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IRS Answers Some, But Not All, Questions in Long-Awaited Cryptocurrency Guidance

Tax Talks Blog on **October 17, 2019**

The first official guidance on the taxation of cryptocurrency transactions in more than five years has been issued.

The guidance includes both a Revenue Ruling (Rev. Rul. 2019-24, 2019-44 I.R.B. 1) and answers to Frequently Asked Questions on Virtual Currency Transactions (the "FAQs," together with Revenue Ruling 2019-24, the "Guidance") was issued on October 9, 2019 by the U.S. Internal Revenue Service (the "IRS"). The Guidance provides much sought information concerning the tax consequences of cryptocurrency "hard forks" as well as acceptable methods of determining tax basis for cryptocurrency transactions. The Guidance also reasserts the IRS's position, announced in Notice 2014-21, 2014-16 I.R.B. 938, that cryptocurrency is "property" for U.S. federal income tax purposes and provides information on how the rules generally applicable to transactions in property apply in the cryptocurrency context. However, important questions remain unanswered. It remains to be seen whether more definitive regulatory or administrative guidance is forthcoming.

The Guidance comes amidst an ongoing campaign by the IRS to increase taxpayer compliance with tax and information reporting obligations in connection with cryptocurrency transactions. In 2017, a U.S. district court ordered a prominent cryptocurrency exchange platform to turn over information pertaining to thousands of account holders and millions of transactions to the IRS as part of its investigation into suspected widespread underreporting of income related to cryptocurrency transactions. Earlier this year, the IRS sent more than 10,000 "educational letters" to taxpayers identified as having virtual currency accounts, alerting them to their tax and information reporting obligations and, in certain cases, instructing them to respond with appropriate information or face possible examination. Schedule 1 of the draft Form 1040 for 2019, released by the IRS shortly after publishing the Guidance, would require taxpayers to indicate whether they received, sold, sent, exchanged, or otherwise acquired virtual currency at any time during 2019.[1]

Taxpayers who own or transact in cryptocurrency or other virtual currency should consider carefully any tax and information reporting obligations they might have. Please contact the authors of this post or your usual Proskauer tax contact to discuss any aspect of the Guidance. Read the following post for background and a detailed discussion of the Guidance.

Except where the context indicates otherwise, the tax consequences discussed in this post generally apply to transactions involving cryptocurrency held by a taxpayer as a capital asset. This post does not consider tax consequences other than U.S. federal income tax consequences.

Terminology

The Guidance describes a “virtual currency” as “a digital representation of value that functions as a medium of exchange, a unit of account, and a store of value,” other than a representation of the U.S. dollar or the official legal currency of a foreign country (referred to in IRS guidance as “real” currency). The term “virtual currency” as used in the FAQs includes digital currency, cryptocurrency, and any other asset having “the characteristics of virtual currency,” regardless of name, but is limited to virtual currencies that have an equivalent value in, or act as a substitute for, real currency (referred to as “convertible” virtual currencies).[2]

The Guidance defines a “cryptocurrency” as a virtual currency that uses encryption to secure transactions digitally recorded on a distributed ledger (for example, a blockchain, DAG, or Tempo). Although this blog specifically considers transactions involving cryptocurrency, certain of the rules discussed may apply to other forms of “convertible” virtual currency.

Tax consequences of “hard forks”: gross income inclusion depends on whether new cryptocurrency units are “received” by the taxpayer

Revenue Ruling 2019-24 specifically addresses the tax implications of a so-called “hard fork,” i.e., a change in the protocol (or software) of a cryptocurrency’s blockchain[3] that causes the new blockchain to permanently split off from the existing or “legacy” blockchain. Where the protocol on the legacy blockchain continues to be utilized by the legacy cryptocurrency, the result is two unique cryptocurrencies, each with its own blockchain, but sharing a common (pre-“fork”) history. In some hard forks, units of the new cryptocurrency are distributed to the distributed addresses of some or all of the account holders at the time of the split (referred to here as the “legacy holder”). The IRS refers to this type of distribution as an “airdrop.”

