Cryptocurrency Meets Tax Accounting

A Review of IRS Guidance and Practical Questions Affecting Taxpayers

January 31, 2019
ABA Section of Taxation – Midyear Meeting

Tax Accounting
Panel Participants
Panel Participants

— Moderator:  **Michael Resnick**, Eversheds Sutherland
— Panelists:  **Karen Messner**, BDO  

**Shanthy Balachanthiran**, Florida Rural Legal Services, Inc.

**John Moriarty**, Associate Chief Counsel – Office of Chief Counsel, Income Tax & Accounting

**Chris Wrobel**, Special Counsel – Office of Chief Counsel, Income Tax & Accounting
Agenda

- Overview – What is cryptocurrency?
- Current Law
  - Notice 2014-21
  - October 2019 FAQs (43)
- Outstanding Questions
What is cryptocurrency?

• According to the IRS, virtual currency is a digital representation of value, other than a representation of the U.S. dollar or a foreign currency, that functions as a unit of account, a store of value, and a medium of exchange.

• Some virtual currencies are convertible, which means that they have an equivalent value in real currency or act as a substitute for real currency, i.e., Bitcoin.

• Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.

• A transaction involving cryptocurrency that is recorded on a distributed ledger is referred to as an “on-chain” transaction; a transaction that is not recorded on the distributed ledger is referred to as an “off-chain” transaction.
Notice 2014-21 - Overview

• Issued by the IRS on March 25, 2014
• “Describes how existing tax principles apply to transactions using virtual currency”
  • Multiple references to non-direct authorities on general tax principles
    • Pub 525, Taxable and Nontaxable Income
    • Pub 551, Basis of Assets
    • Pub 544, Sales and Other Dispositions of Assets
• Reminder – IRS allows taxpayers to rely on Notices during controversy with IRS at administrative level, Notices do not have force and effect of law and do not bind courts
• Limited in scope to “convertible virtual currency” as defined in the Notice
For FIT purposes, virtual currency is treated as property, not currency.

General tax principles apply.

In receipt of virtual currency as payment, must include FMV of virtual currency (as measured in USD) as of the date the virtual currency was received in computing gross income.

Basis of virtual currency received as payment = FMV.

Taxpayers recognize gain or loss upon exchange of virtual currency for other property.

Character of gain/loss depends on whether virtual currency is capital asset in hands of taxpayer.

If a taxpayer mines virtual currency, taxpayer realizes gross income upon receipt of virtual currency.
Rev. Rul. 2019-24 - Overview

• Released by IRS on October 9, 2019
• Accompanied by 43 FAQs which address more specific taxpayer concerns
• Generally addresses tax treatment of hard forks and air drops as well as specifying acceptable methods for calculating and assigning cost basis
• Provides guidance by walking through two examples, relevant law and related analysis and conclusions

• Addresses two issues:
  • Situation 1 → Does a taxpayer have §61 gross income due to a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency?
  • Situation 2 → Does a taxpayer have §61 gross income subsequent to an air drop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency?

• According to the ruling,
  • Hard fork – occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent division from the legacy or existing distributed ledger
    • May result in creation of new cryptocurrency, may not
  • Airdrop – means of distributing units of cryptocurrency to the distributed ledger addresses of multiple taxpayers
    • May follow a hard fork, but not always
Rev. Rul. 2019-24 – Authorities Relied Upon by IRS

- Relevant Law
  - Section 61 – all income from whatever source derived
  - *Glenshaw Glass* – all accessions to wealth, clearly realized, over which the taxpayer has complete dominion
  - Sections 1222/1231/1234A – ordinary income unless gain is from the sale or exchange of a capital asset
  - Section 1011 – adjusted basis is §1012 cost basis
  - Sections 61/1011 generally – if property not purchased, FMV basis of asset
  - Section 451 – income recognition (cash method upon receipt, accrual upon AET satisfied)

• Facts
  • TP holds 50 units of Crypto M
  • On Date 1, distributed ledger of crypto experiences a hard fork
  • Hard fork results in creation of new Crypto N
  • Crypto N is not airdropped or transferred to an account of taxpayer

• Analysis and Holding
  • Taxpayer did not receive units of Crypto N
  • Therefore, taxpayer does not accession to wealth and does not have gross income under section 61 subsequent to hard fork

• Facts
  • Taxpayer holds 50 units of Crypto R
  • On Date 2, distributed ledger for Crypto R experiences a hard fork
  • Hard fork results in creation of new Crypto S
  • On Date 2, 25 units of Crypto S are airdropped to taxpayer’s account and taxpayer has immediate use of Crypto S
  • On Date 2, at Time 1 (time of airdrop), the FMV value of 25 units of Crypto S is $50
  • Taxpayer provided no services, received Crypto S merely because owner of Crypto R

• Analysis and Holding
  • Subsequent to airdrop, taxpayer received a new asset, Crypto S
    • Accession to wealth (§61) and OI in year of receipt (§61, §451)
    • Taxpayer had dominion and control because could immediately use
    • Amount of gross income = $50, i.e., FMV of Crypto S upon receipt
    • Basis of 25 units of Crypto S = $50, i.e., amount of income recognized
October 2019 FAQs - Overview

- 43 in total
- FAQs are not one of possible authorities a taxpayer can rely on to avoid imposition of §6662 substantial understatement penalty
- Address wide range of issues
- Generally provide:
  - Transactions involving virtual currencies are taxable events
  - Gain or loss on those events are determined by reference to a taxpayer’s basis in the currency
  - Gifts of cryptocurrency are not taxable to the recipient
- Detailed examples of how to compute basis in various situations
October 2019 FAQs – Highlights (1 of 3)

• Virtual currency ("VC") = digital representation of value, other than real currency, that functions as a unit of account, a store of value, and a medium of exchange

• Cryptocurrency ("crypto") = type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger (i.e., a blockchain)

• VC is treated as property, general tax principles applicable to property transactions apply to VC transactions
October 2019 FAQs – Highlights (2 of 3)

- Gain recognition upon sale of VC
- Holding period less than one year – short-term capital gain; holding period longer than one year – long-term capital gain
- Gain/loss = amount received less adjusted basis
- Basis = generally, cost basis (inclusive of fees, commissions, other acquisition costs)
- If receive in exchange for services/good, ordinary income upon receipt
  - Amount equal to FMV of VC when received
  - Can constitute self-employment income
  - Subject to employment tax withholding, FICA, FUTA and W-2 reporting requirements
October 2019 FAQs – Highlights (3 of 3)

- Soft fork = no income
- Hard fork, but no new crypto = no income
- Hard fork, followed by airdrop = income equal to FMV, with basis the amount included as income on return
- Addresses various FMV calculations under different scenarios
- Receipt of VC as gift = no income until you sell, exchange, or dispose of VC
  - Holding period for VC as gift includes holding period of giver
- No income if donate VC to charity (deduction amount equals FMV of VC)
- Transfer among personal digital wallets is not taxable event