Commentary

Cryptocurrency

Investment Compliance

IRS Releases New Cryptocurrency Tax Guidance on Hard Forks, Lot Relief and More

Author

Stevie D. Conlon
Vice President, Tax and Regulatory Counsel
Wolters Kluwer

Anna Vayser
Product Manager, Withholding Tax Products
Wolters Kluwer

Robert Schwaba
Senior Tax & Regulatory Specialist
Wolters Kluwer

October 11, 2019 - On Wednesday, October 9, 2019, the IRS released two important items addressing key tax questions that arise in connection with cryptocurrency (such as Bitcoin, Ethereum and more) sold, exchanged or received by taxpayers: Rev. Rul. 2019-24 regarding the tax consequences of hard forks and a Virtual Currency FAQ containing 43 questions. The last substantive guidance on cryptocurrencies issued by the IRS was Notice 2014-21, over five years ago.

Although both new items are consistent with existing law in many respects, they are likely to be controversial because they provide for tax consequences undesirable to taxpayers. Many taxpayers may also find this guidance inconsistent with their prior tax reporting (or the lack thereof). Moreover, Rev. Rul. 2019-24 may be questioned because of flaws in its technical description of blockchain ledger processes relating to hard forks or because of its implicit retroactive effective date. As a result, challenges by taxpayers, their advisors and representatives to their holdings seem likely.

Rev. Rul. 2019-24

Revenue Ruling 2019-24 addresses two issues. First, does the hard fork of a virtual currency result in gross income under Sec. 61 of the IRC when a taxpayer owning the forked virtual currency does not receive units of a new cryptocurrency? Second, does a taxpayer have gross income under Sec. 61 as a result of an airdrop following the hard fork if a taxpayer receives units of a new cryptocurrency in the airdrop?

The Ruling defines a hard fork as a technological protocol change resulting in a permanent diversion from the legacy distributed ledger. It defines an airdrop as a means of distributing units of a cryptocurrency to multiple addresses on a distributed ledger. These definitions conform broadly, but not accurately, to the way these terms are used in the cryptocurrency industry. This flaw may cause some to argue that the Ruling holdings are not correct. However, these facts could have been modified or clarified and the same holdings may nevertheless be appropriate.

The legal analysis of the Ruling is straightforward; Sec. 61(a)(3) of the IRC provides that absent some excluding provision, gross income includes all income, from whatever source derived. Therefore, any accession to wealth over which the taxpayer has dominion should be included in gross income. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 451 (1955). "Found property" generally results in taxable income to the finder under U.S. income tax law. See *Cesarini v. U.S.*, 296 F.Supp. 3 (N.D. Ohio 1969). Capital gain treatment is not available because there was no sale or exchange of the existing cryptocurrency owned by the taxpayer in the facts set forth in the ruling, and no special provision of law otherwise provides for capital gain treatment.

The Ruling further provides that a taxpayer generally has dominion over cryptocurrency received via airdrop at the time it is recorded in the distributed ledger. However, taxpayers holding cryptocurrency via a third party may receive control of airdropped cryptocurrency later (and implicitly, at different times). In the latter situation, the taxpayer is treated as receiving the airdropped cryptocurrency at the time the taxpayer acquires the ability to transfer, sell, or otherwise dispose of the airdropped cryptocurrency. Since virtual currency is property, the taxpayer's basis in the new cryptocurrency received is equal to the amount of gain included in gross income.[1]

The Ruling proceeds to lay out two separate examples. In the first, a taxpayer holds 50 units of a cryptocurrency that undergoes a hard fork without a distribution of new cryptocurrency. In the second, a taxpayer holds 50 units of a cryptocurrency that undergoes a hard fork with a distribution of 25 units of a new cryptocurrency.[2]

In the first example, the Ruling provides that as the taxpayer has not received any new cryptocurrency or other cash or property, there is no taxable income. In the second example, the Ruling provides that when units of the new cryptocurrency are recorded on the distributed ledger, the taxpayer has dominion and control and, therefore, has taxable income and basis equal to the fair market value of the units of the new cryptocurrency received at the time of distribution.

Revenue Ruling 2019-24 does not include an explicit effective date. Thus, it is implicitly retroactively effective. This appears controversial.

