of tokens is important, especially since the I.R.S. has amended Form 1040, *U.S. Individual Tax Return*, to include a question as to whether the taxpayer received, sold, sent, exchanged, or otherwise acquired a financial interest in any virtual currency. In the absence of guidance as to the tax characterization of a token, the specific characteristics of a particular token must be examined based on generally accepted tax principals.

Separately, FinCEN has advised that "virtual currency held in an offshore account is not a foreign account that needs to be reported on [the] FBAR [*i.e.*, Report of Foreign Bank and Financial Accounts]." Nevertheless, FinCEN and the I.R.S. are continuing to study the question of whether offshore virtual currency should be incorporated into F.B.A.R. reporting requirements.

GENERAL TAX PRINCIPALS: DEBT V. EQUITY

The well-developed standards of the debt v. equity treatment of a corporate instrument can be looked to when performing the required analysis of the character of a

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[4] It is largely believed that the answer is yes; however, a legal opinion is generally obtained by the issuer prior to electing to be treated as a R.E.I.T.

[5] I.R.S. Notice 2014-21.

particular token. Debt and equity are two major forms of capital with different rights, risks, and rewards for the holder and the issuing corporation. As one court noted, the "vital" difference between stock and debt is the status it confers on the owner: The shareholder is "an adventurer in the corporate business; he takes the risk, and profits from success," whereas the creditor, "in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into capital when the payment date arrives."[6]

Because companies and investors are often incentivized to treat junior funding as equity or debt, the I.R.S. has often disagreed with a taxpayer's conclusion and re-characterized the instrument. As a result, prior to the 1969 enactment of Code §385,[7] courts devised a variety of tests to determine whether shareholders' or creditors' funding of a corporation in which they own interests should be treated as stock or as debt.

The most widely cited opinion in the debt v. equity area, issued by the Third Circuit, mentioned 16 different factors to be considered in discerning the substance of a shareholder's or creditor's interest as either debt or equity:

- Intent of the parties to fund via debt or equity
- Whether identity exists between the "creditor" and the entity's shareholder base
- Extent of participation in management by the holder of the instrument
- Ability of the corporation to obtain funds from outside sources
- "Thinness" of capital structure in relation to debt
- Risk involved
- Formal indicia of the arrangement
- Relative position of obliges as to other creditors regarding payment of interest and principal (*i.e.*, is there any subordination involved)
- Voting power of the instrument holder
- Provision of a fixed rate of interest
- Contingency of the obligation to repay
- Source of interest payments
- Presence or absence of a fixed maturity date
- Provision for redemption by the corporation
- Provision for redemption at the option of the holder
- Timing of the advance with reference to the organization of the corporation[8]

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6 *Commr. v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2d Cir. 1935).

7 Enacted in 1969 as part of P.L. 91-172, Sec. 415(a).

8 *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3rd Cir. 1968).

In 1969, Congress called on the Treasury to codify the factors into a uniform set. Code §385 provided for the following factors and authorized the Treasury to issue regulations to determine whether an instrument is to be treated as debt or equity:

- Whether there is a written unconditional promise to pay on demand or on a specified date a certain sum of money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest
- Whether there is subordination to or preference over any indebtedness of the corporation
- The ratio of debt to equity of the corporation
- Whether there is convertibility into the stock of the corporation
- The relationship between holdings of stock in the corporation and holdings of the interest in question

Until 2016, the only regulations issued in proposed or final form were withdrawn.[9] Separately, in 1992, Congress enacted Code §385(c), requiring consistency of treatment between issuers and holders. In 2016, the I.R.S. issued new proposed regulations generally applicable to domestic C-corporations, using Code §385 as an additional weapon to attack "earnings stripping" transactions with affiliate debt, primarily in the inversion context.[10] By the time they were finalized in 2019, the rules' relevance had already receded, but they incorporated and extended the multi-factor case law test.[11]

Thus, the case law factors continue to be applicable and fall into four main groups:

- Factors involving the formal rights and remedies of creditors as distinguished from stockholders
- Factors bearing on the genuineness of the intention to create a debtor-creditor relationship
- Factors bearing on the reasonableness or economic reality of that intention (the risk element)
- Factors that are merely rhetorical expressions having no proper evidentiary weight in themselves[12]

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[9] The Treasury proposed comprehensive regulations in March 1980 and final regulations in December of that year but delayed their effective date on two occasions; subsequently, the I.R.S. promulgated proposed amendments. The effective date of these, together with the final regulations, were again postponed until, finally, the regulations were withdrawn by T.D. 7920 in 1983, without ever having been in effect.

[10] These new rules, finally trimmed down, focused on "covered debt instruments" held between related members of the same expanded group that do not result in new investment in the issuer's operations.

[11] The regulations also made clear that caselaw factors will continue to apply in other contexts whenever not contrary to the regulations.

[12] William T. Plumb, Jr., "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal", 26 Tax. L. Rev. 369, at 411-12 (1970-71).

Despite the multitude of factors cited, because this determination is fact-intensive the courts generally focus on a select two or three factors most relevant to the specific facts. Each factor's weight in any particular fact pattern can vary. While most decisions under the multi-factor test have concerned related persons, the factors can be and are applied between unrelated parties, as well when risk takers, assume the guise of lenders.[13]

APPLYING THE FACTORS TO TOKENS

In the context of tokens, the most relevant factors that must be analyzed are likely to include:

- Participation in profits
- The promise of an actual (albeit contingent) consideration for the investment versus the anticipation of mere value growth (*e.g.*, future product developed or access to a platform developed)
- Voting rights
- The issuer's promise to buy back the token

For example, a token that provides for a profit sharing element clearly has an equity characteristic. However, if that same token provides restrictions on eligibility for profit sharing (*e.g.*, blocking the marketability of the token in a smart contract for a period of time) and states that the token holders' right to the participation payment are equal to other claims of creditors, arguably such token should not be treated as equity for U.S. tax purposes, absent other equity-like features.

Another equity-like factor to consider is voting rights. Tokens that are intended to be treated as equity often attach voting rights. However, restrictions may be imposed on such voting power, such as allowing a vote on certain issues only, without it affecting the equity treatment of the token.

CONCLUSION

With the increased popularity of I.C.O.'s as a mean to raise capital for corporations, clarifying the tax treatment of tokens is very important. As mentioned above, it can affect the status of the corporation as well as the income inclusion of its holder. With high penalties imposed on noncompliance, getting this right is crucial.

While specific guidance is not available, general principles used to determine debt v. equity treatment should be applicable here. The I.C.O. documentation must be carefully read, with a goal of extracting the intent of the parties to create an instrument that may or may not be essentially equivalent to stock.

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[13] I.R.S. Notice 94-47, 1994-1 C.B. 357, applicable to hybrid instruments.

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