

IRS Issues Guidance Regarding Virtual Currency Transactions

10 / 17 / 19

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

525 University Avenue
Palo Alto, CA 94301
650.470.4500

On October 9, 2019, the Internal Revenue Service (IRS) issued long-awaited guidance relating to transactions involving virtual currencies, such as cryptocurrencies. Aligned with the agency's continuing efforts to enforce tax compliance in a rapidly growing area, the new guidance consists of determinations made in the first IRS ruling addressing virtual currencies, Revenue Ruling 2019-24 (which all taxpayers can rely on), and a set of frequently asked questions (FAQs) that tackle issues commonly raised by taxpayers. The IRS has indicated that Revenue Ruling 2019-24 and the FAQs are intended to expand on the guidance previously issued in Notice 2014-21, which was the first and only formal guidance regarding virtual currencies that had ever been issued by the IRS.

As discussed in further detail below, Revenue Ruling 2019-24 sets forth the IRS view on whether and when "hard forks" and "airdrops" (defined below) result in taxable events to holders of units in the new cryptocurrency received in such transactions. Adding to the list of questions in Notice 2014-21, the latest set of FAQs serve to better inform taxpayers of the IRS view of the proper U.S. federal income tax treatment of transactions involving virtual currencies, such as exchanges of virtual currencies for other property, real currencies or services, and to respond to previously unanswered questions regarding charitable donations and gifts of virtual currency. Furthermore, taxpayers are reminded to establish prudent record-keeping practices and comply with applicable information reporting requirements.

Definitions

Similar to Notice 2014-21, the FAQs and Revenue Ruling 2019-24 specifically address "convertible virtual currencies." The IRS has broadly defined virtual currency as a digital representation of value, other than a representation of real currency (*i.e.*, U.S. dollar or foreign currency), that functions as a unit of account, store of value and/or medium of exchange. Virtual currencies are convertible if they have an equivalent value in real currency or act as a substitute for real currency, such as cryptocurrencies. For purposes of the discussion below, "virtual currency" refers to convertible virtual currency, as defined by the IRS in its latest guidance.

The FAQs define cryptocurrency as a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. One example of a cryptocurrency that falls under this definition is bitcoin, which can be exchanged for real or virtual currencies. Applying substance-over-form principles, the FAQs expressly provide that an asset will be treated as virtual currency for U.S. federal income tax purposes if it has the characteristics of virtual currency, regardless of its label.

General Tax Treatment of Virtual Currency

In Notice 2014-21, the IRS confirmed that virtual currencies are treated as property, rather than as currency, for U.S. federal income tax purposes. Consequently, general U.S. federal tax principles applicable to property transactions apply to virtual currency transactions. The FAQs and Revenue Ruling 2019-24 expand on this earlier guidance to address common questions by taxpayers regarding the tax treatment of certain hard forks, soft forks and airdrops of cryptocurrency.

As explained in the FAQs and Revenue Ruling 2019-24, a hard fork occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy distributed ledger, resulting in the creation of a

IRS Issues Guidance Regarding Virtual Currency Transactions

new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. In contrast, a soft fork occurs when a distributed ledger undergoes a protocol change that does not result in such diversion of the legacy distributed ledger and, therefore, does not result in the creation of a new cryptocurrency. An airdrop is a method for distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers. Consequently, when a hard fork is followed by an airdrop, units of the new cryptocurrency on the new distributed ledger resulting from the hard fork are distributed to addresses containing the legacy cryptocurrency.

The FAQs provide that, if a taxpayer does not “receive” any new cryptocurrency in the event of a hard fork, no taxable income would result; conversely, and perhaps more controversially, if the taxpayer received new cryptocurrency as part of the hard fork (such as through an airdrop), taxable income would arise in the taxable year such cryptocurrency is received. Revenue Ruling 2019-24 helps clarify that, in the IRS view, cryptocurrency is received when the taxpayer is able to exercise dominion and control over the new cryptocurrency — the ability to transfer, sell, exchange or otherwise dispose of such cryptocurrency. For example, a taxpayer would not have dominion and control over such cryptocurrency if the address to which the cryptocurrency is airdropped is contained in a wallet managed by a cryptocurrency exchange that does not support such cryptocurrency and cannot immediately credit such cryptocurrency to the taxpayer’s account. Such taxpayer would be treated as receiving the cryptocurrency at the time it acquires the right to dispose of such cryptocurrency. Unlike hard forks, soft forks do not result in the receipt of new cryptocurrency and, thus, would not raise the prospect of taxable income.

