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Securities and Tax Law Effects of Token Airdrops

This GT Advisory examines token airdrops in blockchain technology development and finance.[1] The term "airdrop" means a project founder's distribution of tokens or cryptocurrencies without monetary payment from the token recipient in an evolving cryptocurrency lexicon. The practice of token airdrop distributions increased in late 2017 and early 2018 in the midst of closer regulatory scrutiny of initial coin offerings (ICOs) in the United States and worldwide. However, the practice of airdropping tokens to avoid "sales" of tokens while promoting a project is itself under close regulator watch, based on a fundamental tenet of the federal securities laws prohibiting engaging in a transaction indirectly, which would not be allowed directly. It is recommended for token issuers to not engage in any form of airdrop distribution in the absence of advice from experienced securities law practitioners.

Airdrop Activity in ICOs and Marketing Campaigns

Token airdrops or "free crypto" distributions are occurring in conjunction with ICOs and emergent blockchain technology project marketing campaigns. Generally, airdrops take place when a new blockchain project distributes free tokens to existing holders of certain cryptocurrency (also known as the base token in the context of airdrops), such as bitcoin and Ethereum, although not limited to these cryptocurrencies. Airdrops are in some instances utilized as a pre-ICO marketing strategy for an upcoming project designed to build brand recognition, attract users, and provide benefits to the blockchain project and user network. An airdrop can either be announced or unannounced prior to the distribution. While touted as "free" crypto, the blockchain project anticipates that the airdrop recipient

[1] See ***So Long ICOs, Hello Airdrops: The Free Token Giveaway Craze Is Here***, dated March 16, 2018, available at https://www.coindesk.com/long-icos-hello-airdrops-free-token-giveaway-craze/

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will take actions to support the project. To distribute the tokens, the issuer of tokens may take a "snapshot" of a block of a particular cryptocurrency (e.g., Ethereum), and anyone holding such cryptocurrency with the block on the snapshot date or earlier will receive a certain number of free tokens. In some cases, tokens have been airdropped in tandem with an ICO to give potential ICO investors an opportunity to acquire free tokens, as an added incentive to the transaction.

A second way tokens have been distributed without exchange of monetary consideration on the part of the token recipient is through a "hard fork." Hard forks occur when there is a material change to a blockchain system protocol. Hard forks require a legal analysis distinct from token airdrops and are beyond the scope of this Advisory.[2]

Securities Law Analysis

Tokens distributed to recipients without consideration during the launch of a blockchain-based technology project will, in almost all cases, be considered to be a security under the traditional *Howey* test.[3] Depending upon the associated facts and circumstances, the Securities and Exchange Commission (SEC) is likely to view a "free" distribution of tokens to recipients without monetary consideration as an unregistered sale of securities. Section 5 of the Securities Act of 1933, as amended (the Securities Act), declares unlawful the sale of a security, for value, unless a registration statement relating to the security is in effect, or an exemption from registration exists. Section 2(a)(3) of the Securities Act defines "sale" or "sell" to "include every contract of sale or disposition of a security or interest in a security, for value." In the past, the SEC has initiated enforcement action where securities, including stock options, are doled out amongst a group of individuals without cash consideration.[4] In earlier free stock enforcement actions during the development of the internet, the "free" unregistered stock was found to violate Sections 5(a) and (c) of the Securities Act where the distributor of the stock received an economic benefit from the "free" stock distribution by attracting additional people to the website under development in the hopes of increasing potential advertising revenues.

In some airdrop scenarios, a network user may receive a token simply for joining or using a blockchain network under development, similar to a stock option, and have potential monetary upside if the network increases in value over time. The lack of monetary consideration for the shares or tokens, under a "no-sale" theory, does not mean there was not a sale or offer for sale for purposes of Section 5 of the Securities Act. In view of SEC precedent, an airdrop of tokens without consideration may be a "sale" when the purpose of the airdrop is to advance the network's economic objectives, include the establishment of a trading market for the tokens, rather than to make a gift out of generosity. In current crypto-marketplace

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[2] See Mastering Bitcoin, 2nd Edition, Programming the Open Blockchain, Andreas M. Antonopoulos. A hard fork is a material change to a blockchain-system protocol in which the network may diverge into following two chains: a change in the consensus rules requiring coordination between all participants in the system. This type of fork is called a hard fork because, after the fork, the network does not reconverge onto a single chain. See also, ***ICOs Are Out AirDrops Are in*** available at https://steemit.com/bitcoin/@bitcoinflood/icos-are-out-airdrops-are-in stating when a hard fork happens, a new coin is split off of the block chain while everyone that currently owns coins on the main blockchain also gets coins of the new currency... driving up demand for the core coin such as bitcoin or Ethereum.

[3] On July 25, 2017, the SEC issued a Report of Investigation making clear that the sale of tokens could constitute an investment contract or security under the Howey test; *see also*, SEC v. W.J. Howey Co., 328. U.S. 293 (1946). Utilizing the *Howey* test for whether an investment contract exists, if a token investor has an expectation of profits from efforts of the managers and developers of the network, the coin, tokens or other instruments are investment contracts, and thus, securities. This is commonly the case for "pre-sales" of tokens, where funds from token sales are used for development of the platform, infrastructure and services prior to commercialization or product launch.

[4] See https://www.sec.gov/litigation/admin/33-7879.htm. The SEC instituted four cease-and-desist proceedings relating to the issuance of "free" stock on July 21, 1999. In those proceedings the SEC found that the issuance of "free" stock constituted violations of Sections 5(a) and 5(c) of the Securities Act. In the Matter of Wowauction.com Inc. and Steven Michael Gaddis, Securities Act Release No. 7702 (July 21, 1999); In the Matter of Joe Loofbourrow, Securities Act Release No. 7700 (July 21, 1999); In the Matter of Web Works Marketing.com, Inc. and Trace D. Cornell, Securities Act Release No. 7703 (July 21, 1999); In the Matter of Theodore Sotirakis, Securities Act Release No. 7701 (July 21, 1999).

