

Additional IRS guidance on virtual currency transactions

Overview:

On October 9, 2019, the IRS issued guidance relevant to transactions involving virtual currency. The guidance came in the form of a Revenue Ruling (Rev. Rul. 2019-24), and Frequently Asked Questions which apply to taxpayers holding virtual currency as a capital asset ("FAQs", together referred to as the "IRS guidance"). The IRS guidance addresses many areas associated with virtual currency transactions including tax accounting, valuation, reporting, charitable contributions, and the tax implications of "hard forks" and airdrops.

Background:

The IRS guidance related to virtual currency transactions confirms much of our understanding of the tax treatment of virtual currency transactions; however, in some cases, the guidance is limited or based on uncommon fact patterns. Taxpayers and practitioners should review the IRS guidance to determine its applicability to historical, present, or future transactions involving virtual currencies. Because the guidance is in the form of a Revenue Ruling and FAQs, the IRS is likely to apply it retroactively. Transactions in this space can have differing tax treatments based on the specifics of the protocols and types of virtual currencies. It is important to have a solid understanding of the specific facts associated with each virtual currency transaction as you apply the IRS guidance. Further, it may be necessary to reference additional authoritative guidance in determining the appropriate tax treatment of these transactions. Moreover, FAQs, while insightful into the current views of the IRS, are non-authoritative guidance that can be updated or changed by the IRS with little notice.

Issue:

In Notice 2014-21, the IRS stated that convertible virtual currency is treated as property for federal income tax purposes and provided examples intended to illustrate how general income tax principles would apply to transactions using virtual currency. The recently issued FAQs provide several additional examples that continue to emphasize that longstanding federal income tax principles applicable to property will apply to virtual currency in the same manner, notably with respect to: determining gain or loss on sale of virtual currency, determining gain or losses on exchanges of virtual currency (e.g., for services or other property), determining basis on the

purchase of virtual currency, as well as the treatment of the receipt of virtual currency as remuneration for services or wages. While the IRS guidance reiterates many of the areas addressed in Notice 2014-21, it also confirms several of the conclusions that tax practitioners have advocated in serving the industry.

It is important to note that the FAQs are stated as only applicable to taxpayers who hold virtual currency as a capital asset and do not address other uses. Further, the FAQs clarify that the guidance is intended to cover assets that have the characteristics of virtual currencies (defined as a digital representation of value that functions as a unit of account, a store of value, or a medium of exchange). The Revenue Ruling notably carves out from the definition of virtual currency digital representations of the US dollar or foreign currency.

Rev. Rul. 2019-24 Hard Fork Guidance

Rev. Rul. 2019-24 is intended to clarify the federal income tax consequences resulting from a hard fork. The Revenue Ruling describes a hard fork as occurring when a “cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion” from the legacy distributed ledger (“Legacy Ledger”) and results in a new distributed ledger (“New Ledger”). As a result of the hard fork, taxpayers may find themselves with two virtual currencies: one based on their ownership of the virtual currency applicable to the Legacy Ledger, and a second based on the new virtual currency applicable to the New Ledger. If no new currency is received in the hard fork, the Revenue Ruling holds that a taxpayer will not have income.

Prior to the issuance of the Revenue Ruling, many taxpayers were uncertain of the tax treatment of the new virtual currencies resulting from a hard fork and whether and when income would need to be recognized with respect to these new virtual currencies. The Revenue Ruling provides two examples. The first example illustrates the tax consequences related to a “hard fork” (sometimes also referred to as a “chain split.”) Examples of Bitcoin chain splits include Bitcoin Cash (August 1, 2017), and Bitcoin Gold (October 24, 2017). A taxpayer controlling the credentials to bitcoin prior to either chain split would have controlled a corresponding number of bitcoin cash or bitcoin gold after the chain split. Thus, for example, a taxpayer having 10 bitcoins prior to Bitcoin Cash chain split would have had 10 bitcoin cash, along with his 10 bitcoins, after the chain split. No payment of money or exchange of property occurred, nor did the taxpayer give up any rights. The second example illustrates the tax consequences related to an airdrop (occurring after a hard fork). Mechanically, an airdrop is a distribution of virtual currency to addresses on an existing (or, as illustrated in the Revenue Ruling, new) distributed ledger. Most often, an airdrop is an unsolicited distribution of property used to bootstrap a new virtual currency into existence by putting it in the hands of existing virtual currency holders. The Revenue Ruling held that a taxpayer does not have gross income as a result of a hard fork if the taxpayer does not “receive” units of the new cryptocurrency. In the case of an airdrop following a hard fork, the taxpayer was held to have ordinary gross income when the new cryptocurrency was received subject to the taxpayer having dominion and control. The Revenue Ruling describes

dominion and control as the point in time when the taxpayer has the ability to dispose of an airdropped cryptocurrency. This may lead to questions because dominion and control, including under the IRS's own policy, generally requires more than the mere ability to dispose of unsolicited property.