The immediate tax implications of a hard fork to a legacy holder under the Revenue Ruling depend on whether the holder “receives” units of the new cryptocurrency. The determination of receipt is based, in turn, on whether the new cryptocurrency has been distributed to the legacy holder and, if so, whether the taxpayer exercises sufficient “dominion and control” over the new units.[4]

If cryptocurrency units are distributed to a taxpayer via an airdrop (and the distribution occurs by reason of the taxpayer’s holding of the legacy cryptocurrency at the time of the fork)[5], the taxpayer generally will be considered to receive the units at the same date and time as the associated airdrop is recorded on the new blockchain, provided the taxpayer also has dominion and control over the units at that time. A taxpayer is considered to exercise dominion and control for this purpose if it has the ability to transfer, sell, exchange, or otherwise dispose of the units. In contrast, a taxpayer that is unable to transfer, sell, exchange, or dispose of the new units—for example, because the taxpayer’s wallet does not support the new cryptocurrency or the taxpayer holds its units on an exchange platform that does not support the new cryptocurrency—will not have dominion and control (and will not be considered in receipt of the cryptocurrency at the time of the airdrop). In the event the taxpayer later acquires the ability to transfer, sell, exchange, or dispose of the new cryptocurrency, the taxpayer will be treated as “receiving” the cryptocurrency at that later date. Although the Revenue Ruling indicates that other types of transfers may cause a taxpayer to be treated as receiving units created in the hard fork, the specific facts of the ruling only consider transfers via airdrop. The Revenue Ruling similarly indicates that a taxpayer may “constructively receive” cryptocurrency units *prior* to their airdrop into the legacy holder’s digital wallet, but does not provide any examples.

A legacy holder that does not actually (or constructively) receive units of the new cryptocurrency (i.e., because they are neither airdropped nor otherwise transferred to an account owned or controlled by the taxpayer) is not required to recognize income from a hard fork.

The amount of a taxpayer's gross income resulting from a hard fork will generally equal the fair market value of the new units at the time they are received by the taxpayer (in general, the time the airdrop is recorded on the new blockchain, provided the taxpayer has dominion and control over the new units). A taxpayer cannot apply any of its basis in the legacy cryptocurrency to reduce the amount of income recognized on receipt of the new units. While the Revenue Ruling does not provide guidance as to how fair market value is to be determined for this purpose, the FAQs indicate that the IRS will accept value calculated by a blockchain explorer (such as CoinMarketCap) based on an analysis of worldwide cryptocurrency indices as of a specific date and time.[6] A taxpayer that does not rely on the value provided by a blockchain explorer will have the burden of establishing value.

The Revenue Ruling also confirms that gross income recognized in a hard fork will be ordinary, without regard to the taxpayer's holding period in the legacy cryptocurrency units. While this treatment follows from general tax principles (for example, the taxation of lottery winnings and other forms of "free" money), it may come as a surprise (and a disappointment) to taxpayers expecting all gains or losses from cryptocurrency held as a long-term investment to be capital (and perhaps hoping to use other capital losses to offset any gain recognized as a result of a fork). The taxpayer's basis in the new cryptocurrency will equal the units' fair market value at the time of their receipt (generally, the amount of taxable income reported by the taxpayer). Although the Revenue Ruling does not specify, presumably the taxpayer's holding period begins on the day after it is received.[7]

Note that the facts of the Revenue Ruling specifically state that, following the hard fork, transactions involving the legacy cryptocurrency continued to be recorded on the legacy blockchain.[8] Neither the Revenue Ruling nor the FAQs expressly considers the situation where the hard fork results in all transactions moving to the new blockchain with the protocol of the legacy blockchain then abandoned. Where only a single blockchain is maintained following the hard fork, it may be more appropriate to treat this as a "soft" fork (i.e., changes in the protocol of a blockchain that do not cause a new cryptocurrency to be formed), which the FAQs indicate would not give rise to taxable income.[9] Where transactions actually do continue to occur on the legacy blockchain following the hard fork (as under the facts of Situation 2 of the Revenue Ruling), there is nevertheless a risk of character (and timing) mismatches should the legacy cryptocurrency decline in value as a result of the fork. Although not inevitable, devaluation of the legacy cryptocurrency, either as a result of perceived dilution or because of doubt about the survival of the legacy protocol, is certainly possible, particularly in the context of a contentious or "experimental" fork.[10] Whereas a taxpayer would recognize ordinary income upon receipt of the new units (whether or not sold), loss on the legacy units generally would not be recognized until a sale or other disposition, and any such loss would be capital rather than ordinary.

