TAXATION

Understanding the IRS Cryptocurrency Updates

By: Eric P. Rothenberg, Esq.

For the first time since the IRS issued guidance in 2014 (IRS Notice 14-21), the IRS has twice spoken about cryptocurrency despite Congress practically begging for guidance in September 2018 (mscpaonline.org/lettertoirs). And while the IRS did answer some questions, there are still far too many left out.

On October 10, 2019, the IRS released IR-2019-167 which they thought was "additional guidance." It's only a one-page release but it does reference new Frequently Asked Questions (FAQs). The FAQs on cryptocurrency include 43 questions and can be found at mscpaonline.org/irsfaqvcts.

Additionally, the IRS issued Revenue Ruling 2019-24 which deals with the tax consequences of a "hard fork" and "airdrop" to owners of cryptocurrency when those events occur. The Revenue Ruling does provide the IRS' thinking and analysis on how they conclude that some of those events are taxable to taxpayers, and is the basis of the answers in the FAQs dealing with those same events (see questions 21 to 24 at mscpaonline.org/irsfaqvcts).

One of the more interesting FAQs is question 42 which asks where a taxpayer can get more information on tax treatments for cryptocurrency. The entire answer is "Information on virtual currency is available at IRS.gov/virtual_currency." Many questions about the tax treatment of virtual currency can be answered by referring to Notice 2014-21 and Rev. Rul. 2019-24. The link they provide just circles around to the FAQs and the revenue ruling. So in sum, the only available IRS guidance now are those 43 questions and answers.

Before I address the issues of hard forks and air drops, as discussed in Revenue Ruling 2019-24, I need to first explain what they are. First, a "hard fork" is a change in the way the blockchain ledger works. It is a change that can occur with any virtual currency and not just Bitcoin. It can occur where there is no exchange and there is just a blockchain ledger. Since this is a change in the protocol used by all miners of tokens or coins, they all must know about the change

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and agree to use the new protocol. The change instituted is a change on the software protocols, and once it happens, there is a "fork" in the protocol to allow the old currencies to stay and new currencies to use the new protocols. This is what happened to create Bitcoin Cash, Bitcoin Gold and other prominent but non-Bitcoin forks. The forks can be created to protect chains that have security flaws or were already hacked.

There are also "soft forks." The hard fork results in two (or more) chains being created, while the soft fork results only in one new chain with the old one going away. Soft forks, for example, were created on both the Bitcoin and Ethereum blockchains to implement new and upgraded functionalities that are also backwards compatible. Knowing the difference between a hard fork and a soft fork is very important because a soft fork is not a taxable event (see FAQ question 29). The IRS treats this as a mere change in the software (i.e., protocols) and therefore, no new asset is created so no taxable event happened.

And then there is the "airdrop." An airdrop is when virtual tokens or coins are passed down to the holders of records in a blockchain following a fork. The original coins are called "parent coins" and then new coins are often only airdropped to those who held on to their parent coins as a reward for the confidence and holding.

Let's also look closely at:

- Question 35: *"Will I have to recognize income, gain or loss if I own multiple digital wallets, accounts or addresses capable of holding virtual currency and transfer my virtual currency from one to another?* No. If you transfer virtual currency from a wallet, address or account belonging to you, to another wallet, address or account that also belongs to you, then the transfer is a non-taxable event, even if you receive an information return from an exchange or platform as a result of the transfer."

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Surely, if you have Bitcoin on multiple digital wallets and you move them around there is not a tax consequence. But what we really want to know is, if you move it and exchange or trade the coins for a different coin, is that a taxable event? The very next question mentions "one kind of virtual currency" but question 35 doesn't use that phrase to distinguish between different kinds of virtual currency, so it doesn't help the tax practitioner.

- Questions 36 and 37 deal with "specific identification" for sales or exchanges when you have different basis amounts for the same type of currency but purchased at different times. The IRS has now given us guidance and their requirements to do that. You do that by identifying a specific unit of virtual currency, either by documenting the unit's unique digital identifier such as a private key, public key or address – or by records showing the transaction information for all units of a specific virtual currency, such as Bitcoin, held in a single account, wallet or address. This information must 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. It is very helpful to have at least their view of what is required since such guidance has been missing for many years.

- It is quite interesting that question 38 states that if you don't use the specific identification method above, then you must use First In, First Out (FIFO) and apparently, they are not open to using Last In, First Out (LIFO). There is no more information on that, so while the IRS' FAQs are not law, it does appear that there is no good reason why you cannot use LIFO. This is especially true if you used this method in the past and prior to the IRS' issuance of IR-2019-167, as any other method should be considered a change in accounting methods.

Believe it or not, that's all the guidance in their FAQs. In my practice, I not only see many other problems in reporting these transactions, but there are still many unanswered questions. For example, we must file a Report of Foreign Bank and Financial Accounts (FBAR) when the taxpayer has accounts and exchanges in a foreign country, and they exceed the threshold for reporting. But there are many exchanges that move around or, even more difficult, they have no home country and the exchange itself may be in multiple places and countries. A second example is when taxpayers engage in robot currency trading (software driven) and these are available on exchanges overseas as well. These large-volume exchanges are very difficult to account for by the average taxpayer who comes to see me and is lost about what to do. Another unanswered issue is that while the IRS is clear (in question 22) that a hard fork followed by an airdrop is a taxable event, it doesn't state clearly that an airdrop after a soft fork is non-taxable although it seems it clearly is non-taxable.

With many of my own clients who filed with cryptocurrency in 2017, the IRS has sent letters to check with 1099-Ks received from exchanges such as Bitcoin, to verify the return reported all amounts on the 1099-K. Because you could treat exchanges of cryptocurrency as a like-kind exchange in 2017, I have reported some exchanges on Form 8949 for a sale of a capital asset. But in 2017, I also reported many transactions on Form 8824 (tax free exchanges) when the taxpayer traded currencies among various exchanges. The IRS sent letters to my clients claiming that not all amounts from the 1099-K were reported, even though the bulk were reported on Form 8824. If you had a client that reported a real estate sale on Form 8824, it would not go on Form 8949 or Schedule D, and you would not get a letter from the IRS. However, with their eyes now on reports of cryptocurrency sales, they haven't figured out the connection between those two forms.

I trust that now the revenue ruling and FAQs are published, the IRS will issue future guidance on cryptocurrency, and I predict there will be Tax Court cases on the horizon as well.

Also, please note the IRS has added a new line on Schedule 1 of Form 1040 asking the taxpayer: "At any time during 2019, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?" This means the IRS really considers this an important question and most tax prep software companies will likely require the preparer or taxpayer to answer that question to electronically file a return. ◆

MSCPA member Eric P. Rothenberg, Esq. is partner at Orsi Arone Rothenberg Turner, LLP in Needham. Contact him at erothenberg@oarlawyers.com.