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NEWS ANALYSIS

Beyond Digital: Is Cryptocurrency The Next Tax Frontier?

by Mindy Herzfeld

As the cryptocurrency market continues to grow exponentially, it's an understatement to say IRS guidance hasn't kept up. A lack of guidance entails significant risks, including potential revenue loss, leaving taxpayers unsure how to properly comply with the law, and opening the door to illegal activities that can take place unnoticed. It also means the United States is falling behind other countries that recognize digital currency as an innovative asset class and are taking steps to build mature financial systems for it.

But there's also a downside to providing more clarity. For one, the market is transforming so rapidly that any project to address today's realities risks being outdated by completion. There's also little reason to believe that tax administrators' understanding of the technical aspects of the market can keep pace with evolving technology.

The challenges raised by cryptocurrency are multiples of those that tax administrations and the OECD face in developing solutions for the taxation of the digitalized economy, with one important difference: The virtual currency market isn't uniquely dominated by U.S. corporate giants. Although the questions that arise are similar — what type of asset is being created, where it's located, who should be treated as the owner, and how it creates value — they're even more acute for cryptocurrency, which generally exists only on a digital blockchain.

The novelty of virtual currency allows the IRS to revisit questions at the heart of the U.S. tax system, such as how to define property, securities, currency, and tax realization events. The government would be remiss in not taking the opportunity to reconsider those questions in a changing economy that now relies more heavily on digital and intangible assets for producing value. Efforts to answer questions regarding cryptocurrency taxation come while policymakers reexamine similar topics fundamental to the U.S. tax system, including

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moving away from realization to a mark-to-market approach.

What Is Cryptocurrency?

The limited IRS guidance to date tries to answer questions by analogizing cryptocurrency to other asset classes and types of income. The IRS's attempts to develop solutions have been hampered by adherence to the notion that cryptocurrency should be taxed uniformly, even though it serves many purposes: investment assets; securities; derivatives; a means of exchange; and in some cases, fiat currency. By next year, its uses may have expanded further.

Six years ago the IRS issued its first — and still one of only two formal pieces of guidance — on cryptocurrency. Notice 2014-21, 2014-16 IRB 938, describes the application of general tax principles to virtual currency transactions. It defines that currency as a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value that in some environments operates like real currency but doesn't have legal tender status in any jurisdiction. The notice includes frequently asked questions, saying in one that for federal tax purposes, virtual currency is treated as property, with the result that general tax principles applicable to property transactions also apply to cryptocurrency transactions.

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The IRS's answer to how virtual currency is treated for federal tax purposes, along with the evolution of the market since 2014, raises two fundamental questions. The first involves whether, assuming the 2014 response was then valid, it remains valid: Should cryptocurrency always be treated as property? The second question follows from the first: If cryptocurrency is properly to be treated as property, what kind of property is it? The IRS must find the answers to those basic questions before it can move on to more complex ones.

If cryptocurrency isn't property, what might it be? In some cases, it may be appropriate to characterize it as a contract, perhaps for services. It can be used as legal tender for paying suppliers or employees, but classification as property doesn't appear appropriate in those circumstances. A New York State Bar Association Tax Section report on cryptocurrency taxation says investments in cryptocurrency could be more akin to gambling.

The 2014 notice says that because cryptocurrency is property, it can't be treated as foreign currency taxable under section 988. While that analysis may have been valid in 2014, it probably isn't now. Among the types of cryptocurrencies that have arisen since, at least two may be properly categorized as foreign currency: cryptocurrency issued by central governments and stablecoins denominated in foreign currencies. Several countries have indicated that they are intending to test or are testing a digital currency that incorporates aspects of cryptocurrency.

Stablecoins are cryptocurrencies based on another cryptocurrency, fiat money, or other asset. The Wall Street Blockchain Alliance has explained that stablecoins can be differentiated from other types of cryptocurrency in that they have lower volatility and may be developed to be tethered, backed, linked, or otherwise supported by an underlying asset; for that reason, they may be closer to a medium of exchange than other types of digital currency. (The OECD appears to differentiate between cryptocurrency generally and stablecoins specifically, saying in a recent webcast that "the FinTech sector is evolving rapidly, in particular in the cryptocurrency and stablecoin space.")