Determining basis in units sold or exchanged: specific identification or first-in, first-out (FIFO)

In order to calculate the taxable gain or loss realized upon a sale or exchange of cryptocurrency, a taxpayer must determine its basis in the units sold. Prior to the release of the Guidance, there was significant uncertainty surrounding the determination of basis and holding period where the taxpayer acquired units of cryptocurrency at different times and/or at different prices.

The FAQs apply rules of identification similar to those applicable to transactions in stocks and securities. By default, a taxpayer is treated as having sold its earliest-acquired units first, known as the “first-in, first out,” or “FIFO,” method.[11] However, if the taxpayer is able to “specifically identify” the units that are sold, exchanged, or otherwise disposed of in the transaction and can substantiate the basis in those units, it can use its actual basis in the specific units identified (generally, the cost to acquire those units).[12] The FAQs indicate that specific identification may be accomplished either by documenting the specific unit’s or units’ unique digital identifier (e.g., a private or public key and an address) or by providing records showing all transaction information for all units of a specific cryptocurrency held in a single account, wallet, or address. The documentation must show (1) the date and time each unit was acquired, (2) the basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged, or otherwise disposed of, and (4) the fair market value of each unit at the time of its sale, exchange, or other disposition and the amount of money or the value of property received for each unit.[13] Specific identification will also apply to the determination of the taxpayer’s holding period for purposes of determining whether any capital gain or loss recognized upon the sale or exchange is long-term or short-term.[14]

Guidance concerning determination of fair market value and other issues

Because cryptocurrency is treated as property for tax purposes, the tax consequences of a number of transactions involving cryptocurrency depend on the fair market value of the cryptocurrency. These include (but are not limited to) the amount of wage or self-employment income a taxpayer reports for compensation received in the form of cryptocurrency, the amount of a taxpayer’s charitable deduction if appreciated cryptocurrency is donated to charity, the amount of gain or loss recognized when cryptocurrency is sold for cash, and the amount of loss recognized by a taxpayer on the sale or disposition of cryptocurrency received as a gift.

The FAQs provide that the fair market value of cryptocurrency received in a transaction over an exchange platform is equal to the amount recorded by the platform for that specific transaction expressed in U.S. dollars. Where the transaction is “facilitated” by an exchange platform but is not recorded on the blockchain (an “off-chain” transaction), the fair market value is the trading price of the cryptocurrency on that exchange as of the date *and time* the transaction would have been recorded on the blockchain had it been an “on-chain” transaction.[15] For other transactions not conducted on an exchange, the taxpayer may rely on the price provided by a blockchain explorer (discussed above) for the applicable date and time, or else must establish that another value is an “accurate representation” of the cryptocurrency’s fair market value.[16] The fair market value of cryptocurrency received in exchange for property or services that is not traded on any exchange platform and does not have a “published value” is deemed to be equal to the fair market value of the services or property exchanged for the cryptocurrency at the time of the exchange.[17] While Notice 2014-21 required that a taxpayer determine fair market value as of the *date* of the transactions, the FAQs indicate that this determination must be made as of the specific date *and time* of a transaction, a subtle change that may have a material impact given the historic volatility of cryptocurrency trading prices over even the course of a single day.

Notice 2014-21 did not discuss specifically charitable donations of cryptocurrency or the receipt of cryptocurrency as a gift. The FAQs confirm that, consistent with cryptocurrency’s treatment as property for tax purposes, no gain or loss is recognized by a taxpayer on the donation of cryptocurrency assets to a charitable organization or on the receipt of cryptocurrency as a gift.[18]

The FAQs also confirm that a taxpayer generally will not recognize gain or loss on transfers of cryptocurrency between different wallets or accounts on different exchange platforms that are owned by the same taxpayer.[19]

Additional guidance forthcoming?

