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Blockchain, Tokenization, & ICOs: What's the Hype?

What exactly is an Initial Coin Offering (ICO), and why is everyone talking about them? Are they even legal, and what is the risk? This article explains the ICO phenomenon, the risks involved, and the current legal landscape. Initial Coin Offerings, or ICOs for short, come in different flavors, but one common characteristic is the presence of a digital token or "coin" built on a blockchain network (or the promise of one in the future).

But what is blockchain?

At its most basic, blockchain is like a massive spreadsheet or ledger distributed to the public that updates itself with every transaction on its network in real time. This distributed, digital ledger is composed of transactions (or other records) linked and secured using cryptography. Through the use of blockchain technology, developers can create unique and innovative digital assets and platforms with various characteristics.

What are digital tokens or "coins," and where do they come from?

A token is a digital asset that can be transferred almost instantaneously between two parties over the internet without involving a third party. However, not all tokens are the same. Tokens, such as Bitcoin, Ethereum, Litecoin, XRP, or Stellar Lumens, can serve as a replacement for traditional currency. They can be designed to provide the right to a future good or service or even be used to set up and execute smart contracts. Alternatively, tokens can be backed by a particular type of asset, such as gold, silver, or other collateral.

ICOs have raised over $2 Billion in 2017, with some ICOs raising as much as $200 million. Filecoin, for example, raised $257 million over a month of activity. Filecoin aims to provide a decentralized network for digital storage through which users can effectively rent out their spare capacity. In return, those users receive Filecoins as payment.

Another example is Golem, which presents itself as a global, decentralized supercomputer that anyone can access. It is comprised of the combined power of each participating user's machines, from personal computers to data centers. Users who rent out their computing power are compensated with Golem Network Tokens.

The hype: Is it a security or not? It depends . . .

The United States Security and Exchange Commission (SEC), which regulates securities, has warned that, depending on the facts and circumstances of any particular ICO, the offering may involve the sale of securities and, therefore, may be subject to SEC (and

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state) regulation. Assuming an offering of such tokens is not a sale of securities just because it involves a blockchain token is fraught with peril. The facts and circumstances that determine whether an ICO is offering a so-called "utility" token or a security are not clear. However, the SEC has reiterated its historical position, that it considers the substance of a transaction over form.

To date, we have four examples from the SEC to work with. The DAO ICO, PlexCoin ICO, MUN ICO, and the AriseBank ICO were each deemed "investment contracts" under securities law.

Just because an ICO is considered a security, however, does not make it illegal. It only means that the ICO must comply with the applicable securities laws. Registration with the SEC and compliance with the applicable regulations, while potentially expensive and time- consuming, may prevent a tremendous headache later on.

What laws should I consider?

At a minimum, you should consider all federal consumer protection and securities laws, including but not limited to the Dodd-Frank Wall Street Reform and Consumer Protection Act's prohibition against unfair, deceptive, and abusive acts, and the Securities Acts of 1933 and 1934, and their implementing regulations (Regulation A, A+ S-K, S-X, Rule 10b-5). In addition, if an ICO should be classified as a security pursuant to federal law, it would likely be necessary to consider all relevant state securities or "Blue Sky" laws.

Looking ahead

Blockchain, tokenization, and ICO are upon us, and businesses would be well served to keep abreast of the risks, rewards, and legal landscape of these burgeoning phenomena.

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The Transparency Register is On-line now! Action is Required!

The Transparency Register has been on-line since the end of 2017 (www.transparenzregister.de). With the introduction of this register, companies and other associations of individuals (e.g. foundations) are required to disclose the "beneficial owner" for the first time. In the past, companies have already been obliged to file a list of shareholders in the company's commercial register when the company is founded and later in the event of changes. The shareholders' list has already been visible to third parties and it is possible to find out who the shareholders of a business are. In many cases, however, the list of shareholders only tells us that shareholders of, for example, a Private Limited Liability Company (or, “GmbH”) are in turn one or more other companies. The innovation of the Transparency Register is that it requires the registration of individuals who have an equity interest of more than 25 percent in the company or who have a correspondingly large influence on the decision-making process (e.g. through voting right agreements). The new regulation was introduced as part of an amendment to the German Money Laundering Act and it aims at combatting money laundering and the financing of terrorism.

