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Valuation Plays a Critical Role in Digital Assets

Over the past 52 weeks, Bitcoin has traded from a low of about $10,000 to a high of about $65,000, which translates to significant gains or losses depending upon when it was bought and sold. Valuations can play a critical role in decision-making for companies and individuals who hold digital assets such as virtual currencies and obtaining a well-supported appraisal may even allow companies and individuals to take advantage of valuable tax opportunities.

Digital Asset Types

Digital assets are commonly described as anything that can be stored and transmitted digitally and have ownership rights. Digital assets could be photos, videos, or text. Virtual currency (also known as cryptocurrency) is a digital asset that represents value and may function as a medium for exchange. Internal Revenue Service considers virtual currency to be property rather than currency. Thus, general tax principles applicable to property transactions should apply to virtual currency.

Virtual currency is a type of digital asset but other classes exist. A digital token is a digital asset that requires a blockchain network to operate and may serve functions beyond currency. Digital assets also include applications, smart contracts and may convey security ownership characteristics. As a result of ever evolving regulatory and tax definitions of digital assets, the valuation of these assets can be complex.

Valuation of Virtual Currency

Some virtual currencies are traded on a public exchange and fair market value may be substantiated based on the amount recorded by the exchange. Peer-to-peer or other transactions not facilitated by an exchange may need to consider virtual currency indices. For virtual currency without a readily ascertainable value (i.e., not traded on an open market), transaction in these currencies may require valuations.

Charitable contributions of virtual currency can have significant tax advantages, similar to those of donating other assets with significant built-in gains. However, there are strict substantiation requirements for charitable donations of hard-to-value-assets which must be complied with for a taxpayer to get a deduction. If the fair market value of the gift is over $5,000, the valuation must be substantiated, and a qualified appraisal is required. In addition, the donor must complete Schedule B of Form 8283, Noncash Charitable Contributions, which must be signed and dated by a qualified appraiser.

Valuation of Other Digital Assets

What if the transaction giving rise to the tax event does not involve a virtual currency, but rather a digital token? Digital tokens are assets or utilities that sit on top of another blockchain. One example of a digital token is Ethereum. Tokens can represent other tradeable assets like commodities, loyalty points or other virtual currencies.

Tokens

Valuations of tokens are similar to valuations of other intangible assets or even tangible assets. In order to have value, an asset must have utility and widespread use. Many technology start-ups concentrate first on creating a base of active users before solidifying their revenue model. In order for a token to be valuable there has to be a community of support. Scarcity is another consideration as assets are more valuable when scarce. Virtual currencies and tokens may have finite supplies that cause built-in scarcity. Finally, the marketability of utility tokens is impaired by limited amounts in circulation and their close connection with the underlying function of the token.

Simple Agreement for Future Tokens (SAFT)

Securitization of tokens has been a contentious issue with the United States Securities and Exchange Commission (SEC). A SAFT allows investors to finance a startup in exchange for a right to tokens once the token network and technology necessary to create a functional token is developed. Valuation of tokens created in connection with SAFTs is similar to the valuation of technology assets and requires careful consideration of the cost and effort to develop the token.

The Takeaway

Unlike assets and securities with more established tax and valuation treatment, digital assets are constantly evolving. While some digital assets have reported market values, many are less liquid hybrids with securities characteristics and few market indications available to substantiate values. It is more important than ever to seek assistance from an appraiser who can thoroughly analyze and support your fair market value estimates.

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Avoiding Common Pitfalls of Passive Foreign Investment Companies

Many investment opportunities extend beyond U.S. borders. However, U.S. taxpayers often overlook a significant tax risk that exists when investing in certain offshore entities. Specifically, the U.S. enacted special tax rules in 1986 aimed at preventing U.S. taxpayers from deferring tax on passive investments or converting ordinary income to capital gains by making investments through offshore entities referred to as passive foreign investment companies (PFICs). Taxpayers who trigger the PFIC provisions become subject to tax on excess distributions from the PFIC and have additional reporting requirements. Taxpayers investing offshore and their advisors must identify situations in which the PFIC rules are

applicable and take steps to avoid or mitigate the negative outcomes of becoming subject to these rules.