The Guidance is silent on a number of topics, including of the tax consequences of transactions involving non-currency blockchain assets and "simple agreement for future token," or "SAFT" arrangements, initial coin offerings, and token-based compensation awards; the tax treatment of mining activities, including the circumstances in which mining will constitute a trade or business; the tax consequences to an "issuer" of cryptocurrency in a hard fork; the tax and reporting consequences to non-US persons investing in, or engaging in other transactions involving, cryptocurrency; or the treatment of cryptocurrency assets and transactions under the subpart F or passive foreign investment company rules. It is also unclear whether the "receipt" principle announced in Revenue Ruling 2019-24 applies to cryptocurrency airdrops outside of the hard fork context—for example, unsolicited or "promotional" airdrops distributed to holders of other cryptocurrencies as part of a marketing campaign.

The Guidance notably does not contain a "de minimis" threshold for reporting gain or loss from cryptocurrency transactions. Absent such a threshold, taxpayers may find cryptocurrency unappealing or impractical as a medium of exchange for spot transactions, such as buying a cup of coffee or leaving a tip for a server, all of which would have to be reported to the IRS (and may result in taxable income to the consumer) under the existing guidance.

[1] IRS Form 14457, "Voluntary Disclosure Practice Preclearance Request and Application" (March 2019), also contains a box for taxpayers to indicate if the disclosure involves "Virtual Currency Issues."

[2] Examples of convertible virtual currencies identified by the IRS include Bitcoin, Ether, Roblox, and V-bucks. *See* https://www.irs.gov/businesses/small-businesses-self-employed/virtual-currencies.

[3] Although we use the term "blockchain," the concepts discussed should apply to any type of distributed ledger technology. The facts of the Revenue Ruling do not specify the type of distributed ledger used.

[4] *See also Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (generally defining "income" as an accession to wealth that is clearly realized and over which a taxpayer has complete dominion and control); section 61(a)(3).

[5] The facts of Situation 2 of the Revenue Ruling state that the taxpayer received the new cryptocurrency "solely because" of its ownership of the legacy cryptocurrency at the time of the fork.

[6] If the taxpayer held its legacy units on an exchange platform at the time of the airdrop of new units (and assuming the taxpayer has the requisite dominion and control for this to be a "receipt" of those units), it may be appropriate to use the closest exchange price reported by the platform, if available. *See* FAQs, Question 25 (the fair market value of cryptocurrency received in a transaction over an exchange platform is the amount recorded in U.S. dollars by the platform).

[7] *See* FAQs, Question 28 (holding period for cryptocurrency begins the day after it is "received"); *Fogel v. Commissioner*, 203 F.2d 347 (5h Cir. 1953) (a taxpayer's holding period excludes the date of acquisition).

[8] Question 21 of the FAQs is similarly limited to hard forks that result in the creation of a new cryptocurrency "in addition to" the legacy cryptocurrency.

[9] *See* FAQs, Question 29. This is consistent with the nonrecognition rule applicable to exchanges of common stock for common stock in the same corporation. *See* section 1036(a) of the Code; Treas. Reg. § 1.1036-1(a).

[10] In 2016, the developers of Ethereum caused a hard fork in the Ethereum protocol after a glitch enabled the theft of 3.6 million units of its cryptocurrency, Ether. Most (but not all) users abandoned the legacy protocol, with the result that within hours, legacy Ether (renamed Ether Classic) was trading at only 1/10 of the trading price of "new" Ether. As of this writing, transactions continue to occur on both the new and legacy blockchains.

[11] FAQs, Question 38.

[12] FAQs, Question 36.

[13] FAQs, Question 37.

[14] FAQs, Question 37.

[15] FAQs, Question 25.

[16] FAQs, Question 26.

[17] FAQs, Question 27. If cryptocurrency is used by a taxpayer to pay for services or property, the FAQs confirm that the gain or loss recognized by the taxpayer on the exchange will generally equal the difference between the taxpayer's basis in the units exchanged and the fair market value of the property or services received in the exchange. *See* FAQs, Questions 14, 16.

[18] *See* FAQs, Questions 30-34.

[19] FAQs, Question 35.

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