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IRS Cryptocurrency Guidance Leaves Unanswered Questions

By **Amy Lee Rosen**

Law360 (October 11, 2019, 3:58 PM EDT) -- After five years of silence, the Internal Revenue Service has released eagerly awaited cryptocurrency guidance addressing hard forks and airdrops, but the guidance leaves unanswered questions on cryptocurrency foreign reporting requirements, non-hard-fork airdrops and fair market value.

The IRS published a revenue ruling along with frequently asked questions on Wednesday that said the splitting of a cryptocurrency blockchain under a "hard fork," creating another cryptocurrency, does not create taxable income if the holder does not receive new currency. Taxable income is generated and must be reported as ordinary income if new currency is received via an "airdrop," which is a distribution of cryptocurrency units to the ledger addresses of multiple users, the guidance said.

The Internal Revenue Service's long-awaited guidance on cryptocurrency like bitcoin does not address the implications for foreign reporting requirements, among other issues.

While tax practitioners welcomed additional clarity on the tax treatment of cryptocurrencies, since the only other guidance on the topic was in a 2014 notice, they said it did not address several issues that still need clarification.

Foreign Reporting Requirements

Cryptocurrencies can be held not only in U.S. wallets but also in foreign wallets, and it remains unclear whether any of those foreign holdings must be disclosed on informational returns such as Reports of Foreign Bank and Financial Accounts or under the Foreign Account Tax Compliance Act.

FATCA, enacted in 2010, requires foreign financial institutions to examine their records to see if any customers are connected to the U.S. and if so, to report the account holders and assets to the U.S. Department of the Treasury. If a U.S. person has a financial interest in a foreign financial account, they must file an FBAR if the value of the account is more than $10,000.

Both FATCA and FBAR issues could arise when it comes to either U.S. citizens who hold cryptocurrency in a foreign wallet or to foreigners who hold cryptocurrency but have some sort of connection to the

U.S. But so far, the IRS has been silent on the matter, said Omri Marian, a professor of tax law at the University of California, Irvine, who specializes in international taxation.

“I don’t even know what a foreign wallet is or what makes a wallet foreign,” he said. “If the exchange is run by a foreign institution, is it a foreign institution for FATCA purposes?”

Since the government has not answered this or what happens if a U.S. citizen holds currency in a virtual wallet that operates outside the U.S., it is difficult to know if cryptocurrency holders are in compliance with information reporting requirements, Marian said.

“I expected the IRS to say something about it or at least say they’re thinking about it, but it doesn’t seem like they are,” he said.

The IRS did not offer an immediate response to questions about cryptocurrency issues not addressed in the guidance or FAQ.

Airdrops

The IRS said in the FAQ that an airdrop “is a distribution of cryptocurrency to multiple taxpayers’ distributed ledger addresses” and that when an airdrop follows a hard fork, it is a taxable event, and the cryptocurrency is treated as ordinary income equal to the fair market value when it is received. The guidance, however, did not address how to treat an airdrop that happens when a hard fork does not precede it, according to Sarah-Jane Morin, a partner at Morgan Lewis & Bockius LLP who works in complex business transactions.

“Airdrops are more typically used in marketing purposes,” she said. “So if you’re launching a crypto and want to airdrop it for free to new users, that may be one way you’d target it for your new launch, and that is not addressed here.”

However, an example in the revenue ruling may help, Morin told Law360.

As explained in the example, if someone receives new cryptocurrency with a fair market value of $50 that is airdropped to the person's ledger, that qualifies as a taxable accession to wealth since the recipient has dominion and control over the asset, as he or she can immediately dispose of, sell or exchange the new currency. For tax purposes, $50 would be included in the recipient's gross income, and the new coin would have a basis of $50, the IRS said.

If new cryptocurrency is received through an airdrop that does not follow a hard fork, it is likely the IRS will conclude that a free receipt of cryptocurrency should be taxed in a similar way, Morin said.

“However, it would be helpful to have more information with how to treat airdrops more generally and not just in connection to the hard fork,” she said.

Fair Market Value

Calculating the fair market value of a new currency may be problematic since a new coin may not be widely traded, and its value on a market may not be easily ascertainable, according to S. Starling Marshall, a partner in Crowell & Moring LLP's tax and litigation groups.

“I think the challenge is going to be that there might be some issues with how to calculate what the fair market value is of those new coins,” she said.

Question 26 of the FAQ says the fair market value of new cryptocurrency from an airdrop can be determined by a blockchain reporter, a tool that analyzes worldwide indices. But if a blockchain reporter cannot be used, one has to establish the value by an accurate representation, which makes proving value far more difficult, said James Foust, a cryptocurrency tax analyst and former senior research fellow with cryptocurrency advocacy group Coin Center.

“How do you calculate fair market value for something that just came into existence where there may not be liquid markets or fundamental exchanges available?” Foust asked.

A better approach would be to allow the cryptocurrency user to be able to ignore one of the forks entirely and have 100% basis allocation to one post-fork token and nothing to the other, he said. Alternatively, the IRS could, after a reasonable time frame, such as 30 days after the hard fork, determine fair market value once there are markets for both post-fork tokens, and then it would be easier to determine and substantiate those values, Foust said.

Dominion and Control

The revenue ruling says a taxable event occurs only when the airdrop results in new cryptocurrency in which the holder has “dominion and control,” but it is unclear, beyond having the ability to sell, dispose or exchange the asset, what this term specifically means.

John Servidio, a partner at Goodwin Procter LLP who speaks publicly about cryptocurrencies and blockchain technology, told Law360 having dominion and control over cryptocurrency typically involves the receipt of a private key, which is a small bit of code that can be paired with a public key to access cryptocurrency.

Think of the public key as an address for a safe, so that people know where an asset is located, while the private key is the code to the safe that allows someone access to its contents, he said. So if one has a private key, that means they have dominion and control over the cryptocurrency because with that, they can transfer, sell, exchange or otherwise dispose of that cryptocurrency, Servidio said. The guidance, however, did not mention private keys, he said.

The only explanation that the IRS provided for “dominion and control” was in the revenue ruling, which said dominion and control has occurred when a new cryptocurrency recipient’s new coin is recorded on a distributed ledger and the holder has the ability to dispose of that asset.

“We need more information on what dominion and control means and specifically clarify it’s the possession of the private key," Servidio said. "One would assume that, but [the guidance] doesn’t say that.”

--Editing by John Oudens.