What Is a PFIC?

A PFIC is a foreign corporation that satisfies either an asset test or an income test. The asset test is met when the average percentage of assets held that produce passive income or are held for the production of passive income is at least 50%. The income test is met when 75% or more of the gross income is from passive activities. Passive income is defined as interest, dividends, rents, royalties, annuities, and gains over losses from the sale or exchange of property that gives rise to interest, dividends, rents, royalties and annuities. If either of these tests are met, the corporation is treated as a PFIC. Under the IRC 1291 Fund rules, the PFIC will remain a PFIC for the duration of the U.S. taxpayer's holding period regardless of whether it meets the asset or income test for any future year.

The asset and income test may catch companies that do not look like they would be PFICs. For example, a foreign special purpose acquisition corporation (SPAC) may be a PFIC if its primary asset is cash or its only income is interest income. Or a foreign start-up company may have substantial cash on its balance sheet, resulting in it being classified as a PFIC. A foreign operating company may be classified as a PFIC.

Taxation of PFIC Income

Under the default taxation rules applicable to owners of PFICs (referred to generally as IRC 1291 Fund rules) no income is recognized and subject to tax unless a distribution is made by the PFIC or the PFIC is sold. When a distribution is made or the PFIC is sold, any income or gain is generally taxed as ordinary income at the highest marginal rate. In addition, an interest charge based on a taxpayer's holding period of the asset is also levied.

QEF and Mark-to-Market Elections

Two beneficial elections are potentially available to U.S. owners of PFICs.
With a qualified electing fund (QEF) election, the U.S. owner is taxed on a current basis on the ordinary income and net capital gains of the QEF, and gain on sale is eligible for capital gains treatment. A QEF election must generally be made for the first year the taxpayer is a shareholder of the PFIC and requires that the PFIC provide, annually, a required informational statement to the U.S. owner.

Provided a QEF election has been made, if in any future year the foreign corporation does not meet the asset or the income test, it will not be treated as a PFIC for that particular year, and the U.S. owner will not be taxed on the income or net capital gains of the PFIC.

A mark-to-market (MTM) election can also be made in the first year the taxpayer is a shareholder of a PFIC that is traded on a qualified exchange or other market. The MTM election treats any appreciation in value in the PFIC for the year as ordinary income. A deduction is also allowed for unrealized losses, but only to the extent gains have been included previously in income. At the time of disposal, any gain for the year will be included in the U.S. tax return as ordinary income. A MTM election is generally not as advantageous as a QEF election for individuals because long-term capital gains rates are not available. However, because a MTM election will avoid the punitive tax and interest charge under the excess distribution regime, it is still typically recommended if available.

Purging Elections

It is common for a taxpayer to not realize they are owners of a PFIC until it is too late to make a timely QEF or MTM election. In that case, a purging election may be recommended. A purging election treats the PFIC stock as having been sold, which triggers taxation under the excess distribution regime. Then, going forward, the PFIC will be treated as either a QEF or a MTM PFIC.

The Takeaway

For taxpayers investing abroad, the PFIC can be an expense trap for the unwary. Before investing, taxpayers should determine if a foreign corporation qualifies as a PFIC, if a QEF or MTM election is available for certain investments in a foreign corporation, and finally, consider purging options if a timely QEF or MTM election has not been made.

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IRS Signals Increased Enforcement of Requirement to Include Stock Based Compensation in Cost Sharing Agreements

Taxpayers with cost sharing arrangements (CSAs) can expect close audit scrutiny and potential adjustments related to their treatment of stock-based compensation (SBC) costs. In the wake of a government win in Altera v. Commissioner, IRS has issued significant administrative guidance that signals its intent to audit and adjust taxpayers with Altera issues.

Multinational companies should take proactive measures to mitigate or eliminate the risk of an adverse audit finding on the issue of SBC in a CSA. One of the key aspects that multinational companies should analyze is the method they use to quantify the value of SBC.

Background

According to U.S. cost sharing rules, parties under common control may enter into a CSA which allows the parties to share the costs and risks of developing one or more intangibles in proportion to each party's share of reasonably anticipated benefits (RAB) expected to result from the use of the cost shared intangibles. A payment is required for the contribution by a party of any resource, capability, or right to the CSA that it has developed, maintained, or acquired externally to the intangible development activity if it is reasonably anticipated to contribute to the development of the cost shared intangibles.

