Chapter 17

Tokenized and Non-tokenized Assets: Legal Considerations

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Abstract

This chapter discusses legal considerations relating to digital assets. The legal aspects of tokenized and non-tokenized assets are evolving. Although some states have enacted specific laws or regulations for digital assets, Congress and federal agencies have been slower to craft specific rules and regulations for such assets. As a result, regulators, such as the Securities and Exchange Commission, Commodity Futures Trading Commission, and Internal Revenue Service, and market participants must apply existing guidance to digital assets. This chapter examines applying specific aspects of federal securities and tax law to digital assets. It also discusses general business law considerations for blockchain and cyber enterprises. The discussion of state law applications centers on the New York Virtual Currency License and Wyoming and Delaware crypto initiatives. This chapter does not provide a comprehensive review of all legal issues related to cryptocurrency. Each legal issue about cryptocurrency is complex and requires separate analyses.

Keywords: Digital assets; tokenized assets; non-tokenized assets; federal securities law; tax law; blockchain

Introduction

Before discussing the law, understanding the "who, what, when, where, and why" of a digital asset is paramount. Investors should know what they are entitled to receive. Issuers need to understand their obligations to regulators and investors. Understanding the facts involves several lines of inquiry: (1) the parties (the "who" and "where"); (2) tokenomics (the "why"); (3) marketing and offering (the "how," "when," and "where"); (4) business structuring considerations (the "what"), and (5) whether the parties kept their promises.

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The first section describes the various parties of a business transaction involving digital assets, followed by fundamental business questions about digital assets. The following sections discuss securities law considerations, specifically offering and marketing digital assets, business structuring and tax considerations, and New York and Wyoming digital asset regulations. The final section provides a summary and conclusions.

Who are the Players?

The first step in understanding digital assets, specifically tokenized and non-tokenized assets, is knowing the main parties. This task involves asking the following questions.

- Who or what is creating and issuing the digital asset?
- Does the issuer have a legal personality or is the token issuer a decentralized non-entity?
- In what jurisdictions are the token issuer and its sponsor incorporated or resident?
- Does a centralized or decentralized protocol govern the digital asset?
- Who are the potential regulators?
- Who receives the tokens? That is, who are the investors?

The Issuer

Entrepreneurs may create a project involving some element of crypto. Who are the entrepreneurs and innovators? Who is the business team? People often invest in a project based on the reputations of those behind it. High-quality people and business partners provide comfort to investors, regulators, and customers. Teams with business experience may be better suited to run a business than a group of wunderkinds who can solve technical problems but not adequately manage people or finances. A 20-year-old virtuoso with a vision and the ability to execute that vision may be better suited when paired with a 50-year-old chief executive officer with decades of experience.

Another issue involves the legal entity formed for this new business. Deciding on the type of entity requires tax planning and choosing where to incorporate it. States typically allow someone to establish a limited liability company (LLC) for less than $200. LLCs are attractive because they provide tax flexibility, economic flexibility, and the legal liability protection of a corporation but with fewer corporate formalities. Although many choose LLCs, some should weigh other business forms' benefits and considerations, such as limited partnerships and corporations.

Tax structuring is also incredibly important at this stage. Taxes affect the type of entity, as corporations have *double taxation*. A domestic corporation pays a corporate-level tax on its taxable income. Its shareholders pay tax on dividends paid by the corporation. Besides federal taxation, corporations also pay income and franchise taxes to states and certain cities where the corporation is incorporated and does business. Finally, taxes affect the decision to incorporate offshore or stay in the United States.

Deciding where to form entities is another critical decision. State laws differ. Some states are more business- or crypto-friendly than others. Suppose someone creates an entity outside the state where that person lives or maintains an office. In that case, the person should hire a company to function as a registered agent in the state of incorporation. This additional expense can be at least several hundred dollars. When forming new companies, many lawyers reflexively incorporate in Delaware.

