22 October 2019
Global Tax Alert

US: New cryptocurrency tax guidance addresses some open questions, leave others unanswered

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

On 9 October 2019, the United States (US) Internal Revenue Service (IRS) issued guidance on the tax treatment of cryptocurrency transactions. In Revenue Ruling 2019-24, the IRS ruled that a "hard fork" (e.g., when one cryptocurrency becomes two) will not cause taxpayers to recognize income under Internal Revenue Code[1] Section 61. Taxpayers will recognize ordinary income, however, if they receive new units of cryptocurrency (i.e., an "airdrop") following the hard fork.

In frequently asked questions (FAQs), the IRS expands on its 2014 cryptocurrency guidance (Notice 2014-21) by providing more examples of (i) when taxpayers recognize gain or loss on an exchange of cryptocurrency, (ii) how to calculate basis in cryptocurrency, and (iii) when taxpayers recognize income on other cryptocurrency-related transactions.

Detailed discussion

Background

Under Section 1011, a taxpayer's adjusted basis for determining the gain or loss from the sale or exchange of property is the cost or other basis determined under Section 1012, adjusted to the extent provided under Section 1016.

Building a better working world

For property received as a gift, the donee's basis depends on whether gain or loss is involved. For gains, the donee's basis generally equals the adjusted basis in the hands of the donor (including any gift taxes paid as a result of the transfer). For losses, the donee's basis generally equals the lower of (i) the fair market value (FMV) of the gift at the time of the transfer or (ii) the donor's adjusted basis at the time of transfer.

Section 451 requires a cash-method taxpayer to include an amount in gross income in the tax year it is actually or constructively received. An accrual-method taxpayer generally includes an amount in gross income no later than the tax year in which all the events have occurred that fix the right to receive the amount.

Revenue 2019-24

The ruling deals with two fact patterns. In both fact patterns, a taxpayer owns 50 units of a particular cryptocurrency, and the distributed ledger for each cryptocurrency undergoes a hard fork. In the first fact pattern, the taxpayer does not receive any additional cryptocurrency following the hard fork. In the second fact pattern, 25 units of a new cryptocurrency are airdropped to the taxpayer's distributed ledger address, and the taxpayer can dispose of the new cryptocurrency. Following the airdrop, transactions related to each cryptocurrency are recorded on separate distributed ledgers (i.e., a distinct distributed ledger for each cryptocurrency).

The ruling clarifies a hard fork and airdrop timing issue that was previously unresolved. When a hard fork is followed by an airdrop, the cryptocurrency is generally received when it is recorded on the distributed ledger. A taxpayer that does not have dominion and control over the cryptocurrency, however, does not receive the cryptocurrency when the airdrop is recorded on the distributed ledger. When the taxpayer later acquires the ability to transfer, sell, exchange, or otherwise dispose of the cryptocurrency, the taxpayer is treated as receiving the cryptocurrency at that time. For accrual-method taxpayers, the cryptocurrency accrues when the "all events" test is satisfied.

The ruling characterizes the receipt of new cryptocurrency from a hard fork as ordinary income. When a hard fork does not result in an airdrop, the taxpayer does not have taxable income.

Accordingly, if a hard fork occurs in Year 1, but taxpayers don't gain access to the new cryptocurrency until Year 2, the ruling supports deferring recognition until Year 2. Taxpayers that previously reported taxable income from a fork may want to revisit their filed returns if they reported the income before having dominion and control over the underlying cryptocurrency.

While addressing previously open questions on hard forks and airdrops, the ruling still leaves many issues unanswered. No determinations have been made on the applicability of the wash sale rules, de minimis exceptions, the tax treatment of initial coin offerings and security token offerings, the tax treatment for those receiving tokens in connection with providing proof of stake, or how cryptocurrency interacts with international tax rules. In addition, guidance is needed on whether merely trading cryptocurrencies in the United States can give rise to income that is effectively connected with a US trade or business.

The ruling provides another reminder that the IRS is focused on enforcement and collection activities in the cryptocurrency space. As the ruling only provides limited guidance on a limited set of issues, taxpayers should continue seeking assistance on the many remaining unanswered questions.

FAQs

The FAQs explain basis determinations for taxpayers holding virtual currency, as well as when taxpayers recognize income on certain cryptocurrency transactions.

The FAQs define the basis of airdropped cryptocurrency as the FMV of the cryptocurrency when the taxpayer can exercise dominion and control over the cryptocurrency (e.g., basis equals FMV at the time of "receipt"). Again, the taxpayer includes income from the cryptocurrency transaction in gross income in the tax year received. The FAQs also clarify that the income is ordinary in character.

The basis of cryptocurrencies purchased with fiat currency equals the amount spent to buy the cryptocurrency, including acquisition costs like commissions. Presumably, for a fiat currency that is a nonfunctional currency, the basis would equal the fair market value of that currency, although the IRS does not state this explicitly.

Taxpayers receiving virtual currency from an employer as remuneration for services rendered receive payments that are classified as wages or self-employment income and are subject to employment or self-employment taxes. The basis in that cryptocurrency will be the FMV on receipt.

