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IRS Issues Long-Awaited Guidance on Virtual Currency

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The Internal Revenue Service ("IRS") issued highly anticipated guidance on taxation of virtual currencies by publishing Revenue Ruling 2019-24 and posting a series of 43 [Frequently Asked Questions](#) ("FAQs") on its website. In addition, it issued a draft schedule to be attached to an individual's 2019 Form 1040 or Form 1040-SR, which discloses whether or not the taxpayer received a financial interest in virtual currency during 2019.

This guidance supplements Notice 2014-21 that was issued in March 2014, where the IRS took the position that virtual currency should be treated as property for federal income tax purposes.

I. Taxation of Property Transaction Principles Apply

Consistent with the IRS' approach in Notice 2014-21, the guidance generally applies principles related to the taxation of property transactions to virtual currency transactions. It is important to note that the newly issued FAQs generally apply to taxpayers holding virtual currency as a capital asset (as opposed to inventory). The following examples appear in the FAQs:

- The sale of virtual currency will result in capital gain or loss subject to any limitations on the deductibility of capital losses. (FAQ 4.)
- Gain or loss will be the difference between adjusted basis in the virtual currency and the amount received in exchange for the virtual currency. (FAQ 6.)
- Whether the gain or loss is long-term or short-term depends on whether the virtual currency was held for more than one year before selling or exchanging it. (FAQ 5.)
- The basis in the virtual currency is the amount spent to acquire the virtual currency, including fees, commissions and other acquisition costs in U.S. dollars. (FAQ 7.)
- If appreciated virtual currency was used to obtain either goods or services, then the transferor will be required to recognize gain on the transfer. The gain is the difference between the fair market value of the property (or service) received and the basis in the property given up. (FAQs 14, 15.)
- Basis in virtual currency received in an arm's length taxable exchange will be the fair market value of the virtual currency received. (FAQ 20.)



- Virtual currency received as a bona fide gift is not income to the recipient. For purposes of determining gain, the basis for the donee is equal to the donor's basis, plus any gift tax the donor paid on the gift. For purposes of determining a loss, the basis for the donee is equal to the lesser of the donor's basis or the fair market value of the virtual currency at the time of the gift.¹ (FAQs 30, 31.)

These examples follow the general tax principles relating to the taxation of property transactions. However, the IRS has received requests from tax practitioners regarding particular transactions involving virtual currency. See ABA Letter to IRS, *Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017*, (March 19, 2018); AICPA Letter to IRS, *Updated Comments on Notice 2014-21: Virtual Currency Guidance*, (May 30, 2018).

II. Hard Forks and Airdrops

In Revenue Ruling 2019-24, the IRS addressed the taxation of two transactions unique to cryptocurrency: hard forks and airdrops. The IRS summarized its description of a hard fork as follows:

A hard fork is unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.

For example, on August 1, 2017, Bitcoin engaged in a hard fork which split into bitcoin (BTC) and bitcoin cash (BCH). Other examples of Bitcoin hard forks include bitcoin gold in October 2017, bitcoin diamond in November 2017, and superbitcoin, bitcoin hot, and lightning bitcoin in December 2017.

The IRS has identified an airdrop as a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers. Rev. Rul. 2019-24. A hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency. *Id.*

The taxation of the hard fork and airdrop depends upon whether the taxpayer can exercise dominion and control over the newly issued virtual currency. *Id.* The IRS observed that a taxpayer would not have dominion and control if the address to which the cryptocurrency was airdropped into a wallet managed through a cryptocurrency exchange if the exchange does not support the newly created cryptocurrency. *Id.* In that regard, the taxpayer could not sell or exchange the virtual currency. If the taxpayer later obtains the ability to transfer, sell, exchange, or otherwise dispose of the virtual currency then taxpayer would have income at that time. *Id.*

As a practical reality, this may encourage holders of virtual currency to move their digital assets to exchanges that do not support the air-dropped tokens in order to defer the recognition of income. In fact, the taxpayer could choose to transfer the air dropped tokens to an exchange that supports those tokens only when the taxpayer wishes to sell those tokens.