However, a prudent approach is to look first to the state where the company's principals are located to avoid registered agent expenses or incorporate in Wyoming, a crypto-friendly state. Delaware and Nevada are popular states for incorporation because they do not impose a state-level tax on out-of-state activities, offer a well-developed body of corporate law, and may offer some degree of anonymity to shareholders. However, other states may provide a legal advantage unavailable elsewhere. For instance, Wyoming has engaged in several crypto-friendly laws. South Dakota is a popular jurisdiction to form trust companies for financial institutions' crypto custody. Regardless of where incorporation occurs, a company should generally qualify to do business in each state where it conducts business activities.

Investors

This section discusses two investor categories: early investors and token investors. A detailed discussion of venture capital (VC) investments into start-ups is beyond this section's scope. VC deals involve a high level of negotiation. Often the non-economic terms are as crucial to a start-up's success as is capital infusion. Non-monetary benefits include bringing in board members, creating synergies with other companies in which a VC firm invests, and providing mentorship, oversight, and management.

Early Investors. Start-ups need money to incorporate, pay outside advisors (e.g., legal, tax, accounting, and audit fees), acquire resources, and pay for outsourced items (e.g., developers and marketers). These costs can quickly get into hundreds of thousands of dollars and are necessary to get to an actual early round of funding from seed investors.

When the founders exhaust their capital, they look to friends and family. Investors at this stage invest in stock and usually other securities, such as warrants, preferred stock, or forward contracts. When an entity issues a digital asset, these early investors typically get a significant amount upon issuance. However, these are generally small investments, in the thousands or tens of thousands of dollars. But if a start-up attracts considerable attention, these early investments could be worth millions or billions.

These offerings should be exempt from registration under the Securities Act of 1933 under Rule 504 or Rule 506 of Regulation D. Under either type of exempt offering, 35 or fewer non-accredited investors can raise capital. Unlike Rule 504 offerings, offerings under Rule 506 allow for general solicitation and no limit to the funds obtained from accredited investors. However, Rule 506 offerings require additional disclosure. Therefore, raising funds from friends and family under Rule 504 may be more accessible, despite certain limitations.

A start-up may need to raise additional capital at a certain point. After the friends and family round, a company may attempt to raise a *series A round of funding*, a private offering to accredited investors, including angel investors and VC firms. These investors may also seek to be high in the capital stack, with common and preferred stock, and have access to the digital assets once the funding round launches. This round of funding is typically a private offering, exempt from registration under Rule 506 of Regulation D.

Token Investors. Determining who the token investors are can be a function of the digital asset and its *tokenomics*, which is the study of the economics of crypto tokens or cryptocurrencies. One potential investor category in a digital asset is a future customer, who may view the investment as buying a future product or service at a discount. Another investor category is a true investor, who sees value in a digital asset or promise in the start-up. A third investor category is a speculator. A speculator may invest in a token when it trades at pennies, hoping it catches on in the pages of Reddit or another online community and takes off "to the moon" in the parlance of such fora.

How or where a token trades may affect who invests. If an investor needs to convert dollars to ether (ETH) to Binance coin (BNB) and then BNB into an obscure digital asset, the investor may only be a crypto enthusiast and not an average investor. A final investor category is the average retail investor, who wants economic exposure without maintaining wallets and private keys. This investor may invest in an exchange-traded fund or a private fund that trades crypto. A retail investor may also own bitcoin through a traditional brokerage or Coinbase account.

Regulators

Regulators depend on where the company is formed and does business, the token issuer's business type, whether the digital asset is a security, and how the digital asset is issued. For instance, crypto companies in New York may need to apply for a BitLicense. New York's BitLicense applies to different crypto organizations, including those transmitting crypto, buying and selling cryptocurrency as a customer business, providing exchange services to customers, and issuing cryptocurrency. Crypto exchanges must also register and make filings with the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA). Money transmitters must deal with each state having money transmission rules where they have customers. Selling tokens in a private offering (e.g., Reg D to accredited investors) or public offering (e.g., Reg A) requires the issuer to make certain filings to the SEC or state securities regulators (e.g., SEC Form D).

