

## IRS Rules New Cryptocurrency From Hard Forks Is Taxable

by Nathan J. Richman and Kristen A. Parillo

The IRS has ruled that receipt of new currency in a hard fork is taxable in what is only the second piece of guidance on the tax treatment of cryptocurrencies it has issued.

The October 9 release of Rev. Rul. 2019-24, 2019-44 IRB 1, and accompanying FAQs addresses the tax treatment of forks as well as specifying acceptable methods for calculating and assigning cost basis.

The action provides “much-needed guidance in virtual currency reporting,” James N. Mastracchio of Eversheds Sutherland (US) LLP told *Tax Notes*. “The announcement today is also important given the recent letters issued to taxpayers who may not have been compliant in reporting their crypto transactions.”

Stakeholder groups had urged the IRS to issue new guidance, explaining that many questions remained unanswered by Notice 2014-21, 2014-16 IRB 938.

In that March 2014 notice, the agency’s first formal piece of guidance on the topic, the IRS said that virtual currencies such as bitcoin should be treated as property rather than currency for federal income tax purposes and that general tax principles regarding property transactions apply to transactions using virtual currency.

While the latest batch of guidance addressed some pressing issues, particularly on the treatment of forks, taxpayers will need answers to a host of other questions, said Sarah-Jane Morin of Morgan, Lewis & Bockius LLP.

### Hard Forks

The revenue ruling addresses the tax consequences for a taxpayer whose cryptocurrency went through a hard fork, which refers to a change to the software of cryptocurrency that creates two separate versions of the blockchain with a shared history.

According to the IRS, whether the taxpayer has gross income under section 61 in those circumstances depends on whether new cryptocurrency associated with the fork is airdropped to the taxpayer’s account. An airdrop

is a distribution of a cryptocurrency token or coin, usually for free, to multiple wallet addresses.

If the taxpayer doesn’t receive new cryptocurrency, he or she doesn’t have gross income. However, if the taxpayer does receive new cryptocurrency, then he or she has gross ordinary income.

The IRS’s analysis is helpful, “particularly if you’re looking at the treatment of forks and any airdropped cryptocurrency associated with a fork, in terms of the IRS’s perspective and what they would view as accession to wealth,” said Morin.

*Whether a taxpayer whose cryptocurrency went through a hard fork has gross income under section 61 depends on whether new cryptocurrency associated with the fork is airdropped to the taxpayer’s account, the IRS says.*

Nevertheless, it would have been helpful for the IRS to address an airdrop outside the hard fork context, Morin said.

“For example, what happens if you had an airdrop for a marketing purpose or to garner interest in a new forum for people using some sort of blockchain digital asset?” Morin asked.

Monte A. Jackel of Jackel Tax Law noted that the revenue ruling has no effective date. “That means it is fully retroactive,” he said. “Shouldn’t these be regs? I think it is a revenue ruling to finesse the section 7805 effective date. That should not be allowed.”

Jackel noted that Treasury’s March policy statement on the tax regulatory process promised no new law using revenue rulings. “Was this ruling appropriate?” he wondered.

### FAQs

The 43 FAQs accompanying Rev. Rul. 2019-24 address a wide range of additional issues.

Apart from the relatively obvious statements that transactions involving virtual currencies are taxable events, that gain or loss on those events is determined by reference to a taxpayer’s basis in the currency, and that gifts of cryptocurrency

aren't taxable to the recipient, the FAQs describe how to compute that basis in several situations.

For cryptocurrencies purchased for fiat currency, the basis is the amount spent to buy the cryptocurrency, including acquisition costs like commissions, with further basis adjustments common to normal capital assets.

The issue of taxpayers receiving virtual currency in remuneration for services raises a few questions. The IRS notes that those payments are wages or self-employment income, as appropriate, and subject to employment taxes. The basis in that cryptocurrency will be the fair market value on receipt.

The IRS notes that taxpayers need to compute gain or loss when using virtual currencies to pay for goods or services. Gain or loss should be computed by comparing the value of the goods or services with the taxpayer's basis in the currency, and the taxpayer's new basis in a purchased capital asset would be its FMV at the time of purchase.

Similarly, a seller receiving cryptocurrency for a piece of property takes a basis in that currency of its FMV, in dollars, on receipt.

A taxpayer dealing in cryptocurrency through an exchange can rely on the value recorded by the exchange if the transaction is on the particular currency's distributed ledger, but must trace the value at the time of the transaction if the transaction is off-chain.

***Taxpayers need to compute gain or loss when using virtual currencies to pay for goods or services, the IRS says.***

For transactions not facilitated by a cryptocurrency exchange, the IRS said that it will accept evidence of FMV from blockchain or cryptocurrency explorers that analyze worldwide indices. If the currency isn't traded on an exchange and doesn't have a published value, the IRS says to look to the value of the other part of the transaction — that is, the item or service purchased or sold.