A CSA produces results that are consistent with an arm's length result if, and only if, each controlled participant's intangible development cost share is proportionate to its RAB share, each controlled participant compensates its RAB share of the value of all platform contributions by other controlled participants, and all other requirements of the cost sharing regulations are satisfied.

Many multinational companies will enter into a CSA with a controlled foreign corporation (CFC) in a low or no tax jurisdiction. However, such arrangements could also take place with a CFC in a non-low-tax jurisdiction and an adjustment may also be required if a payment is not arm's length.

Altera Ruling

The validity of the Treasury regulation requiring controlled entities entering into CSAs to share SBC was upheld by the Ninth Circuit in *Altera v. Commissioner* in 2019. The ruling stands after the U.S. Supreme Court declined to issue a writ of certiorari in *Altera* in June 2020. The Supreme Court's denial of certiorari ends the Altera case. But the issues it raises will likely have long-term implications for multinational companies. Many of these companies in the technology sector are located within the Ninth Circuit's jurisdiction (AK, AZ, CA, HI, ID, MT, NV, OR, WA) and often rely on SBC in recruiting their workforce. IRS will also seek to use the *Altera* decision as persuasive authority in other jurisdictions.

Administrative Guidance

LB&I Practice Unit

In late 2020, IRS released the practice unit Cost Sharing Arrangement With Stock Based Compensation as part of the agency's Large Business and International Division's (LB&I) knowledge management efforts. IRS practice units serve as a roadmap for the examination teams handling the covered issues. Its issuance is a clear signal IRS is planning to audit the inclusion of SBC in CSAs. Further confirmation of this intent came in July 2021, when IRS issued Advice Memorandum 2021-004 (AM 2021-004) and asserted that it can make certain allocations to make cost sharing transactions consistent with an arm's-length result.

Legal Advice Memorandum

Advice Memorandum 2021-004 sets forth the tax agency's views on the treatment of SBC in CSAs that include a reverse claw-back provision, but do not share SBC costs. Some taxpayers added "reverse claw-back" provisions to their CSAs while the *Altera* litigation was pending. The claw-back provisions generally allow a taxpayer to remove or claw back SBC included in cost pools if the 2003 SBC regulation is: 1) invalidated as the result of a final decision in a court of law, 2) revised or 3) withdrawn.

Reverse claw-back provisions provide that taxpayers excluding SBC from their cost pools may later include those SBC amounts upon a certain triggering event (e.g., a court ruling) and make a payment to reflect the sum of SBC costs that should have been shared in prior years. After Altera was resolved in IRS's favor, it was unclear whether IRS would honor the reverse claw-back provisions or require adjustments to be made for each relevant year. In addition, companies were unsure whether they should report the claw-back amount in 2020, or amend prior year returns to include the SBC costs in the cost pool for each open year.

In AM 2021-004, IRS concluded that SBC should be included in the cost pools under the cost sharing regulations. The tax agency also asserted that it could adjust the results of a cost sharing transaction in the year in which the intangible development costs were incurred under Reg. 1.482-7(i)(2), regardless of whether or not there was a reverse claw-back provision. As a result, taxpayers should consider filing amended returns for open years. Adjustments may be required for closed years as well as a result of the review methodology set forth in the memorandum.

The Role of Valuation

IRS's issuance of the LB&I practice unit and memorandum signals the agency's intent to enforce the regulation requiring the inclusion of SBC in CSAs. As a result, it is important for multinational companies to be proactive in mitigating or eliminating the risk of an adverse audit finding on this issue. One of the key aspects that multinational companies should analyze is the method they use to quantify the value of SBC.

The default method under the Sec. 482 cost sharing regulations for determining the measurement of SBC costs is the amount that would be allowed as a deduction. However, publicly traded companies may elect to use the fair value method of measuring SBC. Privately held companies should figure the tax cost of SBC using the FMV that is quantified based on a 409A valuation performed by an independent third-party appraiser.