An essential item to consider is federal preemption. A start-up often must deal with a federal regulator, such as the SEC, instead of state regulators. However, suppose a start-up does not involve a federal regulator. In that case, that entity may have to deal with up to 50 state regulators and attorney generals. Although a start-up may not want to contend with the SEC, doing so may be strategic because it does not have to make individual filings in multiple states and comply with up to 50 state laws.

Service Providers

Crypto start-ups rely on outside advisers and service providers. For example, law firms incorporate businesses, draft operating agreements, employment agreements, investor documents, represent clients before regulators, prepare applications for business licenses and regulatory approvals, and structure businesses for tax efficiency. Accounting firms prepare tax returns, maintain financial books, prepare financial statements, and can help a start-up manage its business. Third-party services providers may include:

- external consultants to lobby the government;
- outside developers for coding;
- financial institutions to serve as custodians of digital assets or assist with "know your customer" (KYC) and anti-money laundering (AML) compliance;
- cybersecurity specialists;
- marketing; and
- investment bankers and other placement agents to help sell the digital asset.

A start-up must pay these service providers and establish a relationship governed under an appropriate contract. Here are a few guidelines between these two parties. First, a start-up company should usually own any work product developed by outside contractors. Third-party developers should not retain ownership of any code they wrote for hire.

Second, a start-up may be held liable for the actions of its service providers. If a social media influencer says, "Your investment will increase 10-fold," the SEC will have accessible evidence in its action against the start-up.

Finally, if a start-up pays a service provider in tokens, both the employer and service face tax, regulatory, and business issues. A discussion of these tax issues follows. From a business perspective, some service providers, such as law and accounting firms, want to receive fiat currency or highly liquid crypto for their services. Furthermore, in certain circumstances, insiders may be restricted in how they trade their employer's securities.

Tokenomics

As previously noted, *tokenomics* refers to the economics of a digital asset. At its most basic level, tokenomics means the business deal between the issuer and token holders. From a business perspective, the token offering must be worthwhile for investors. From a legal perspective, a clear understanding of the business terms of a digital asset sale may reduce legal costs. Therefore, tokenomics is important for crypto businesses when selling digital assets.

Without understanding tokenomics, lawyers may inadequately describe the digital asset in an offering prospectus, and ambiguities in offering documents may lead to investor confusion. Investors that feel wronged may sue the issuer or report the issuer to a regulator. Viewing a situation from an investor's viewpoint could help prevent future litigation. Crypto businesses and their lawyers that think about tokenomics should consider the following:

- What are the digital asset issuer's obligations and entitlements to the purchaser?
- Does a built-in economic benefit exist to owning the digital asset (i.e., the holder can redeem it for something of value), or is the potential return based only on the premise that the digital asset will appreciate given its speculative nature?
- Is the deal fair and balanced for all parties?
- Does the digital asset utility value? Can it redeem or use the tokens for goods or services with intrinsic value? How are the digital assets used or redeemed?

If an issuer can answer these questions, it may reduce the likelihood of a dispute with investors. It may also reduce the time lawyers need to understand the digital asset, adequately describe it in offering materials, and lead to corresponding savings in legal costs. As discussed in the next section, clearly defined tokenomics can also assist marketing efforts.

Marketing and Securities Law Considerations

A digital asset's marketing could have significant legal ramifications. Although a digital asset may not be a security, it could be a security offering. The SEC is active in policing these matters.

Since 2013, the SEC has brought over 75 cases against defendants relating to digital assets and initial coin offerings (ICOs), with only 11 cases brought before 2018 (Securities and Exchange Commission, 2021). In addition, at least 20 trading suspension cases involve digital assets.

The first case *SEC* v. *Shavers et al*. (2013), brought in 2013, alleged a Ponzi scheme involving bitcoin instead of dollars. Specifically, a federal judge ruled that the operator of Bitcoin Savings and Trust had operated a Ponzi scheme that defrauded investors. The judge awarded $40.7 million in damages following SEC charges of investment fraud. The crime alleged in the *Shavers* case was not a "crypto-crime." Instead, crypto was the medium used to commit the crime.