Rev. Rul. 2019-24 does not directly address the consequences of an airdrop without a hard fork.

FAQs on Virtual Currency Transactions

In Notice 2014-21, the IRS stated that virtual currency is treated as property for federal income tax purposes and provided examples that illustrate how general income tax principles would apply to transactions using virtual currency. The recently issued FAQs provide several additional examples that continue to emphasize that longstanding federal income tax principles applicable to property will apply to virtual currency in the same manner, notably with respect to: determining gain or loss on sale of virtual currency, determining gain or losses on exchanges of virtual currency (*e.g.*, for services or other property), determining basis on the purchase of virtual currency, as well as the treatment of the receipt of virtual currency as remuneration for services or wages.

Importantly, the FAQs provide guidance on specifically identifying the cost of tax lots of virtual currency upon disposition. The guidance does not exactly follow the rules which apply to stocks and securities (perhaps because broker confirmations are unavailable); however, it is analogous.

The FAQs also provide guidance that may be helpful in clarifying certain issues specific to virtual currency transactions which may not have previously been clear to taxpayers:

Recognition Events

- Virtual currency is received on the date and time the transaction is recorded on a distributed ledger provided the taxpayer can transfer, sell, exchange, or otherwise dispose of the cryptocurrency on such date.
- Cryptocurrency that goes through a "hard fork" will result in gross income to a taxpayer only if it receives new cryptocurrency as a result and has dominion and control over such currency.
- Transactions involving virtual currency received in exchange for another virtual currency, received in exchange for services, or provided to another taxpayer in exchange for services is a taxable transaction.
- So-called "off-chain" transactions (*i.e.*, transfers of cryptocurrency not reflected on a distributed ledger) are recorded as gross income at the fair market value that the cryptocurrency was trading for on a cryptocurrency exchange at the date and time the transaction would have been recorded on a distributed ledger had the transaction occurred on a distributed ledger.

Valuation

- The amount to be included in gross income on account of the receipt, sale, or exchange of virtual currency is determined as the fair market value of such virtual currency

on the date of receipt.

- Cryptocurrency received through a cryptocurrency exchange is valued at the amount recorded by the cryptocurrency exchange for that transaction in U.S. dollars.
- In transactions in which cryptocurrency is not received through a cryptocurrency exchange, the IRS will accept as evidence of fair market value the values determined by a cryptocurrency or blockchain explorer that calculates value based on worldwide indices of cryptocurrency.
- If a taxpayer does not receive cryptocurrency through a cryptocurrency exchange and the taxpayer does not use a cryptocurrency or blockchain explorer to determine value, the taxpayer must find other means to establish that the value used is an accurate representation of the cryptocurrency's fair market value.

Reporting

- In the case of a sale, exchange, or other disposition taxpayers that hold multiple units of a single type of virtual currency which were acquired at different times and for which there may be different basis amounts may choose which units are deemed to be sold, exchange, or otherwise disposed if they can specifically identify and substantiate the basis and holding period of those units. Taxpayers that do not specifically identify units sold must use a first-in-first-out approach to determine the basis of the units sold, exchanged, or otherwise disposed.
- Taxpayers must report income, gain, or loss from all taxable transactions involving virtual currency on the federal income tax return for the taxable year of the transaction, regardless of whether the taxpayer received a payee statement (*e.g.*, Form W-2 or Form 1099) during that year.
- The cost of fees and commissions are included in determining the basis of purchased virtual currency.

Gifts and Donations

- Cryptocurrency is "property" for gift tax purposes – it is not treated as cash or any other currency. This means that no income is recognized upon receipt of a bona fide gift. The basis in cryptocurrency follows carry-over basis rules for other property – namely carryover basis (plus gift tax paid by the donor) if sold for a gain, or if sold for a loss, carryover basis or fair market value at the time of gift receipt (whichever is lower). In addition, cryptocurrency follows the standard property rules for holding periods – the donor's holding period is counted for the donee's holding period. Finally, standard valuation requirements are required to report donations of cryptocurrency, which would normally require a qualified appraisal under gift tax regulations.
- Cryptocurrency is "property" for charitable donation purposes – it is not treated as cash or any other currency. This means that no income, gain, or loss is recognized when donated to a charitable organization. Moreover, the cryptocurrency is valued at fair market value, if held greater than 1 year. If the cryptocurrency has been held 1

year or less, then the basis in the cryptocurrency or the fair market value (whichever is lower) will be the allowed deduction.

- The FAQs do not address whether cryptocurrency is a “publicly traded security” for charitable donation purposes. If it is not, then a qualified appraisal made by a qualified appraiser is required to substantiate any charitable tax deduction in excess of \$5,000. Moreover, all formal substantiation requirements for charitable deductions (proper reporting on Form 8283, *Noncash Charitable Contributions*, contemporaneous acknowledgment letters that meet all regulatory guidance, etc.) must be followed.

Contact:

If you have any questions or would like additional information regarding the tax treatment of virtual currency transactions, please contact your Deloitte engagement team.

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