Another example of the challenges the IRS faces is seen in guidance issued in late 2019 addressing hard forks and airdrops (Rev. Rul. 2019-24, 2019-44 IRB 1004, and accompanying FAQs). When it issued that guidance, the IRS identified Bitcoin, Ether, Roblox, and V-bucks as examples of convertible virtual currencies. But someone apparently advised it that Roblox and V-bucks shouldn't be treated as cryptocurrencies. As a result, the IRS removed references to those currencies, explaining that virtual currencies that are "part of a game that do not leave the game

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environment" aren't virtual currencies for tax purposes. But under Notice 2014-21, any type of digital representation of value (think airline miles) may be considered virtual currency. The confusion created by the IRS highlights the need to develop a better and more flexible framework before attempting to regulate those topics.

Even if the uncertainty over whether a type of digital currency or means of exchange is a virtual currency can be resolved, classifying cryptocurrency as property still leaves questions. It could be classified as many different types of property, including a commodity, a security, or a financial contract. Instead of blanket treatment as property, a better approach might be to tax cryptocurrency based on how it's used (the Wall Street Blockchain Alliance made that argument in its comments on the 2019 guidance). For example, the IRS might want to characterize an exchange that holds cryptocurrency as an integral part of its business differently from cryptocurrency held for another purpose, while cryptocurrency that's regularly traded perhaps should receive different tax treatment from that held as a long-term investment. Virtual currency that's used as an asset in a trade or business could be treated like depreciable property or inventory. And cryptocurrency used in lending transactions presents its own questions, given that the code characterizes debt as an obligation to pay "a sum certain in money." Other possible characterizations include securities loans, notional principal contracts, or leases.

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The lack of guidance from the IRS is compounded by the fact that different federal agencies have claimed jurisdiction for the legal definition of cryptocurrency. The Commodity Futures Trading Commission treats bitcoin and ether as commodities, while the SEC treats some tokens and coins offered in initial coin offerings as securities. The IRS generally defers to the CFTC for the definition of commodity, but it hasn't issued guidance on whether it would apply that principle to cryptocurrency. Its guidance has been limited to digital currency convertible to fiat currency that functions as a substitute for cash, leaving taxpayers with no direction for tokens used to access services, blockchain that does more than function as digital money, or coins that represent a profits interest in a company.

Questions About Income From Cryptocurrency

When Does Income Arise?

Determining how best to define cryptocurrency from a tax perspective — recognizing that simply calling it property doesn't begin to address the situation — is necessary before other questions can be answered. But taxpayers can't wait for the IRS to find a satisfactory answer to that before figuring out whether they have a tax recognition event for cryptocurrency and how to calculate any gain or loss. And the analysis is circular: Determining what types of cryptocurrency transactions the IRS wants to treat as recognition events might inform how to characterize the underlying assets.

Rev. Rul. 2019-24 partially addresses the timing question for cryptocurrency transactions. It considers the tax consequences of two types of transactions: hard forks (for some of which the IRS says the taxpayer doesn't receive a new unit of cryptocurrency) and airdrops following a hard fork. The revenue ruling describes the second situation as resulting in the distribution of units of the new cryptocurrency. It concludes that the airdrop is a recognition event for tax purposes because it represents an accession to wealth (because the taxpayer received additional property over which it has dominion and control) when the new cryptocurrency is recorded on the new ledger.

However, it's unclear whether the IRS properly understood the hard fork and airdrop transactions the ruling was intended to address. Just like in its attempts to define virtual currency, the Service has created confusion with a technical analysis of the terms "hard fork," "chain split," and "airdrop" that's inconsistent with the market's understanding of those terms.

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Partly for that reason, in commenting on the ruling, the American Institute of CPAs argued that transactions resulting in airdropped and chain-split coins shouldn't be treated as recognition events. Instead, the receipt of cryptocurrency in those transactions should be treated as the receipt of unsolicited property, because while in theory taxpayers can exercise dominion and control over the new cryptocurrency, they often can't claim the coins at the time of the airdrop because they're not supported by wallets or coin-splitting services, the AICPA said. An alternative characterization of the airdrop is as an open transaction if the stream of payments from a hard fork can't be fully determined.