Since this first case, the SEC has brought enforcement actions that involved:

- the unregistered offering of securities, including ICOs, security token offerings (STOs), and the like, and including crypto lending and decentralized finance (DeFi) investment programs;
- operating online venues for trading securities using digital assets without registering the websites as broker-dealers or stock exchanges and other unregistered broker-dealers;
- defrauding investors in ICOs and the like;
- obtaining cease and desist orders where a company was selling digital tokens in an unregistered offering to investors and other violations of various US federal securities laws;
- additional digital asset denominated Ponzi schemes and other general fraud denominated in cryptocurrency, and disgorgement actions for selling restricted stock in a blockchain technology company at market price and not the fixed price under a registration statement;
- false marketing of a crypto-focused investment fund;

- misleading promotion of an ICO without proper disclosure;
- obtaining a cease-and-desist where a CEO misrepresented the use of proceeds of securities offer to invest in blockchain companies and digital assets; and
- market manipulation, including charging an iced tea company with stock manipulation by falsely stating it was pivoting into crypto.

Besides actions against issuers, promotors, and other bad actors, the SEC also released valuable guidance to the industry in the form of an investigative report – the DAO report (Securities and Exchange Commission, 2017) – and public speeches at industry events – notably a speech by SEC Director William Hinman (2018). Although this guidance is non-binding, issuers should understand how the SEC views cryptocurrency and how issuers and legal counsel can analyze whether a digital asset is a security and whether the offering is a securities offering.

Whether a digital asset is a security for federal securities law purposes depends partly on whether it is an investment contract. Under the Howey Test (*SEC* v. *Howey*, 1946), a transaction is an investment contract if:

- there is an investment of money;
- there is an expectation of profits from the investment;
- the investment of money is in a common enterprise; and
- any profit comes from the efforts of a promoter or third party.

The latter two elements generated considerable discussion among securities lawyers in the cryptocurrency context. Assume that bitcoin's price is market-driven and bitcoin transactions are verified through mining. However, does that satisfy the element requiring profits coming from the efforts of others? Most attorneys say no.

In the DAO report, the SEC analyzed whether tokens issued by a decentralized, autonomous organization might have been securities. For reference, a corporation or other business entity traditionally issues stock and other securities. The DAO is a "virtual" organization embodied in computer code and executed on a blockchain. The DAO sold tokens, intending to use the token sale proceeds to fund various projects and profit from them, thereby giving value to the DAO tokens. In applying the Howey Test, the SEC concluded that investors gave money to a common enterprise (i.e., the DAO) with a reasonable expectation of profit derived predominantly from the managerial efforts of others.

The DAO's facts are less important than the analysis applying the Howey Test to cryptocurrency. This analysis put the industry on notice of the SEC's litigating position. The conversation developed and distinguished between investment or security tokens, which authorities generally regarded as securities for federal securities law purposes, and utility tokens. Unlike security tokens, usually intended to offer only investment value, utility tokens offer holders non-investment value. Utility tokens might be redeemed for goods or services or used on a platform for the services provided. Could that non-investment-related value be enough to cause a digital asset not to be classified as a security?

SEC Director Hinman offered his view on this subject in a public speech. Hinman's view was that investors purchased digital assets with an expectation of profit derived from the efforts of others, regardless of any utility value of the digital asset. In Hinman's opinion, ether was not a security, but it might have been a security at its issuance. Hinman pointed to "sufficient decentralization" to indicate that something could be a security and lose its character as such as it develops. A digital asset only used on the platform where created could be viewed differently, even if its initial offering was a security offering.

Finally, Hinman identified several non-exhaustive factors to consider when determining whether a digital asset is a security. What are the roles of the sponsors and promotors? Did the sponsors retain a financial interest in the digital asset and remain incentivized to increase the digital asset's value? What are investors seeking when acquiring the digital asset? For example, are they seeking a return on their investment? Who controls the issuing entity? Does applying the Securities Act make sense?

