GMS Flash Alert

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United States - IRS Guidance on Taxation of Cryptocurrency

On October 9, 2019, the U.S. Internal Revenue Service (IRS) issued new guidance on the tax treatment of virtual currency.[1] It is intended to help taxpayers understand tax and reporting obligations for transactions involving virtual currency, including the tax treatment of "hard fork" transactions. Also, on October 11, 2019, the IRS released a draft of Schedule 1 to Form 1040, which would require taxpayers to answer whether they had any transactions in virtual currency during the tax year.[2]

WHY THIS MATTERS

The issuance of this new guidance and the proposed amendment of Schedule 1 form part of the IRS' Virtual Currency Compliance campaign that was initiated in July 2018[3] and emphasizes that the tax consequences of virtual currency or "cryptocurrency" transactions are an area of focus for the IRS.

For most taxpayers it may come as a shock to find that they may have taxable income and reporting obligations by reason of holding an interest in cryptocurrency, or making or receiving payments using cryptocurrency. The new guidance also clarifies the income tax treatment of certain transactions that are unique to cryptocurrency, such as "hard forks" and "air drops."

Tax Treatment of Cryptocurrency

Background

Cryptocurrency such as Bitcoin uses blockchain technology to secure and record transactions on a distributed ledger. Units of cryptocurrency are generally referred to as "coins" or "tokens." Simply put, blockchain is a shared collection of data which uses cryptography to confirm transactions or entries which are recorded on a "block."[4] Each block containing a certain amount of entries is sequentially linked, creating a "chain" of information. Blockchain is a type of distributed ledger, which records and synchronizes transactions using independent digital systems spread across several locations, or among multiple peers in a network. This is different from the traditional centralized system for financial transactions in that it does not require a clearing house or an intermediary like a bank to clear and authenticate transactions.

Hard Forks and Air Drops

As stated above, concepts such as hard forks and airdrops are unique to cryptocurrency. A hard fork is a significant shift in blockchain protocol that creates a new branch of blockchain, resulting in a new cryptocurrency. It is similar to a fork in the road, where a single path splits into two. An airdrop is when units of cryptocurrency are distributed to existing ledger addresses of multiple taxpayers. A ledger address is a single-use destination where cryptocurrency is sent and received. An airdrop is a form of promotional activity on the part of a blockchain project that can occur with or without the knowledge of the taxpayer; it does not necessarily need to follow a hard fork. This is because airdrops serve various purposes such as: (i) to generate "buzz" and awareness about a particular cryptocurrency, (ii) information collection, (iii) to incentivize and reward loyalty among existing holders, (iv) wider distribution of the cryptocurrency, and (v) the distribution of new cryptocurrency following hard forks. The focus of Rev. Rul. 2019-24 is the tax consequences of airdrops following hard forks.

The New Guidance

Revenue Ruling 2019-24 and the related FAQs represent the first substantive guidance issued by the IRS on cryptocurrencies since the issuance of Notice 2014-21,[5] which provided general guidance on the tax consequences of cryptocurrency transactions. Specifically, the 2014 Notice provided that cryptocurrencies should be treated as property rather than foreign currency for federal income tax purposes.

Revenue Ruling 2019-24 addresses issues that were not addressed by the 2014 Notice, and specifically sets out the income tax consequences of hard fork and airdrop transactions.

According to the new guidance: (i) a taxpayer does not recognize gross income as a result of a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive any units of a new cryptocurrency; however (ii) a taxpayer does recognize gross income, ordinary in character, as a result of an airdrop of new cryptocurrency following a hard fork if the taxpayer receives units of a new cryptocurrency. The amount of the gross income to be recognized is the fair market value of the new cryptocurrency. The key factor in the second situation is whether the taxpayer has "dominion" and "control" over the cryptocurrency. If the taxpayer is able to "transfer, sell, exchange, or otherwise dispose of the cryptocurrency," which will be the case once the cryptocurrency has been recorded in the taxpayer's distributed ledger, then the taxpayer has the requisite degree of dominion and control. In instances where the taxpayer's ledger at a cryptocurrency exchange does not get credited because the exchange does not yet support the new cryptocurrency, the taxpayer does not have dominion until the new cryptocurrency is credited.

While virtual currency such as cryptocurrency is generally treated as a capital asset and taxed as such, airdropped units of new currency are taxed as ordinary income. The amount of ordinary income is the fair market value of the new units at the time the airdrop was made.

Updated FAQs

The FAQs issued by the IRS in conjunction with Rev. Rul. 2019-24 expand on the guidance provided in Notice 2014-21 and provide guidance on additional situations. For example, the FAQs clarify that when cryptocurrency is received as remuneration for services, such payments should be treated as wages or self-employment income and are subject to employment taxes. Also, when a taxpayer uses cryptocurrency to pay for good or services, gain or loss should be computed by comparing the value of the good or services with the taxpayer's basis in the cryptocurrency.

In general, the guidance provided in the FAQs is based on the fundamental principle that cryptocurrency is treated as property and general tax principles applicable to property transactions apply to transactions using cryptocurrency.

Draft Form 1040, Schedule 1

The draft Schedule 1 for 2019 released by the IRS includes the following "Yes/No" question: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any cryptocurrency?" It remains to be seen whether this question will be included in the final version of Schedule 1 for 2019. If so, it will represent an important tool for the IRS for collecting information on taxpayers who may have reportable income from cryptocurrency transactions.

FOOTNOTES:

1 Revenue Ruling 2019-24 and accompanying Frequently Asked Questions (FAQ).

2 See the early release draft of Schedule 1 at https://www.irs.gov/pub/irs-dft/f1040s1–dft.pdf .

3 See the IRS announcement of compliance campaigns at https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns .

4 For more on blockchain, see the play-back of The Power of Blockchain Webcast Series: "Understanding Blockchain – It's Not Just about Crypto" from KPMG LLP (U.S.) presented in February 2019.

5 IRS Notice 2014-21.

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