The amount of income to be recognized in an airdrop is the fair market value of the virtual currency, so long as the taxpayer has dominion and control over the virtual currency, presumably at some point in the future. (FAQ 23.) Likewise, the basis in the newly received virtual currency is the amount that was included in income on the income tax return. (FAQ 24.)

As a practical matter, it could be very difficult to determine the fair market value of the airdropped tokens as they may not be listed on an exchange, and therefore, may not have an ascertainable fair market value or may have no initial value at all.

III. Soft Forks

In a soft fork, the same blockchain is maintained, but some changes to the related software are made such that the blockchain functions somewhat differently after the soft fork. ABA Letter to IRS, *Tax Treatment of Cryptocurrency Hard Forks for Taxable Year 2017*, (March 19, 2018). A soft fork is analogous to the release of a new version of an existing variety of software. *Id.* The IRS stated that “[b]ecause soft forks do not result in [taxpayers] receiving new cryptocurrency, [taxpayers] will be in the same position [they] were in prior to the soft fork, meaning that the soft fork will not result in any income....” (FAQ 29.)

IV. Charitable Contribution Deductions

Virtual currencies can be contributed to charities and can support a charitable contribution deduction. Gain or loss is not recognized on the contribution of appreciated virtual currencies. (FAQ 33.) The amount of the charitable contribution depends upon the length of time the virtual currency is held before contribution.

Generally, if the virtual currency has been held for more than one year, the donation is equal to the fair market value of the virtual currency at the time of the donation. (FAQ 33.) However, if the virtual currency has been held for one year or less at the time of the donation, the deduction is the lesser of (i) basis in the virtual currency or (ii) the virtual currency’s fair market value at the time of the contribution. (FAQ 34.)

V. Specific Identification of Virtual Currencies for Disposition

One area in which tax practitioners were eager to see guidance was whether taxpayers would be permitted to identify particular virtual currency as part of a disposition. An inability to specifically identify particular digital assets could have resulted in significant gains for those taxpayers with very low basis but a high fair market value in virtual currencies.

The IRS will allow specific identification by either (i) documenting the specific unit’s unique digital identifier, such as a private key, public key, and address, or (ii) by records showing the transaction information for all units of a specific virtual currency held in a single account, wallet, or address. The information must show:

1. The date and time each unit was acquired;
2. The 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.



(FAQ 37.) If a taxpayer cannot specifically identify the digital asset(s), then the taxpayer must utilize a first-in, first-out (FIFO) accounting method.

VI. Unanswered Questions

While the additional IRS guidance is welcome in providing guidance for tax professionals, there remain outstanding questions and gray areas:

- How will tokens issued pursuant to initial coin offerings be taxed?
- Are tokens treated as equity for federal income tax purposes?
- How are prepaid forward contracts for the future purchase of tokens (i.e., SAFTs) treated for federal income tax purposes?
- Will virtual currency held overseas be considered a commodity (or something else) for purposes of Subpart F income? If a commodity, does it qualify for the safe harbor under IRC § 864(b)(2)(B) that would allow foreign investors to avoid engaging in a U.S. trade or business? Will foreign investment in virtual currencies in the United States be considered to be engaged in a U.S. trade or business?

VII. Draft 2019 Tax Return Form

The IRS has also recently published a draft tax return form that requires individual taxpayers to disclose whether they acquired virtual currency in 2019. The draft Schedule 1 to Form 1040 or Form 1040-SR, asks:

At any time in 2019 did you receive, sell, exchange, or otherwise acquire any financial interest in virtual currency?

The draft form can be found [here](#).

Whether a taxpayer received, sold, or exchanged virtual currency should be relatively straight forward; however, the term “or otherwise acquire[d] any financial interest” is exceptionally broad. Presumably, this would cover virtual currencies over which the taxpayer does not have dominion and control. Additionally, this could easily cover tokens that a taxpayer has acquired through an initial coin offering (ICO).

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¹ If the donee does not have any documentation to substantiate the donor's basis, then then the donee takes a basis of zero.

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