Upon receipt of units of new cryptocurrency following an airdrop or other transfer after a hard fork, the IRS states that a taxpayer would realize ordinary income equal to the fair market value of such cryptocurrency at the time the transaction is recorded on the distributed ledger. We note that the IRS’ treatment may not recognize that the facts involved in hard forks and airdrops may not be the same in all instances and that the specific facts surrounding a given hard fork may afford taxpayers with arguments against realization. Moreover, the *Glenshaw Glass* case, to which the IRS cites, is arguably not as supportive of the position in Revenue Ruling 2019-24 as the IRS and some commentators suggest when considering the facts relating to hard forks. Under the IRS view, the taxpayer’s basis in the new cryptocurrency is equal to such amount realized on the taxpayer’s tax return. The taxpayer’s holding period in such cryptocurrency begins the day after it is received.

In Notice 2014-21, the IRS required the fair market value of virtual currency to be determined in U.S. dollars as of the date

of payment or receipt. The FAQs provide additional guidance with respect to the determination of fair market value, with the consequences depending upon whether the cryptocurrency is received through a cryptocurrency exchange, such as a trading platform, or in some other manner not involving a cryptocurrency exchange, such as a peer-to-peer transaction. In the case of a transaction involving an exchange, the value of the cryptocurrency received is the amount that the exchange records on a distributed ledger for the transaction (*i.e.*, an on-chain transaction) in U.S. dollars. If the transaction is not recorded on a distributed ledger (*i.e.*, an off-chain transaction), then the value is the amount the cryptocurrency was trading for on the exchange at the date and time such transaction would have been recorded on the ledger had it been an on-chain transaction. In the case of a transaction not involving an exchange, the value of the cryptocurrency is determined as of the date and time the transaction is recorded (or would have been recorded, in the case of an on-chain transaction) on the distributed ledger. For this purpose, the IRS will accept a valuation determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates its value at an exact date and time.

Exchanges for Other Property or Real Currency

As provided in Notice 2014-21, a taxpayer will recognize gain or loss upon an exchange of virtual currency for other property or an exchange of other property for virtual currency. The character of the gain or loss generally depends on whether such currency or other property was held as a capital asset, in which case the taxpayer would recognize capital gain or loss. The FAQs further clarify that the amount of gain or loss recognized is equal to the difference between the fair market value of such other property or virtual currency received, and the adjusted basis in virtual currency or other property exchanged. In general, the basis in such other property or virtual currency received is equal to its fair market value at the time of the exchange. As noted above, the IRS has required that fair market value of virtual currency be determined in U.S. dollars. The FAQs provide that, in the event cryptocurrency is received in exchange for other property and such other cryptocurrency is not traded on an exchange and does not have a published value, its fair market value is equal to the fair market value of such other property exchanged.

Under the FAQs, similar rules apply with respect to the determination of gain or loss in the sale of virtual currency for real currency. Specifically, in the sale of virtual currency, a taxpayer recognizes capital gain or loss, subject to any limitations on the deductibility of capital losses, in the amount of the difference between the adjusted basis in the virtual currency and the amount of real currency received in the exchange. For this purpose, the adjusted basis in virtual currency purchased with real currency is equal to the cost (in U.S. dollars) of acquiring

IRS Issues Guidance Regarding Virtual Currency Transactions

such currency, including any fees, commission and other acquisition costs, in excess of certain applicable deductions or credits.

