

## Demystifying Blockchain, Cryptoassets and Tokenization

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Blockchain was conceptualized about a decade ago, and today, the technology has many applications. The first major innovation using this technology was the digital currency called Bitcoin. While the cryptocurrency market capitalization was approximately \$112 billion in December 2018, it had fallen by nearly \$700 billion from January 2018 due to the drop in price of cryptocurrencies and increased potential for regulatory scrutiny<sup>1</sup>. However, the total number of cryptoassets have continued to grow. To help you better understand the new types of cryptoassets, we have provided the following definitions:

**Blockchain:** A decentralized, digital ledger that keeps a record of all transactions that take place across a peer-to-peer network. Note that in order to be considered a blockchain, data has to be organized in blocks using an append-only structure and linked to other blocks using cryptography<sup>2</sup>. Some of its applications include cryptocurrencies, smart contracts, fund transfers, settling trades, and many others.

**Initial Coin Offerings (ICOs):** ICOs are another fundraising tool which are very similar to Initial Public Offerings (IPOs). ICOs are a method of funding start-ups by using new digital tokens/coins. First, a start-up creates a new token using a platform like Ethereum. Next, the start-up invites investors to buy the newly-minted digital tokens and the investors can buy the new token using other cryptocurrencies (like Bitcoin or Ether) or fiat currency<sup>3</sup>.

**The Difference Between an IPO and ICO:** The basic difference between an ICO and an IPO is that unlike an IPO, **an investor in an ICO does not get an equity stake in the company.** The goal of the ICO is that the new token/coin from the ICO will become actively traded and appreciate in value.

**Cryptoassets:** All the different types of digital assets (including cryptocurrencies) use blockchain technology. Cryptoassets are broken down into three main types: **cryptocurrencies, security tokens and utility tokens.**

- 1. Cryptocurrencies:** Cryptocurrency is a digital or virtual currency that is encrypted for security using cryptography, the most famous of which is Bitcoin. Like fiat currencies, a fundamental characteristic of cryptocurrencies is that they are a medium of exchange and/or a store of value<sup>4</sup>. In addition to Bitcoin, other examples of cryptocurrencies include Ripple, Tether and Dash.
- 2. Security Tokens:** These are a way of raising money for blockchain projects. Security Token Offerings (STOs) are always backed by some form of tangible asset or share of revenue<sup>5</sup>. The question naturally arises, do these **fall within the scope of Securities and Exchange Commission (SEC) oversight? The answer is Yes.** However, first it has to be determined whether the token falls within the category of security tokens.

### How to determine if a token is a Security Token

In order to be considered a security and to fall within the scope of SEC oversight, security tokens have to fulfill the requirements of the Howey Test as established by SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

**Requirement 1:** Is the token sold as an investment?

**Requirement 2:** Do the investments and the investors' profits rely on a single entity or a group of entities<sup>4</sup>?

**Requirement 3:** Is there an expectation of profits substantially from the efforts of others?

**Are STOs only subject to the security regulations of the country they are launched in?**

No. Like other securities, STOs are subject to the regulations of both the country they are launched in and the country of the investor. In the U.S., STOs are registered with the SEC while ICOs are not registered. The SEC's Division of Enforcement 2018 Annual Report references five principles used to guide the Division of Enforcement's efforts with multiple of the principles addressing the continuously changing markets including ICOs.

- 3. Utility Tokens:** These are tokens that do not qualify as security tokens under the Howey test as a Utility Token typically does not provide a right to profits. These blockchain-based tokens give owners the access to a service or a product in the future.

Investors currently have more barriers to entry for STOs than Utility Tokens. In the United States, STOs are registered under a specific regulation depending on the nature of the investors (accredited vs. non-accredited) and the amount of the capital raise: Regulation D, Regulation A+, Regulation S.

**STO or Utility Tokens: The Importance to Issuers and Investors**

Organizations and start-ups wanting to use ICOs and STOs for fundraising or investors looking for investment opportunities should be aware of the regulatory trends and understand the underlying risks associated with investing in these cryptoassets.

**Tax Implications:** In general, the facts and circumstances of each offering, whether it be a STO or a Utility Token, will drive the taxability of the events. For both ICOs and STOs, the actual issuance event does not create any currently recognized tax. There may be deviations from this (for example, a characterization of "prepayment of goods" for an issued Utility Token), but there isn't any differentiating factor that would make one offering taxable or non-taxable over the other.

The largest difference is the classification of a token: STOs result in strictly security, or asset-backed, tokens, while ICOs may result in the issuance of either security or Utility Tokens. In certain cases, security tokens provide a fixed income to the investor, which results in dividend reporting for both U.S. and foreign participants in a U.S. based offering. Meanwhile, Utility Tokens may represent a "pre-payment of goods" to the issuer, which would result in subsequent tax reporting on income received. Overall, the taxability of these two offering types will be similar until the relevant taxing authorities issue more guidance.

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Richey May is dedicated to sharing best practices and trends in the industry to help you stay competitive in the local and national marketplace. If you have questions about cryptoassets, Richey May's Alternative Investment professionals are available to help. For more information, please contact [Stephen Vlasak](#) or visit our website at [www.richeymay.com](http://www.richeymay.com).

**Endnotes - Sources**

1. <https://www.cnbc.com/2018/11/23/cryptocurrencies-have-shed-almost-700-billion-since-january-peak.html>
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5. <https://hackernoon.com/ico-vs-sto-all-you-need-to-know-about-the-new-fundraising-method-in-the-crypto-world-54a1a43a08d6>

**Additional Sources**

1. <https://hackernoon.com/security-token-offerings-stos-what-you-need-to-know-8628574d11e2>
2. <https://www.icodata.io/stats/2018>