Many in the industry latched onto Hinman's remarks. However, they were just one senior SEC official's view, not its official stance. If nothing else, Hinman's speech provided valuable insights to help determine whether a digital asset offering might be a security offering.

Digital Asset Offerings Under Regulation A of the Securities Act

On July 10, 2019, the SEC granted qualification to Blockstack Token LLC's sale of $28 million worth of digital tokens to the public under the SEC's Regulation A registration exemption (Blockstack Token LLC, 2019). This offering was the first-ever SEC-compliant public sale of securities tokens in the United States.

Congress amended Regulation A under the Securities Act of 1933 as part of the Jumpstart Our Business Startups Act of 2012. Many now call it "Regulation A+." Regulation A allows companies to raise up to $50 million in 12 months without the burden of the full range of disclosure obligations that come with a traditional initial public offering.

Until this approval, companies wanting to sell tokens that are securities could not do so, except in private sales under Regulation D of the Securities Act or a different exemption from the registration requirement of the Securities Act. Although this approach permits token sellers to raise funds, many token platforms are designed with tokenomics requiring freely tradeable tokens. Tokens sold according to Regulation D are not freely tradeable for the first year. By offering and selling tokens under Regulation A+, Blockstack can sell freely tradeable tokens to the public.

The day the SEC qualified Blockstack's Regulation A offer, it also qualified another Regulation A offering, YouNow, Inc.'s offering of up to 178 million Props Tokens. These tokens can reward users for in-app activities, administration, blockchain development, and subsequent sale to the public (YouNow, Inc., 2019). However, Regulation A offerings are limited to no more than $50 million annually (so-called "Tier 2" offerings). Any registrant wanting to register a larger amount of securities for sale must do so through a full-blown registration process. No one has successfully registered a token offering under that process.

Structuring Crypto Businesses: Tax, Legal, and Regulatory Considerations

At this point, entrepreneurs can communicate to their lawyers about what the business does or will do, where it operates, its owners and investors, customers to be served, and other pertinent information. This information is key to determining: (1) an efficient tax structure; (2) what licenses or registrations or exemptions from registrations need to be filed; (3) what key documents are needed; and (4) what else lawyers and other advisers need to do to help establish the business.

Tax Structuring

All crypto businesses are just businesses, and general tax planning considerations apply to crypto and traditional companies almost equally. This section discusses cryptocurrency taxation, specific token offerings, and tax considerations for structuring crypto start-ups.

Crypto Taxation. Image the following situation. A lawyer was on a conference call with a client who planned to launch a cryptocurrency-focused hedge fund. As the lawyer explained specific rules around in-kind contributions of bitcoin and ether, the client interjects, "But where in the tax code are cryptocurrencies mentioned? There are no rules right now!" The client learned that US federal income tax authorities and general tax principles apply to transactions in cryptocurrency.

The seminal piece of guidance is Internal Revenue Service (IRS) Notice 2014-21. The IRS released this notice before the Ethereum network's launch, but after the launch of Litecoin, Dogecoin, Ripple, and about a dozen others. In this notice, the IRS stated that cryptocurrencies readily convertible into fiat currency should be treated as property and not as currency. This ruling means that:

- special rules that apply to foreign currency transactions do not apply to crypto;
- if crypto is held as a capital asset, gains upon a sale would be capital gains;
- mining crypto by an individual was self-employment income;
- businesses that accept crypto as payment for goods or services must include crypto's fair market value in income as they received cash, and such amount was the business's tax basis in the crypto;
- employees and other service providers compensated in crypto must take the crypto into account for purposes of computing their income taxes and payroll or self-employment taxes; and
- general tax principles should be applied to crypto transactions without further guidance.

Although helpful, many unanswered questions remain. One issue involves valuation. Cryptos trade at different prices on different exchanges. Due to high volatility, an hour's difference could mean significant tax savings or tax costs.

