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Tax considerations for ICO promoters

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The meteoric rise of cryptocurrencies, both in terms of valuation and public awareness, has been one of the biggest news stories in finance of the past year. Token-based fundraising grew rapidly and is now seen as a preferred alternative to early stage venture capital financing for blockchain-based projects.

Most practitioners now understand the basics of an initial coin offering (' ICO') and the challenges associated with undertaking a token-based fundraising. The main focus of the perceived legal risks of an ICO quite rightly remains the characterisation of a token – whether a token is classified as a security and subject to securities regulation. Get this wrong and there is a real risk of severe regulatory sanctions being imposed on the promoters.

However, the regulatory position of a token issuer is not the only structuring consideration which must be carefully analysed. There are a variety of taxation issues which should be carefully thought through as part of the structuring of an ICO. One of the most significant of these is the remuneration of the individual promoters and key personnel. This issue has yet to be fully addressed by revenue authorities in the form of specific regulation or guidance. Just like the questions of securities law which still linger, it is generally a matter of turning to general principles of income taxation to come up with a sensible answer.

Pre-mine allocation

There is a wide variety in the terms of an ICO and in the rights attaching to tokens which are issued. It is very common for the total supply of a token to be fixed from the outset. This harks back to one of the fundamental tenets of many cryptocurrencies which specifically reject the idea that, like fiat currency, the value of the cryptocurrencies can be manipulated by controlling their supply.

The total number of tokens generated as part of an ICO is typically a round, arbitrary number. This is hardwired into the smart contract by which they are created and cannot be subsequently changed. The creation of the entire supply of a token at the commencement of a project is known as the 'pre-mine'. This term is used to distinguish this model from the alternative approach where new coins are created over time. Bitcoin is perhaps the best example of this alternative approach. While the total supply of Bitcoin is capped at 21 million, there are currently less than 17 million in existence as of today. New Bitcoins are provided to miners as the block reward for verifying transactions on the Bitcoin blockchain.

The share of a pre-mine which is not allocated to the promoters or sold to the ICO participants is generally retained by the token-issuing entity to fund ongoing expenditure such as development, legal and marketing expenses. This supplements the proceeds from the subsequent sale of cryptocurrencies contributed as part of the ICO. In some cases where an ICO does not reach its hard cap, unsold tokens in excess of the tokens retained by the token issuing entity are burnt. This creates a permanent difference in the fixed and maximum circulating supply.

The day one creation of the entire supply of tokens means that there is an enormous amount of flexibility in the way in which the tokens may be used to incentivise the promoters of a project. If a project succeeds and the value of these tokens appreciate, the promoters' allocation of a pre-mine may become substantially valuable.

There is in theory nothing to stop a promoter from selling their pre-mined tokens opportunistically to extract a short-term gain. In the worst case, a promoter may have no intention of bringing a project to fruition and may simply sell their share of a pre-mine and walk away from the project altogether. Unsophisticated investors are most susceptible to such pump and dump ICOs. These investors are the least likely to be able to assess the technical merits of a project which should be clearly set out in a project whitepaper or obvious from the code posted on GitHub.

To assure participants that an ICO is not a pump and dump, it is increasingly common for new projects to impose restrictions on the ability of a promoter to sell their allocation of a pre-mine. There is a variety of possible options. These include locking up the promoter's pre-mine allocation in an escrow smart contract, or traditional contractual mechanisms such as promoter warranties or a contractual deferral of vesting.

Taxation of pre-mine allocation

The taxation of their share of a pre-mine is perhaps one of the most significant tax issues faced by the promoters of an ICO. In the context of a traditional equity-based fundraising, the analytical pathway is usually set by specific employee share and option rules. These rules generally seek to align the point of derivation of these shares or options for tax purposes with the time that these interests become fully vested. This avoids a situation where an employee receives a tax bill for a valuable block of shares or options which they are unable to convert into cash.

In the absence of specific rules, the taxation of the promoter's allocation of a pre-mine is left to be determined by general principles. The starting point is therefore that the value of the tokens forms part of the taxable income of a promotor at the time they are derived. If these tokens are issued outright to a promoter, then this point of derivation is clear. The more complicated question in this otherwise straightforward scenario is the value of these tokens on that day. The proximity of the date of grant of these tokens to the date of the ICO itself is likely to be highly relevant. It stands to reason that the value of tokens issued to a promoter the day before a public ICO, which has a set issue price and a long whitelist, should be higher than the value of tokens issued at the very early concept stage of a project which may not even materialise into a whitepaper.

The next consideration which is highly relevant is the vesting or escrow conditions which are imposed on the promoter's allocation of a pre-mine. Depending on the mechanism used and the applicable rules of the jurisdiction in which the promoter may be resident, these conditions may be successful in deferring the point of derivation both economically and for tax purposes. This is more likely the answer than in relation to clawbacks and bad leaver provisions which may be used to take back tokens in limited circumstances. If the point of derivation of a pre-mine allocation is successfully deferred until after the ICO, the token will be more likely to have become tradeable. It will therefore have an objectively determinable market price which will be its average value on cryptocurrency exchanges or at which it may be swapped on a peer-to-peer basis. There is therefore no room to argue for a discount in the value of tokens based on the remoteness of the project launch.

In analysing the tax position of a promoter, care is needed to consider the possible imposition of foreign attribution rules. These could potentially lead to a nasty surprise for a promoter. Controlled foreign corporation ('CFC') provisions are a common feature of jurisdictions having a worldwide basis of taxation. They are designed to attribute the income of generally passive offshore companies to shareholders who may control that company. These rules are a form of specific anti-avoidance to stop the potentially indefinite deferral of income taxation. In the context of an ICO, the risks are significant. Take for example the situation where a promoter is resident in a jurisdiction with a worldwide basis of taxation and CFC rules. Further assume that the promoter holds the shares in an offshore token-issuing entity. If the proceeds of the token raise are considered to be income according to the jurisdiction of residence of the promoter, then these entire proceeds may be subject to tax in the hands of the promoter. This may be the outcome even though the promoter may have no capacity to access the proceeds of the token raise to fund the payment of that tax.

What to do?

The taxation of the individual promoters of an ICO should be considered as part of the structuring of a project. Depending upon the specific circumstances of the ICO, there may be ways to mitigate the taxation costs associated with the promoter's share of a pre-mine, though it would be rare to achieve a zero tax outcome.

The most critical factor is the jurisdiction(s) in which a promoter is resident and the applicable basis of taxation. The rules of the jurisdiction(s) will need to be carefully considered within the context of the individual circumstances of each promoter. This analysis should cover not only the taxation implications of the receipt or vesting of the pre-mine, but also the taxation implications arising upon the eventual disposal of the tokens. Where applicable, alternatives should be explored to ensure that the ownership of the shares in a token-issuing entity does not give rise to adverse tax implications for a promoter. This may be easy where an alternative beneficial shareholder can be found but this is likely to be more difficult if all of the promoters of a project face the risk of attribution under CFC or equivalent rules.

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