A seller receiving cryptocurrency for property takes a basis in that cryptocurrency equal to the FMV, in dollars, of the cryptocurrency received at the time of the sale.

In keeping with standard gift tax rules, basis determinations for cryptocurrency gifts depend on whether gains or losses are involved. When calculating gains, the donee's basis equals the donor's basis, increased by any gift tax that the donor pays; when calculating losses, the donee's basis equals the lower of (i) the donor's basis or (ii) the FMV of the currency on receipt. If a donor lacks documentation to substantiate the basis, the donee's basis is zero. The receipt of the gift does not cause the donee to recognize income (though it may, as noted, trigger gift tax liability for the donor). For purposes of determining gains and losses, a donee's holding period in virtual currency includes the time that the donor held the virtual currency.

Taxpayers using virtual currencies to pay for goods or services should compute gain or loss by comparing the value of the goods or services with the taxpayer's basis in the currency. The taxpayer's new basis in a purchased capital asset would be its FMV at the time of purchase.

The FAQs further confirm that individuals may transfer virtual currency between their "wallets" (i.e., a digital account through which a cryptocurrency is tracked, received or spent) without incurring tax. Additionally, taxpayers disposing one of several units of cryptocurrency can specify which units are disposed. 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 specify the unit of cryptocurrency used, the IRS will default to first-in, first-out (FIFO) tracking.

Forms

The IRS has started adding references to virtual currency to a few forms and their instructions. A taxpayer must report ordinary income from virtual currency on Form 1040, *U.S. Individual Tax Return*, Form 1040-SS, Form 1040-NR, or Form 1040, Schedule 1, *Additional Income and Adjustments to Income (PDF)*, as applicable. Taxpayers must calculate and report capital gain or loss from virtual currency and other capital transactions in accordance with IRS forms and instructions, including Form 8949, *Sales and Other Dispositions of Capital Assets*, and then summarize capital gains and deductible capital losses on Form 1040, Schedule D, *Capital Gains and Losses*.

A recently released second draft of Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, includes the following question: "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" The wording is similar to the question included on Form 1040, Schedule B, asking taxpayers whether they have interests in offshore accounts. This suggests that the IRS's enforcement of cryptocurrency reporting could resemble its enforcement of offshore accounts reporting.

Implications

Revenue Ruling 2019-24 provides welcome guidance on how to treat new cryptocurrency that is airdropped after a hard fork. Before this guidance, taxpayers and practitioners may have viewed the new cryptocurrency as having zero basis and no tax consequences at the time of receipt. Others, while considering the new cryptocurrency non-taxable upon "receipt," may have apportioned basis between the new cryptocurrency and the cryptocurrency that existed immediately before the hard fork.

In addition, the revenue ruling provides some welcome guidance on recognition timing by conditioning receipt of the new cryptocurrency on the taxpayer's dominion and control over the new cryptocurrency. At the same time, the revenue ruling raises a new issue as to what is meant by dominion and control. Additional guidance could be needed to explain this, depending on the facts and circumstances of different forks and airdrops.

The FAQs provide welcome insight into how the IRS will consider computations of gains and losses on various cryptocurrency transactions, along with the IRS's views on information reporting requirements under certain circumstances. Many answers are consistent with conclusions that taxpayers reached before guidance was released. Having written affirmation of how the IRS will consider these transactions, however, is helpful in eliminating prior confusion.

Now that guidance has been released, taxpayers should review previously filed returns to confirm that they accurately reported gains and losses from cryptocurrency transactions. Taxpayers might need to consider amending returns to comply with the new guidance. For example, taxpayers that failed to include the FMV of cryptocurrencies airdropped after a hard fork should consider whether they must amend a previously filed tax return.

In addition, taxpayers should consider whether an accounting method change is warranted for previously filed tax returns, as FAQ 37 allows taxpayers to either specifically identify or default to FIFO when computing basis for cryptocurrency

sales or exchanges. In the absence of guidance, some taxpayers may have used an impermissible accounting method to compute tax basis. Taxpayers that may have used an impermissible method of accounting should consider applying for a change of accounting method.

Taxpayers and tax return preparers should continue monitoring progress on Form 1040, Schedule 1, *Additional Income and Adjustments to Income*. A 30-day comment period on the schedule began on 11 October 2019. If the form is finalized as currently drafted, taxpayers and tax return preparers may have to file Schedule 1 solely to indicate whether they engaged in cryptocurrency transactions. While a taxpayer with no cryptocurrency transactions should not have an issue, taxpayers that must answer "yes" and have no other reason to file Schedule 1 could accidentally fail to respond to the question.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United States), Blockchain/Cryptocurrency Tax Center of Excellence

- Michael Meisler, *New York* michael.meisler@ey.com
- Matthew Stevens, *Washington, DC* matthew.stevens@ey.com
- David Golden, *Washington, DC* david.golden@ey.com

Ernst & Young LLP (United States), Private Client Services

- Marianne Kayan, *Washington, DC* marianne.kayan@ey.com
- John Fusco, *Washington, DC* john.fusco@ey.com
- Rosy Lor, *Washington, DC* rosy.l.lor@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 004769-19Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com