Second, tax uncertainties exist when trading cryptos for other cryptos. For instance, a lack of clarity exists about whether crypto-for-crypto trades are eligible for tax deferral under section 1031 of the Internal Revenue Code of 1986, as amended. This section allowed for tax-deferred sales of real estate and property used in a trade or business. In 2017, section 1031 applied only to real estate. The IRS also came out in FAQs on its website that this section did not apply to crypto-for-crypto trades for tax years before 2018. This pronouncement was noteworthy at the time because few people reported their crypto gains. If the IRS had audited this issue, crypto traders might have had a large tax bill. Additionally, tracking is a complicated issue because investors may buy cryptos at different times and price points, trade cryptos for other cryptos, and trade one crypto at different prices on various exchanges. Additionally, some cryptos do not have a readily determinable US dollar equivalent. Some taxpayers may be unaware of these tax issues and trade crypto without keeping these records.

Third, the crypto space was rapidly evolving, and the IRS was largely silent on new developments. Hedge funds began trading crypto, which meant more investors and questions, including:

- Would a non-US domiciled hedge fund's crypto trading activities constitute a US trade or business for US federal income tax purposes?
- Could hedge funds or individual traders make a mark-to-market election on crypto?
- Firms tried to launch exchange-traded crypto funds to expand access to retail investors. Could these funds be structured as grantor trusts, publicly traded partnerships, or mutual funds?
- Investors could buy and trade bitcoin futures. Did wash sales and straddle rules apply to bitcoin specifically and crypto generally?
- New blockchain start-ups attempted to raise capital with token issuances in ICOs or STOs. What are the consequences to the issuing company?

Besides these questions, vast uncertainty prevailed as to how the tax authorities would treat smart contacts, airdrops, hard forks, DeFi, the tokenization of assets, and centralized bank decentralized currencies for tax purposes. Tax attorneys and certified public accountants had to determine reasonable tax positions without additional guidance when dealing with these and other issues.

Further guidance occurred in 2019 in Revenue Ruling 2019-24. In this ruling, the IRS provided advice on the federal income tax treatment of cryptocurrency received in an airdrop or a hard fork. A person receives tokens in an airdrop, usually because of existing ownership of another token. A hard fork occurs when a cryptocurrency on a blockchain undergoes a protocol change resulting in a permanent diversion from the legacy blockchain. The legacy cryptocurrency's owners receive units of the progeny cryptocurrency. The IRS stated that cryptocurrency received in an airdrop or a hard fork was a taxable event. Also, the value of the crypto received was ordinary income. A taxable event occurs when a taxpayer can sell the crypto received. Suppose a taxpayer's wallet does not support the crypto received in the airdrop or hard fork. In that case, the taxable event might occur days or weeks later, when the crypto might have significantly appreciated.

Given the scarcity of official IRS guidance, tax advisers must apply general tax principles to crypto. The tax positions related to acquiring, holding, or selling cryptocurrency depend on the transaction's specific facts. Some cryptocurrencies look and act more like gift cards that some can use to purchase services or goods from the crypto's issuer. Others look and act more like a transactional medium of exchange (currency). Still, other cryptos resemble financial products. How an issuer and taxpayer use crypto helps determine the tax consequences related to its ownership and sale.

- If a person buys cryptocurrency as an investment, the IRS taxes the gains from its sale as capital gains.
- If a person is a crypto dealer or otherwise uses it in a trade or business, gains from the sale of cryptocurrency are ordinary income.
- If someone uses crypto to pay for goods or services, the IRS taxes the person on the difference between that person's basis in the crypto and the value of the goods or services received.

Token Offerings

From a US federal income tax perspective, the economic rights and obligations of issuers and holders of digital assets are paramount in determining the proper tax treatment. According to Code sections 721(a) and 1032, a company's issuance of debt or equity does not generally recognize taxable income to the company. However, the sale of other property by a company does result in taxable income. Before 2018, the US federal corporate income tax rate was 35 percent. Authorities lowered the corporate tax rate beginning in 2018 to 21 percent. Consequently, an improperly structured ICO might have only been 65–79 percent effective after taxes.