Virtual Currency FAQ

The 43 frequently asked questions expand upon the examples initially provided in Notice 2014-21. They generally only apply to taxpayers who hold virtual currency as a capital asset, and range in scope from the very basic ("What is virtual currency?") to more complex ("How do I determine my basis in virtual currency that I received as a bona fide gift?").

The questions in the FAQ are organized to address several broad categories of issues. Questions 1-7 address similar basic issues of timing and gain or loss to those addressed in the previous Notice 2014-21. The next set of questions (Q8-Q14) address receipt or payment of virtual currency in exchange for services. Questions 15-20 address basic gain/loss and basis issues.

The next broad category, questions 20-29, is concerned with the fork issues presented in Revenue Ruling 2019-24, including timing and amount of income from hard forks and cryptocurrency received in various ways. FAQ answers 25 and 26 provide additional details regarding how a taxpayer should determine the fair market value of cryptocurrency received, including from trading platforms

---

[1] Note that FAQ A24 further provides that "your basis in that cryptocurrency is equal to the amount you included in income on your Federal income tax return."

[2] Understanding the first example in the ruling, Situation 1, hinges on interpretation of precisely what the Ruling means by "legacy" and "new" distributed ledger and cryptocurrency. It seems unlikely that the Ruling is intended to create a rule that results in a technological upgrade being deemed a distribution of "new" cryptocurrency on a "new" distributed ledger. However, from a purely technological standpoint, a hard fork that is a technological upgrade might be understood to create a "new" distributed ledger distinct from the old ledger, with identical address holdings of a new, distinct cryptocurrency being traded instead of the old, legacy cryptocurrency. Automatic migration by wallet software may mask this from end users. This is particularly evident where, for example, some users disagree with the change and continue to use the old technology and the old ledger.

and in peer-to-peer (P2P) transactions, or other transactions that do not involve a cryptocurrency exchange. In P2P transactions, A26 provides in part that "[t]he IRS will accept as evidence of fair market value the value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates the value of the cryptocurrency at an exact date and time."

Questions 30-35 address specific applications of gift and charitable contribution rules. Questions 36-39 provide information about tax lot relief methods and questions 40-43 delineate information reporting concerns.

The FAQ includes unique rules that a taxpayer must satisfy in order to specifically identify a particular lot of cryptocurrency as sold. A37 of the FAQ provides that a taxpayer can document "the specific unit's unique digital identifier such as a private key, public key and address..." Alternatively, a taxpayer can identify a particular lot by records that "... show (1) the date and time each unit was acquired, (2) your 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 when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit." These rules are different from the IRS's specific identification rules generally applicable to stock and bonds and could present documentation challenges. If these requirements aren't met, A38 of the FAQ provides that units are deemed sold on a first-in, first-out (FIFO) basis.

Conclusion

Rev. Rul. 2019-24 and the Virtual Currency FAQ are important new items of tax guidance, particularly given the many open questions relating to tax calculations and reporting for cryptocurrencies. Although this guidance is intended to be helpful, it will likely not be taken positively by many. It simply isn't "the Droids" taxpayers are looking for...

Stevie D. Conlon is a vice president and regulatory tax counsel for Wolters Kluwer and has written and spoken extensively on legal matters relating to financial products and compliance.

Anna Vayser, CPA is a product manager with Wolters Kluwer.

Robert Schwaba, JD is a senior tax and regulatory specialist with Wolters Kluwer.

Contact: Anna Vayser at (847) 267-7826 or Robert Schwaba (847) 267-2026.

About Wolters Kluwer Governance, Risk & Compliance

Governance, Risk & Compliance (GRC) is a division of Wolters Kluwer, which provides legal and banking professionals with solutions to ensure compliance with ever-changing regulatory and legal obligations, manage risk, increase efficiency, and produce better business outcomes. GRC offers a portfolio of technology-enabled expert services and solutions focused on legal entity compliance, legal operations management, banking product compliance, and banking regulatory compliance.

Wolters Kluwer (AEX: WKL) is a global leader in information services and solutions for professionals in the health, tax and accounting, risk and compliance, finance and legal sectors. Wolters Kluwer reported 2018 annual revenues of €4.3 billion. The company, headquartered in Alphen aan den Rijn, the Netherlands, serves customers in over 180 countries, maintains operations in over 40 countries and employs 18,600 people worldwide.

Wolters Kluwer

When you have to be right