In each case, using the FMV approach may more accurately reflect the current value of the SBC as a result of the economic turbulence created by the COVID-19 pandemic.

Other actions multinational companies can take include:

- Reevaluating tax return positions and tax accruals;
- Reviewing cost-sharing agreements to ensure that they comply with the Treasury regulation's requirements regarding SBC;
- Weighing the impact that a change to a CSA's treatment of SBC may have on platform contribution transaction valuations;
- Gauging the impact of a change to related party service agreements compensated on a cost-plus markup basis (note: although *Altera* addresses a CSA, IRS requires SBC to be included in service transactions as well);
- Determining if it would be beneficial to adopt a CSA that is not subject to the regulatory requirements at issue in *Altera*;
- Considering how to account for tax return positions under the recognition and measurement framework of ASC 740; and/or
- Identifying other relevant, practical approaches to dealing with the potential impacts to tax return positions.

The Takeaway

After winning a key court ruling on the issue, IRS issued administrative guidance that signals the agency's intent to increase audit activity related to the inclusion of SBC in CSAs. As a result, it is important for multinational companies to take steps to mitigate or eliminate the risk of an adverse audit finding on this issue. One of the key aspects that multinational companies should analyze is the method they use to quantify the value of SBC.

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2021 Legislative Update: Proposals Include Tax Increases for Businesses and Individuals

As we approach the end of 2021, Congressional Democrats are pursuing President Joseph Biden's tax policy agenda through two legislative measures: one bill focused on infrastructure and another on budget reconciliation. This 2021 legislative update summarizes the actions taken with respect to the pending legislation as of October 15, 2021, explains the steps that will be followed towards enacting the legislation, and provides highlights of some of the tax proposals along with resources to find out more about how they might impact your tax position. Please see Tax Policy Update: Biden's 2021 Tax Proposals for further details on the Biden administration's planned agenda and legislative priorities that set the stage for the current proposals.

Bipartisan Infrastructure Legislation

On August 10, 2021, the Senate approved the Infrastructure Investment and Jobs Act, which would provide approximately $1.2 trillion in federal funds for public transit, roads, bridges, water and other infrastructure-related items over the next several years. The legislation must next be approved by the House before it can receive President Biden's signature and be enacted into law. At this time, House leadership has indicated that they plan to hold a vote on the legislation before the end of October. Tax provisions in the measure include a new information reporting regime for digital assets, such as cryptocurrencies, an early termination of the Employee Retention Credit and several other tax-related measures. For further discussion on the tax proposals included in the infrastructure bill, see the Tax Release – Senate Approves Bipartisan Infrastructure Legislation; Releases Budget Resolution Framework.

Budget Reconciliation Legislation

Meanwhile, on August 9, 2021, Senate Democrats also released the FY2022 Budget Resolution Agreement Framework, which lays out the proposed guidelines and instructions for the House and Senate to follow in developing reconciliation legislation to address additional infrastructure and other policy priorities proposed by the Biden administration, including corporate and individual tax changes. The $3.5 trillion budget resolution was formally adopted on August 24, 2021 and includes a mix of tax policies that both increase and decrease tax revenue.

On September 15, 2021, the House Ways and Means Committee approved tax increase and tax relief proposals to be acted on by the House as part of the "Build Back Better" reconciliation legislation. For further discussion on the reconciliation process and the path to a signed bill see the Tax Release – Understanding the Reconciliation Process – Planning for Potential Law Changes.

Click this link to view the highlights of the tax proposals included in the House Ways and Means Committee's proposed budget reconciliation legislation.

The Takeaway

With slim margins of control in both houses, Congressional Democrats are pushing to enact two separate pieces of legislation this year that include significant changes to current tax law. Bipartisan infrastructure legislation is awaiting a vote in the House and would then need to be signed by President Biden to become law. Budget reconciliation legislation is also awaiting a vote in the House, and would then be considered by the Senate as a next step. The provisions included in the legislative text are likely to change as the bills move through the legislative process. However, taking steps now to plan for, and model, the potential impacts of the legislation may increase your ability to timely respond should the proposals become law.

For the latest developments on the pending tax proposals discussed above, see Andersen's Tax Policy and Legislative Updates page.