Assuming the tokens were not characterized as debt or equity for US federal income tax purposes, the recognition of taxable income might not occur on day one. In early ICOs, issuers sold tokens before their creation and issuance under a "simple agreement for future tokens" ("SAFT"). For US federal income tax purposes, US issuers of tokens under a SAFT usually would not recognize income until token delivery. In addition, if the tokens were like gift cards, in the sense that the tokens entitled the holder to some future benefit from the issuer, the holder could elect to recognize income for US tax purposes during the subsequent tax year.

As mentioned previously, the issuance of debt and equity does not result in taxable income to the issuer. However, Delaware allows issuing equity on a blockchain. Tokenized equity issued by a Delaware corporation should typically be regarded as equity in a corporation for tax purposes. The analysis is unclear when a digital asset is not issued as tokenized equity or a tokenized debt instrument but may be treated as such.

Whether an instrument is a debt or equity for US federal income tax purposes depends on the facts and circumstances. A token can potentially be characterized as equity for US federal income tax purposes under certain circumstances: it is perpetual, has voting rights, has economic exposure to the issuer's growth or negative growth, and offers a right to distribute ongoing profits. The issuer typically makes this determination, which is binding on the investors, whether by statute or by contract.

Alternatively, characterizing a token as indebtedness for US federal income tax purposes may be possible if it has a limited term, offers little upside (i.e., interest payments that are not contingent on profits) and downside protection (i.e., principal protection), provides for a lump-sum or series of distributions and contains other signs of debt. The unconditional obligation to pay interest and repay the principal by a fixed maturity date is a hallmark of debt instruments. The right of token holders to enforce payment of principal and interest in the event of default indicates that the token is more likely to be characterized as debt for tax purposes. Understanding all economic terms regarding a digital asset is vital in determining how to describe a digital asset for tax purposes.

Crypto Business Structuring Considerations

New businesses must consider legal and tax factors from day one. The failure to consider liability protection, governance and capitalization flexibility, and taxes could be costly later in a business's life. Poor corporate structuring could result in costly litigation between founders or key employees, and inadequate tax planning could mean forgone tax savings.

Choice of Entity Considerations

A crypto start-up can be established as an LLC. LLCs offer incredibly flexible governance (member-management or an appointed manager). For example, they can allocate income and expenses similar to partnerships but limit their members' liability similar to a corporation. LLCs are also flexible from a tax perspective. Multi-member LLCs are partnerships for income tax purposes. However, they can elect to be a C or an S corporation for federal income tax purposes. By contrast, domestic corporations have corporate formalities, can only be taxed as a C or an S corporation, and offer less flexibility to get the right economics to their shareholders. For this reason, an LLC is a popular choice for a start-up business.

A US-based business can be taxed as a pass-through entity, such as a partnership or an S or C corporation, for tax purposes. Although a discussion of partnership-S and corporation-C corporations is beyond this section's scope, this section discusses one ownership benefit of qualified small business corporations (QSBCs).

Qualified Small Business Stock Considerations

If a company qualifies as a QSBC, each shareholder can exclude gain on the sale by meeting a five-year holding period. The amount of gain excluded from income is the greater of $10 million or 10 times the shareholder's tax basis in the QSBS stock. The requirements for this tax benefit generally are:

- The company was formed in the United States and classified as a C corporation for tax purposes.
- The taxpayer disposing of the QSBC stock must have acquired the stock at its original issuance for money, property other than stock in the issuer, or services provided to the company.

- The gross value of the company's assets is less than $50 million before and immediately after the stock issuance.
- At least 80 percent of the company's assets are used in the active conduct of one or more qualified trades or businesses, including research and development activities.
- Certain tax filings occur.

Structuring a business as a QSBC offers benefits to founders and investors. VC and private equity investors have realized most of the tax savings attributable to QSBS stock investment.