The company or association itself is subject to the reporting requirement, acting through its managing director or other representative body. The obligation to report the beneficial owners to the transparency register also applies if the direct shareholder is a foreign company (e.g. an English Ltd. or a US Corporation holding an equity interest in a German Private Limited Liability Company). In such a case, the individual holding an equity interest of more than 25 percent in the foreign parent company shall be published in the Transparency Register.

However, if the ownership structure and the beneficial owners are already shown in another German register—for example, the Commercial Register—there is no such obligation to notify the Transparency Register (the latter is the case if shareholders are individuals). Furthermore, listed companies are excluded from separate notifications to the Transparency Register if the controlling position already results from corresponding notifications of voting rights.

The Transparency Register can in principle be inspected by anyone who has a legitimate interest to do so (e.g. a potential acquirer of the shares). The legitimate interest must be demonstrated. The right of inspection may, however, be restricted on the beneficial owner's request if his/her overriding interests are in conflict with the disclosure of certain private information (it is the intention to protect individuals against criminal offences such as kidnapping and extortion).

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In case of non-compliance with the obligation to notify the beneficial owner to the Transparency Register, fines of up to EUR 100,000.00 can be imposed. In the case of severe or repeated violations, there is a risk of significantly higher consequences (fines of up to EUR 1 million or up to twice the economic benefit resulting from the violation). Unless already done, action is required now.

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Bitcoin, Cryptocurrency and Blockchain – Challenges of an Evolving Regulatory Framework in the U.S.

Everyone has heard the terms Bitcoin, cryptocurrency and blockchain. However, most people outside of the technology industry have a limited understanding of the underlying technology. This includes regulators forced to determine how to apply existing financial market securities and commodities regulation to the use of this technology for fundraising and other purposes. The purpose of this article is to provide an overview of the principal regulatory challenges that German technology companies may face in the United States.

Bitcoin and other cryptocurrencies are decentralized digital currencies that rely on digital encryption. Unlike traditional currencies, cryptocurrencies are not issued by a central bank. No governmental entity backs the integrity of Bitcoin or dictates monetary policy. Cryptocurrencies use blockchain technology to create a public ledger by chaining together blocks of verified information. Blockchain is a revolutionary technology that has many other potential applications, including to raise capital, conduct transactions, or in healthcare. Accordingly, multiple regulators potentially can assert jurisdiction over blockchain transactions. U.S. regulators are struggling to keep up with this technology and its application in cryptocurrencies. Symptomatic of the evolving regulatory environment and the challenges that German companies creating or employing blockchain technology face in the U.S., are the evolving positions of the Securities and Exchange Commission (SEC) on initial coin offerings (ICO) and trading in digital coins and tokens, and the view of the Commodity Futures Trading Commission (CFTC) on the characterization of digital and virtual currencies as commodities.

In July 2017, the SEC issued a report on an investigation it made into an ICO conducted by a German company for the purpose of raising capital. In it, the SEC asserted jurisdiction over ICOs and trading with respect to coins or tokens that had the characteristics of a security as defined for purposes of the federal securities laws. The SEC concluded that all elements of a security were satisfied and that the digital tokens offered were securities. Specifically, the SEC concluded that the coin holders invested in the virtual organization in exchange for digital tokens expected to increase in value due to management's involvement. The SEC concluded that the ICO was an offering of securities and therefore needed to be registered under the U.S. Securities Act or exempt from such registration. The SEC did not go so far as to say all virtual tokens were securities required to be offered in a registered offering. Instead, the SEC stated that whether or not a digital token was a security depended on the facts and circumstances. This distinction led to a

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discussion among market participants that properly structured token offerings could avoid SEC jurisdiction.

In December 2017, the SEC's Chairman shut the door to any speculation that the SEC would take a narrow view of its jurisdiction over token offerings and trading. In a February 2018 enforcement action, the SEC stated that any platform engaged in the activities of a national securities exchange is subject to SEC jurisdiction regardless of whether or not a security is involved or whether it involves a digital asset, token or coin. Accordingly, German companies considering offering tokens or coins to U.S. persons should assume that they are offering a security in the United States that would be subject to the registration requirements of the Securities Act of 1933 or an exemption from the registration thereunder (such as Regulation D). When offering or transacting in tokens or coins outside of the United States, German companies should comply with SEC Regulation S.