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activity, the purported "gifting" of tokens to a donee may be considered a sale of securities as the donee is providing consideration to the developing platform by influencing consumers to use the platform services and increasing recognition and the value of the airdropped token.

Subject to the attendant facts and circumstances, airdrop deal sweeteners and crypto-giveaways may be considered regulated issuances of securities requiring registration under the Securities Act, or a valid exemption from registration, based on the free-stock case precedent.[5] Blockchain developers should seek advice of securities law practitioners experienced with these issues. It may also be appropriate to engage in discussions with and obtain comfort from the SEC staff in structuring securities law-compliant airdrops so as not to run afoul of regulatory scrutiny in the United States. Restricting airdrop campaigns to countries outside the United States does not alleviate the need to comply with applicable local laws in structuring and effecting airdrop campaigns and, as a result, appropriate advice should be taken in applicable jurisdictions as well.

Tax Law Analysis

The only guidance relating to the U.S. tax implications of transactions involving cryptocurrency is Notice 2014-21 (the Notice),[6] pursuant to which all cryptocurrencies are treated as *property, not currency*, for federal tax purposes. However, the general guidance provided by the Notice does not shed any light on the potential tax impact of certain developments in the blockchain world that took place after the Notice was issued, such as receiving tokens in airdrops. Thus, many questions remain unanswered, including the amount that must be recognized as income and the timing thereof, the allocation of basis, the fair market value at the time of receipt of such airdropped tokens, and the characterization of income, etc.

Generally, a U.S. taxpayer's gross income means all income from whatever source derived.[7] In *Glenshaw Glass,*[8] the Supreme Court defined gross income as an undeniable access to wealth over which the taxpayer has complete dominion. Thus, it is likely that the IRS would consider receipt of tokens by a taxpayer via airdrops as undeniable access to wealth.[9] However, it becomes difficult to determine the time (if at all) as of which a taxpayer can be considered to have complete dominion over such tokens. For example, most airdrops target owners of Ethereum. However, a rightful Ethereum owner will not have any control or dominion on an airdropped token unless such owner's Ethereum is kept on an ERC-20 compatible wallet that supports Ethereum and provides private keys. Thus, if an owner uses an exchange to hold Ethereum, such owner will not have any access (i.e., no dominion or control) to (and may not even be aware of) the airdropped tokens, which he/she might otherwise be entitled to. Nonetheless, if an airdrop is announced and the owner can gain unfettered access to the airdropped token at any time by transferring his/her Ethereum coins from one wallet to an ERC-20 compatible wallet, the IRS may be able

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[5] See https://www.sec.gov/news/headlines/webstock.htm. In response to the wave of so-called "free stock" offerings in 1999, SEC Enforcement Director Richard H. Walker stated in the cited press release "[f]ree stock is really a misnomer in these cases. While cash did not change hands, the companies that issued the stock received valuable benefits. Under these circumstances, the securities laws entitle investors to full and fair disclosure, which they did not receive in these cases."

[6] Notice 2014-21, 2014-16 IRB 938, 03/25/2014, IRC Sec(s). 1001.

[7] IRC § 61.

[8] *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431 (1955).

[9] The IRS can also draw an analogy from other existing tax principles to come to this conclusion, *for example*, discovery of treasure trove constitutes income (Treas. Reg. § 1.61-14(a); Cesarini v. U.S., 296 F.Supp. 3 (N.D. Ohio 1969); receipt of a Corvette (as an award) for performance in a game is income (Hornung v. Commissioner, 47 T.C. 428, 1967 (T.C. 1967); receipt of unsolicited sample text books is considered as income, Haverly v. United Case, 513 F.2d 224 (7th Cir. 1975). However, the determinative facts on which these principles are based may be distinguished from airdrops.

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to apply the constructive receipt doctrine, pursuant to which dominion or control can be deemed, to subject the owner to taxation.[10]

Once a taxpayer is considered to have dominion over airdropped tokens, it becomes important to determine the amount that must be recognized as income. Generally, the fair market value of tokens received by a taxpayer in airdrops should be includible in his/her taxable income. Most airdropped tokens will not result in any taxable income if their value at the time of the airdrop is equal to zero (which is generally the case). The Notice does not provide any guidance for purposes of determining the fair market value of tokens that are not listed on an exchange. In such cases, the general rules of taxation apply, and the taxpayer must make a good faith effort to determine the value of such tokens by considering all the relevant factors.[11] The income, if any, of a holder on the receipt of tokens in an airdrop should be treated as ordinary income as there is no sale or exchange of a capital asset that resulted in such accretion to wealth. The post-acquisition basis in the tokens received in an airdrop should be equal to the fair market value of the tokens at the time the taxpayer realizes gain on such receipt.[12] *For example*, if an owner of Ethereum receives an airdropped token valued at $10 at the time of the receipt, the owner will be required to include $10 in his/her gross income as ordinary income. The basis in the token in the hands the owner will be $10, which means that on a subsequent sale of the token, the owner will recognize capital gain/loss equal to the difference between the amount received in the sale and $10.

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[10] *See* Treas. Reg. § 1.451-2(a).

[11] Such factors could include the utility of tokens, the value of the underlying assets (if any), the supply-demand analysis (i.e., scarcity), mining cost, transaction time, the underlying technology and the team working on the technology, market cap and volume, competition, etc.

[12] There is no authority under which the basis of an airdropped token will be split between the base token and the airdropped token.

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