Equity-based or Token-based Compensation Considerations

Many start-up businesses want to attract and reward key employees by issuing tokens or equity. Issuing property for services is generally taxable. The issuing company must value the equity or tokens on their issuance date and determine and remit applicable withholding taxes, such as payroll taxes for employees. The service provider must take such value into account as income.

Suppose the issuance of tokens or equity is subject to a vesting schedule (i.e., if the vesting conditions are not satisfied, the tokens are forfeited). In that case, the taxable event occurs at the earliest of the following dates: (1) the date the service provider freely transfers the property to a third party, (2) the date the property is no longer subject to a substantial risk of forfeiture, or (3) the issue date if an election under Code section 83(b) occurs within 30 days of the property's issuance. The 83(b) election is usually advisable when the value at issuance is low but expected to appreciate by the time of vesting.

Regulatory Licenses and Registrations

Federal and state licensing and registration obligations may apply depending on what the business is doing and where the activities occur.

- Crypto exchanges may be required to register with the SEC as a broker-dealer or exchange. The business may also need to register with FINRA.
- A crypto-business that helps customers send money to people in other countries may be required to register as a money transmitter in the states where it operates.

NY BitLicense

New York enacted a requirement for certain crypto-businesses based or doing business in New York to apply for a virtual currency license, colloquially known as the BitLicense. The BitLicense applies to five types of incorporated companies or doing business in New York or with New York customers:

- receiving virtual currency for transmission or transmitting virtual currency;
- storing, holding, or maintaining custody or control of virtual currency on behalf of others;

- buying and selling virtual currency as a customer business; performing exchange services as a customer business; or
- controlling, administering, or issuing a virtual currency.

These conditions apply to many New York businesses where digital assets are integral to their business plan. Besides requiring filing an application, the New York Department of Financial Services imposes specific capitalization requirements and annual reporting obligations on licensees.

Wyoming

Wyoming has passed 24 crypto-friendly laws, making it a crypto-friendly state. One law allows a crypto business to apply for a watered-down bank charter, allowing it to become a special-purpose depository institution (SPDI) to offer banking services for crypto. Other states require a crypto business to undergo an expensive and time-consuming traditional bank charter process. Banks are subject to a strict regulatory and compliance regime relative to other financial institutions. Complying with all such regulatory requirements for banks in most cases does not make sense for crypto. The Wyoming SPDI is an example of state drafting laws specific to crypto.

Promises Kept: Ongoing Obligations

A company may have an annual reporting obligation to investors and regulators. These reports aim to provide transparency to investors and other interested parties. For instance, as part of the BitLicense requirements, licensees must report to the NY Department of Financial Services annually. Companies whose securities are registered under the Securities Act must report annually to the SEC. In addition, key investors typically ask to see audited financial statements each year. These reporting obligations require companies to collaborate with accountants, auditors, and attorneys.

Summary and Conclusions

US federal and state laws generally apply to cryptocurrency, even though they are not specific to cryptocurrency. This situation may create uncertainty and doubt about how a transaction fits within a particular legal or regulatory framework. However, it does not mean that cryptocurrency transactions are somehow outside the reach of existing US federal and state laws.

Notwithstanding the applicability of current law and regulation to cryptocurrency transactions, federal regulatory agencies, such as the SEC, CFTC, and the IRS, have already begun issuing guidance and writing rules specifically aimed at the cryptocurrency space. In addition, some states, such as Wyoming, Delaware, and New York, have enacted crypto-specific laws and regulatory regimes governing how a cryptocurrency business can operate. However, the legal aspects involving digital assets are still in their infancy. Federal and state legislative and regulatory bodies will continue to monitor the cryptocurrency space and ideally write thoughtful rules to help the industry grow and build public confidence.

Discussion Questions

1. Discuss how general securities laws might apply to a blockchain-based project or start-up company.
2. Discuss the treatment of digital assets for federal legal purposes.
3. Explain the factors founders and investors should consider when raising capital.
4. Explain whether profits on crypto investments are subject to taxation.
5. Describe the tax implications of paying for goods and services, including employees, in crypto.

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