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INSIGHT: Cryptocurrency Taxation—Recent Guidance Is a Good Start, But More Is Needed

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On Oct. 11, 2019, the Internal Revenue Service issued Revenue Ruling 2019-24 to address the tax consequences of cryptocurrency hard forks and airdrops. The crypto community has been anxious to receive definitive guidance since the IRS issued Notice 2014-21. Although taxpayers and tax professionals have been waiting for guidance dealing with a plethora of issues relating to taxation of cryptocurrencies, the Ruling is strictly narrowed to an analysis of the U.S. federal income tax consequences of hard forks and airdrops. In addition to the Ruling, the IRS released a list of Frequently Asked Questions ''FAQs'' to elaborate on Notice 2014-21. The FAQs create an expectation of compliance in a milieu of uncertainty.

On the same day the Ruling was released, the leaders of the U.S Commodity Futures Trading Commission, the Financial Crimes Enforcement Network, and the U.S. Securities and Exchange Commission issued a joint statement to warn persons engaged in activities involving digital assets of anti-money laundering rules and countering the financing of terrorism requirements (AML/CFT) under the Bank Secrecy Act. The administrative agencies, together, send a strong signal to the crypto community that transactions using virtual currencies have regulatory and tax consequences of note. However, the released guidance (the Ruling and the FAQs), while helpful to understanding the IRS's position on taxation of hard forks and airdrops, leaves much open for interpretation on other aspects of transactions involving cryptocurrencies.

Summary of the Ruling

Very generally, in the context of cryptocurrencies, a ''hard fork'' occurs where there is a change in the underlying protocol splitting the cryptocurrency in two (e.g., where bitcoin splits into bitcoin cash). A hard fork thus leads to two blockchain coins. An ''airdrop,'' on the other hand, is when a blockchain distributes tokens or coins to the crypto community as a matter of protocol of the underlying project (i.e., without consideration). It is a ''means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers.'' Rev. Rul. 2019-24. In general, to receive these coins, the taxpayer must already own cryptocurrencies from the relevant blockchain.

The Ruling provides that a taxpayer does not receive gross income as a result of a hard fork; however, an ''accession to wealth'' results from a cryptocurrency airdrop following a hard fork. The analysis stems from the fact that a taxpayer obtaining ''new'' cryptocurrencies from an air drop following a hard fork that is earmarked in the taxpayer's account and the taxpayer may exercise control and dominion leads to realization and recognition of income under tax code Section 61.

Summary of FAQs

The FAQs is a very good start to understanding the U.S. federal income tax consequences of virtual currency transactions. After all, we have to learn to crawl before we can walk. The FAQs provide an explanation of what is a virtual currency; how it is treated for U.S. federal income tax purposes; how it differs from a cryptocurrency; what is the calculation of gain or loss; what are the relevant basis rule; how are receipt of tokens in exchange for services treated as income; what are the rules pertaining to self-employment income; and provides guidance pertaining to relevant and corresponding holding periods. It also clarified that the receipt of

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virtual currency as a bona fide gift does not result in ''income'' until the taxpayer ''sells, exchanges, or otherwise disposes of that virtual currency'' and donations of virtual currencies to a charitable organization will not result in recognition of income, gain, or loss from the donation. The FAQs provide further guidelines for reporting and the importance of documentation. That is all very helpful.

Additional Guidance Needed

Where additional guidance is still warranted is in the context of international reporting, assistance with determining the fair market value of a token or cryptocurrency that is not traded on any cryptocurrency exchange and does not have a published value (e.g., Q27 in the FAQs) and federal income tax consequences of ''out of the box'' transactions.

Compliance with FATCA and FinCen

One the main areas that lack guidance is in the realm of international reporting and compliance with foreign reporting rules. The Ruling and the FAQs do not address repeated queries from the tax community as to whether U.S. taxpayers holding cryptocurrencies in foreign wallets are required to file a Foreign Bank Account Report (FBAR) with the Treasury Department's Financial Crimes Enforcement Network (FinCen). In general, if a U.S. person has a financial interest in, or authority over, any financial account outside of the U.S. where the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year, the taxpayer is required to file an ''FBAR'' with FinCen. The definition of a ''financial account'' for FBAR purposes, does not include ''cryptocurrencies on a foreign exchange'' or something similar to it. A cryptocurrency wallet on an exchange is not a ''bank account, security account, commodity futures or options account, insurance policy or annuity contract, a mutual fund or pooled fund, or some type of pension or retirement account''—all of which require FBAR reporting.

The Ruling and FAQs do not provide specific guidance as to whether a taxpayer holding cryptocurrencies on a foreign cryptocurrency exchange (*e.g.*, Xapo.com or Binance.com) or in a foreign virtual wallet (*e.g.*, Blockchain.com) is required to report the cryptocurrency account(s) on an FBAR to FinCen. However, leaning on the language contained in three letters that the IRS released earlier this year (IRS Letter 6173, IRS Letter 6174, and IRS Letter 6174-A), IRS Letter 6174 provides that the obligation to report all sales, exchanges and other dispositions of virtual currency ''applies regardless [emphasis added] of whether the account is held in the U.S. or abroad.'' IRS Letter 6174. It would be helpful if the IRS in the FAQs would have confirmed this conclusion.

In addition to filing an FBAR with FinCen, U.S. persons are also required to report on annual basis their offshore assets on IRS Form 8938, *Statement of Specified Foreign Financial Assets*. **See Section 6038D and Treas. Reg. Section 1.6038D0 through and including Treas. Reg. Section 1.6038D8. The Treasury Regulations define a ''financial asset'' as ''any financial account. . . maintained by a foreign financial institution'' and ''any interest in a foreign entity.'' Thus, for example, a taxpayer holding cryptocurrencies in** *physical form* **on a foreign virtual currency exchange (***e.g.***, Xapo.com) or wallet (***e.g.***, Blockchain.com) is presumably required to report the cryptocurrencies for purposes of IRS Form 8938. In addition, a U.S. taxpayer holding ''an interest [the virtual currency] in a foreign entity [a cryptocurrency exchange or wallet that is formed under the laws of a foreign country]'' may be required to report the interest on IRS Form 8938. To avoid confusion, it would be helpful if the IRS would provide specific guidance on this score in the FAQs.**

Additional Guidance to Calculate Fair Market Value

One of the key challenges to correctly reporting gain or loss is to accurately determine fair market value. The FAQs simplistic approach to determining fair market value (e.g., Question 27) leaves taxpayers in a vulnerable position of a guessing game. Where taxpayers have traded tokens for services or received tokens in exchange for property, and the tokens are not widely traded (e.g., Bitcoin or Etherum) such that a blockchain reporter (a platform that analyzes the fair market value of worldwide indices); the taxpayer is left to assess fair market value in a vacuum with no measurable standard and is exposed to potential penalties and interest for underreporting. It would be helpful if the IRS would revise the FAQs to provide more specific guidance as to what measure of recourse can taxpayers have in these circumstances.

Other Open Topics That Require Guidance

In addition to the above, the IRS has still not provided guidance with respect to treatment of miners, application of the wash sale and straddle rules, confirmation as to treatment of like-kind exchanges before the passage of the 2017 Tax Act, tax treatment of Initial Coin Offerings (ICOs), tax implications in case of loss or theft, and application to foreign international tax rules. It would be helpful if the FAQs would be amended to cover these additional areas.

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