Exchanges for Services

Consistent with the guidance in Notice 2014-21, the FAQs provide that the receipt of virtual currency in exchange for performing services, regardless of whether such services are performed by an employee or independent contractor, constitutes ordinary income to the service provider. In addition, virtual currency received by an independent contractor in connection with services rendered (measured by reference to its fair market value in U.S. dollars on the date of receipt) constitutes self-employment income and is, therefore, subject to self-employment tax. Similarly, virtual currency paid by an employer as remuneration for services constitute wages for employment tax purposes and is, therefore, subject to U.S. federal income tax withholding and applicable employment taxes and information reporting. In addition, the FAQs clarify that payment of virtual currency for services results in capital gain or loss to the service recipient if such virtual currency was held as a capital asset in the hands of the service recipient. Although not expressly addressed by the IRS in the FAQs, virtual currency not held as a capital asset would presumably result in ordinary gain or loss to that service recipient.

Charitable Contributions and Bona Fide Gifts

The FAQs address the treatment of virtual currency in the context of charitable donations and gifts tax. In general, donations of virtual currency to charitable organizations do not result in income, gain or loss to the donors. The amount of the charitable contribution deduction resulting from such a donation is equal to the fair market value of the virtual currency, if held for more than one year by the donor, and equal to the lesser of the basis of the virtual currency or its fair market value at the time of contribution, if held for one year or less by the donor.

In the context of gifts, a recipient of virtual currency that constitutes a bona fide gift for U.S. federal income tax purposes generally does not recognize any income until such currency is subsequently sold, exchanged or otherwise disposed. For purposes of determining gain when such virtual exchange is subsequently disposed, such recipient's basis in the virtual currency is equal to the sum of the donor's basis in the virtual currency and any gift tax paid by the donor with respect to such virtual currency. For purposes of determining any loss, such recipient's basis is equal to the lesser of the donor's basis or the fair market value of the

virtual currency at the time the gift was received. In addition, the donor's holding period is tacked onto the holding period of the gift recipient. In the FAQs, the IRS expressly provides that basis is presumed to be zero when there is a lack of documentation to substantiate the donor's basis in the virtual currency. Similarly, a lack of documentation to substantiate the donor's holding period results in the gift recipient's holding period beginning the day after the gift is received.

Record-Keeping and Information Reporting

The FAQs remind taxpayers that they are required to maintain records, such as documentation of receipts, sales, exchanges or other dispositions of virtual currency and the fair market value of such virtual currency. Furthermore, prudent record-keeping plays an important role in substantiating certain positions a taxpayer may take on its tax returns. For example, if the taxpayer owns multiple units of one type of currency that were acquired at different times or have different basis amounts, the taxpayer has the option of choosing which units of virtual currency are deemed to be exchanged, provided that the taxpayer is able to identify the specific units involved in the transaction and substantiate the basis in such units. The FAQs set forth specific information that the taxpayer must provide (*e.g.*, date and time each unit was acquired and exchanged and basis and fair market value of each unit when acquired and exchanged) and documentation of each specific unit's unique digital identifier (*e.g.*, private key, public key or address).

If the taxpayer is unable to identify specific units, such units are deemed to have been exchanged in chronological order beginning with the first unit acquired, on a first-in, first-out basis. Furthermore, if the taxpayer transfers virtual currency from one wallet, address or account to another wallet, address or account, the FAQs provide that such a transfer is not a taxable event, even if an information return is issued in connection with such transfer. This presumably would require the taxpayer to maintain records that sufficiently document whether the same virtual currency had been transferred between multiple wallets, addresses or accounts.

The FAQs also provide additional guidance regarding information reporting requirements with respect to virtual currency that reference tax reporting procedures applicable to similar types of income outside of the virtual currency context. Notably, the IRS reminds taxpayers that they must report any income, gain or loss arising from all transactions involving virtual currency, regardless of whether any information returns had been issued.

IRS Issues Guidance Regarding Virtual Currency Transactions

Contacts

Nathan W. Giesselman

Partner / Palo Alto
650.470.3182
nathan.giesselman@skadden.com

Edward E. Gonzalez

Partner / New York
212.735.3160
edward.gonzalez@skadden.com

Diana M. Lopo

Partner / New York
212.735.3475
diana.lopo@skadden.com

Steven J. Matays

Partner / New York
212.735.2372
steven.matays@skadden.com

Su Da

Associate / Palo Alto
650.470.4536
su.da@skadden.com