For cryptocurrency received as a gift, a taxpayer calculates basis differently for gains than for losses. Gains are compared with the donor's basis increased by any gift tax paid, but losses are

compared with the lower of the donor's basis and the FMV of the currency on receipt. "If you do not have any documentation to substantiate the donor's basis, then your basis is zero," the IRS said.

The IRS said that a taxpayer disposing of one of several units of virtual currency can decide which units are disposed of. This will help taxpayers who want to use the unit with the highest basis in the transaction to minimize gain. If the taxpayer doesn't specifically track the unit of currency used, the IRS will default to first-in, first-out tracking.

### **Helpful but Not 'Substantial Authority'**

Morin said it was helpful to see the IRS approve of, even if only in FAQs, both specific identification and FIFO as the default alternative. Taxpayers and practitioners had assumed that those methods of basis tracking were available, but it's helpful to see the IRS's limited blessing of them, she said.

Mastracchio said that the IRS's allowance of both specific identification and FIFO could provide taxpayers with meaningful planning opportunities.

It was also helpful to see the IRS affirm that a taxpayer with multiple wallets or exchange accounts moving cryptocurrency between those wallets or accounts doesn't have a taxable event, Morin said. The same is true for the IRS's position that an otherwise valid charitable donation doesn't become a taxable event if the donation is virtual currency, she added.

Jackel pointed out that a taxpayer applying the FAQs won't be able to rely on them to defeat assertion of a penalty because they aren't "authority" for the purposes of reg. section 1.6662-4.

A taxpayer taking a position supported by substantial authority can avoid imposition of the section 6662 substantial understatement penalty. But, as Jackel noted, the reg doesn't list FAQs as one of the possible authorities to consider.

Morin said the reduced clout of the FAQs means that taxpayers looking to take contrary positions might still have room to do so. Those taxpayers should keep the IRS's positions in the FAQs in mind but will have legal room to present

well-crafted legal arguments for the positions they would prefer, she said.

Mastracchio said that the guidance will be useful for taxpayers when they start on their 2019 tax returns and even for those finishing their 2018 tax returns filed on extension.

### More Questions

Morin said the largest issue not addressed by the revenue ruling and FAQs is taxpayer and practitioner requests for a de minimis exception.

“There’s nothing in here that says if you had only bought a couple of pizzas, then you would not have to report your gain and loss accordingly,” she said, adding that she expects taxpayers and legislators to be frustrated by that outcome.

Also not addressed are wash sale issues, Morin said. “A lot of people are trading or exchanging cryptocurrencies frequently and arguably fall under the wash sale or straddle rules, which may in turn affect the basis in their assets,” she explained.

The tax treatment of initial coin offerings is also an open question. “Typically, we use analogies to the corporate context and stock issuances or debt-offering-type analogies, but I can’t say the IRS would or wouldn’t agree with those analogies, because we don’t have guidance in that area,” Morin said.

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Morin said the tax treatment of people who perform mining or validations as part of a ledger also needs to be addressed. “Are they part of a deemed partnership with the exchange, or are they service providers for tax purposes? Or are they something else we haven’t thought of?”

How cryptocurrency interacts with international tax provisions is another major area of uncertainty, Morin added.

“Just by virtue of the nature of cryptocurrency and where a lot of exchange is and a lot of participants sit in terms of the global infrastructure, we’re still waiting on guidance on how to treat these types of transactions and assets from an international tax perspective,” Morin explained.

How those assets should be viewed for purposes of the global intangible low-tax income regime, subpart F, and the passive foreign investment income rules is especially critical, Morin said.

“Do we need to worry about those issues, and if we do, to what extent and how do we analyze them?” Morin asked.

### Forms

The IRS has started adding references to virtual currency to a few forms and their instructions. For example, Form 14457, “Voluntary Disclosure Practice Preclearance Request and Application,” and Forms 433-A and -B, “Collection Information Statements,” each now contain boxes for virtual currency.

While the current Form 1040 and Schedule B don’t mention virtual currency, the instructions for Schedule D, “Capital Gains and Losses,” do. The same pattern holds for Form 1041, “U.S. Income Tax Return for Trusts and Estates.”

There is a similar pattern for transfer tax returns: Form 706, “United States Estate (and Generation-Skipping Transfer) Tax Return,” doesn’t mention virtual currencies, but the instructions to Form 709, “United States Gift (and Generation-Skipping Transfer) Tax Return,” do.

No Forms 1099 mention cryptocurrency and neither do the partnership or corporate income tax returns, even on their Schedules D. ■