The CFTC has long maintained that virtual and digital currencies are commodities. The CFTC broadly interprets virtual currencies to include any medium of exchange, including coins and tokens, distributed using blockchain. The CFTC asserts that it therefore has explicit authority to regulate retail transactions in virtual currencies. As a result, the CFTC could potentially assert jurisdiction over both the type of digital token referenced above that the SEC determined to be a security and, unless such a transaction is ultimately determined to be exempt from CFTC oversight, the ICO transaction itself. Accordingly, a German company engaging in activity involving virtual currencies in the U.S. also must consider the potential application of U.S. commodities laws and regulations.

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Europe is different!

US citizens are used to a single, uniform trademark law, enforceable throughout the whole United States and effective against every single one of the 322 million citizens.

Is this situation comparable to that in the European Union and its 511 million citizens? As you might have guessed, the answer is clearly: No! Although the Community Trademark is valid in the complete EU and may be renewed with a single payment to a single office, its enforcement is not unitarily regulated by a single law.

The German High Court (BGH) ended last year with a flourish: the cross-border offering of trademark infringing products can not be pursued in Germany based on a Community Trademark (BGH, I ZR 164/16).

What happened? The claimant produces and sells perfumes in Germany and owns various Community Trademarks and International Registrations with validity in Germany. The plaintiff is an Italian company, which has obliged itself not to import or sell certain fragrances to Germany. On its Italian homepage, certain advertisings in the German language appeared and the company has sold and delivered a certain quantity of fragrances to Germany. The question now was, to which national court the German claimant had to file his lawsuit, based on his Community Trademarks. Traditionally, the claimant could file his lawsuit based on tort action in the country, to which the infringing goods were delivered. This no longer is the case.

The BGH decided that cross-border lawsuits based on Community Trademarks have to be filed in the country and based on that countries law, in which the basic deed of infringement took place. The basic deed of infringement has to be determined by comprehensive consideration of all relevant factors of the case. Here, it was stated that the Italian company has started the infringement in Italy by offering the infringing goods on its homepage.

This decision devaluates Community Trademarks and increases the relevance of national trademarks in the EU. For example, this case could have been successfully filed in Germany, if it would have been based on a German national trademark or an International Registration valid in Germany.

Again, it was made clear that the European Union is far from being the United States of Europe…

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RECENT DEVELOPMENTS IN U.S. IMMIGRATION

In carrying out the April 18, 2017 "Buy American and Hire American" Executive Order, the Secretaries of State, Labor and Homeland Security, as well as the Attorney General, issued new guidance to protect the interests of U.S. workers in the administration of the U.S immigration system. Consequently, these agencies have implemented a combination of rulemaking, policy memoranda and operational changes that impact the adjudication of various U.S. visas. Moreover, the DOL (Department of Labor) and DOS (Department of State) are increasing their efforts to monitor and enforce compliance with H-1B employers.

In December 2017, the "Travel Ban" for individuals from various countries (Chad, Iran, Libya, North Korea, Somalia, Syria, Yemen and Venezuela) became effective limiting visa issuance and U.S. entries accordingly. Final arguments on the Travel Ban will be heard by the Supreme Court in March 2018.

Travelers can expect increased scrutiny for visa applications and more intense port of entry questioning. Consequently, employers should provide their workforce with clear guidance on U.S. admission protocols and travel documentation requirements, and HR personnel should stay informed on further restrictions. In addition, since the Customs and Border Protection officers are now empowered to search devices such as mobile phones, laptops, computers and tablets, confidential data should be archived and secured in advance of travel.

There has been a noticeable increase in visa application processing delays due to Section 221(g) of the Immigration and Nationality Act, otherwise known as "Administrative Processing." Such processing can be triggered by the following factors: applicants with intended occupations in targeted fields on the Technology Alert List, applicants appearing in national security and law enforcement databases, such as the Interagency Border Inspection System (IBIS), or information found on Form DS-160, such as criminal records and employment history. Visa processing delays due to Administrative Processing can last from a few weeks to several months. In most cases, Consular Posts will retain the application documents and the applicant's passport until the matter is resolved. It is important to note that the visa applicant will be prohibited from entering or re-entering the U.S. until the Administrative Processing has been completed.

