

CLIENT ALERT

Cryptocurrency in Small Bytes: How Does the IRS Treat the Tokens You Issue in Your ICO?

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Many startups—not just cryptocurrency ventures—have been using initial coin offerings (ICOs) as a way to raise money. In exchange for cash (which may be in dollars, another “real” currency, or a cryptocurrency), an investor receives a “token” issued by the startup. The token may itself be tradable for other currency or may entitle the holder to future services or products to be sold by the startup, or both. ICOs raise complex tax issues both for issuers and investors. There is no IRS guidance on the tax treatment of ICOs. The purpose of this alert is to raise certain U.S. federal income tax issues that may arise where a U.S. investor purchases tokens issued by a U.S. company.

The only IRS guidance on the tax treatment of cryptocurrency is Notice 2014-21, which deals with the class of virtual currency referred to as “convertible virtual currency.” 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. Virtual currency with an equivalent value in real currency or that acts as a substitute for real currency is referred to as convertible virtual currency. Bitcoin, for example, is a convertible virtual currency because it can be traded between users and purchased for or exchanged into U.S. dollars, Euros, and other real or virtual currencies. Under Notice 2014-21, convertible virtual currency is “property” for federal income tax purposes and therefore can result in taxable gain or loss for those who are paid with it or use it to purchase other property or services. By its terms, Notice 2014-21 applies only to convertible virtual currency and not every type of token issued in an ICO may constitute a convertible virtual currency.

A company issuing tokens in an ICO may have taxable income as a result of the issuance. Based on the terms of most ICOs, it is unlikely that the tokens would be characterized as debt or equity in the issuing company for federal income tax purposes. Thus, the ICO proceeds are taxable, likely in the year they are raised (though depending on the terms, a one-year deferral may be possible). See [Notice 2014-21, Q&A 8](#) (virtual currency “miner” includes value of mined currency in income). Applicable tax rates depend on whether the issuing company is treated as a C corporation, S corporation, or partnership for federal income tax purposes. Generally, startups engage in ICOs in order to raise funds for operations, and may ultimately have deductible expenses to offset the ICO proceeds. In a big raise, however, the issuing company may have income in the year of the ICO but may not have fully offsetting deductions for several years. A startup should factor this tax cost into its planning.

An investor may also encounter federal income tax issues, especially if the investor uses another cryptocurrency to purchase the token. In that case, the use of a cryptocurrency to purchase the token in the ICO may result in a tax liability for the investor. Similarly, investors will also need to determine the tax consequences that arise from “using” the purchased tokens, whether they are traded or redeemed by the issuing company at a later point.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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