Furthermore, the U.S. administration has carried out changes to two primary visa categories, the H-1B and L-1. For example, there are new standards for H-1B petition approvals for employment in entry-level positions in that USCIS questions Level 1 prevailing wages and the relevancy of the beneficiary's academic degree to the offered position. Employer site visits are also increasing to ascertain compliance with the H-1B

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and L-1 visa programs. Furthermore, USCIS eliminated a longstanding policy of deference in H and L extension petitions, now requiring full adjudication and scrutiny.

Notably, effective October 1, 2017, all applicants of an employment-based immigrant/green card petition and their derivative family members are required to appear for a personal interview at USCIS prior to the issuance of the green cards.

Employers should review all aspects of their visa programs and ascertain that compliance of the new regulations is monitored.

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How the tax reform offers tax planning opportunities for German owned corporations in the U.S.

By using the new FDII regime as well as the decreased federal corporate income tax rate German owned U.S. corporations may be able to significantly reduce the group's overall tax burden where eligible functions such as research and development or certain services are relocated to the U.S.

Corporate Taxation under the Tax Cuts and Jobs Act

Historically, the U.S. has been known for its high effective corporate tax rate relative to other developed countries, as well as its "worldwide" system of taxation on foreign-sourced income. The Tax Cuts and Jobs Act makes significant reductions to the rate as well as major changes to taxation of foreign income.

The centerpiece of the act and its touted benefits to corporations is that the U.S. federal corporate tax rate is decreased from 35% to 21%. Historically, the high corporate tax rate in the United States has provided an incentive for multinational businesses to minimize profits attributable to their U.S. affiliates, which is often accomplished through transfer pricing mechanisms such as royalty payments.

The greatly reduced U.S. corporate rate dramatically changes the arbitrage equation, as it is now likely more tax-favorable on a worldwide basis in many cases to earn a dollar of income in the United States than in a foreign country where rates may exceed the new lower rate.

In addition to the reduction of the general federal corporate tax rate, the tax reform provides further incentives for multinational businesses to generate revenue in the U.S. For German companies, being subject to an average corporate income taxation of 30.18% (OECD statutory corporate income tax rates 2017), the new rules provide a strong planning opportunity to reduce the group's overall tax burden by restructuring the U.S. subsidiary's functions and activities.

Foreign Derived Intangible Income taxed at 13.125%

The reform establishes a new tax regime for so-called Foreign Derived Intangible Income ("FDII") which acts as a taxpayer-favorable counterpart to anti-deferral rules for Global Intangible Low-Taxed Income ("GILTI"). Under new Section 250 (a) (1) of the Internal Revenue Code, the FDII rules are an incentive for U.S. companies to sell goods and provide services to foreign customers. Qualified income from the sale of goods and services abroad is effectively taxed at a rate of 13.125% rather than 21%.

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The reduced rate is applicable to the company to the extent the domestic entity has certain types of foreign service or sales destination income and the profits of the domestic entity exceed a level above an average return on its tangible qualified business asset investments (10%).

The FDII rules apply to taxable years beginning after December 31, 2017 and is reduced to an effective tax rate of 16.4% in taxable years beginning after December 31, 2025. Further guidance is expected from the IRS to explain the operations of this new regime.

German Tax Implications

From a German tax perspective – either as the source country of FDII or as the U.S. company's German parent's country of residence – the tax implications depend on the qualification of FDII under German laws.

As far as FDII is based on the foreign use of IP, the IP needs to be the result of research and development activities based in the U.S. Otherwise FDII payments may not be deducted as business expenses on the German source company level or the payments could be subject to German CFC-rules on the German parent company level.

As far as FDII is based on services, which are part of the U.S. company's ordinary business, the company can basically benefit from the FDII rules without negative tax implications in Germany. Naturally, transactions between related parties need to be in accordance with the so called arm's length principle and general transfer pricing guidelines.

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