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While exchanges of property are generally recognition events, some issuances of new cryptocurrency tokens may be better understood as continuations of the original investments, representing the underlying assets (the currency that provides access to services or uses of the blockchain) the holder wanted to acquire at the outset. Those issuances of "new" cryptocurrency might therefore also be better characterized as nontaxable events, analogized to an exchange of stock for debt or receipt of an asset on settlement of a prepaid forward contract. Alternatively, one could apply the principles of reg. section 1.1001-3 by analogy.

Other cryptocurrency transactions give rise to different types of realization questions. Stablecoins, which track the movement of different types of underlying (or referenced) assets, may be understood to represent an interest in the underlying basket of assets that gives rise to their value. That leads to the question whether foreign currency gains or losses generated by an underlying basket of fiat currencies tracked by a particular stablecoin should give rise to a taxable event when the taxpayer has not exchanged or redeemed the stablecoin during the reporting period. There are similar questions for stablecoins stabilized by commodities. Any attempt to tax cryptocurrency holders on the underlying value of the assets — or to tax holders of entities that own cryptocurrency assets on the fluctuation in value of the cryptocurrency — would require implementing new reporting systems.

What Kind of Income Is It?

From proper characterization of cryptocurrency and the timing of income realized from it come questions about how to characterize that income. Here again, taxpayers and the government are probably best served by a flexible approach: Assets can give rise to different types of income, depending on why they're held or on the tax status of their owners. For example, the IRS might want to develop different rules for dealers and traders in cryptocurrency, just as it did for dealers and traders in commodities and securities. It might want to require that mark-to-market treatment be applied more broadly for cryptocurrency, given that it's developing rules for a new asset class, or not at all, given the market's volatility.

Lots of other questions follow, including the application of the wash sale rules under section 1091, the potential applicability of section 1234A to hard forks, the treatment of cryptocurrency for determining whether an entity is an investment company under section 351(e), the application of section 1256 to cryptocurrency contracts, and the potential applicability of the section 1092 straddle rules. Without a holistic understanding and treatment of cryptocurrency, the IRS will likely be unable to provide coherent solutions.

What Does the Government (Need to) Know?

Answering substantive questions is one aspect of the challenges facing the IRS — but that goes hand in hand with determining how to obtain information from taxpayers. Again, some circularity is involved in developing the correct response, because ensuring compliance often helps guide practical responses for substantive tax treatment. Failing to provide clear and administrable compliance requirements involves significant risk, because taxpayers could engage

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in cryptocurrency transactions to avoid taxable gains and hide illegal transactions.

For the moment, the IRS has mostly performed a fishing expedition. The Form 1040 for fiscal 2019 asks whether the taxpayer received, sold, sent, exchanged, or otherwise acquired "any financial interest in any virtual currency." The instructions provide that a transaction involving virtual currency includes "the receipt or transfer of virtual currency for free (without providing any consideration), including from an airdrop or following a hard fork; an exchange of virtual currency for goods or services; a sale of virtual currency; and an exchange of virtual currency for other property, including for another virtual currency." Even that broad description doesn't address all possible scenarios, such as whether a trustee of an account that owns cryptocurrency or someone who moved virtual currency from one wallet to another would be covered.

Moreover, while the IRS has defined virtual currency (albeit in a way that might not make sense), it hasn't told taxpayers what it means to hold a financial interest therein. Return preparers have thus struggled to advise taxpayers on how best to answer that. And the definition doesn't address whether taxpayers that hold an interest in cryptocurrency through a transparent entity need to disclose that or have a duty to inquire from an entity in which they own an interest. Schedule B of Form 1040 requires taxpayers to report an interest in any foreign financial account — high-profile convictions of individuals who failed to properly do that raise the stakes in answering the virtual currency question properly.

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Another reporting regime to look to for analogy is the Foreign Account Tax Compliance Act. Section 6038D requires some U.S. taxpayers to report holdings of specified foreign financial assets over a threshold. That includes any financial account maintained by a foreign financial institution.

Regulations under section 6038D define a financial account to include a custodial account or any arrangement for holding a financial instrument, contract, or investment. The FATCA reporting obligations are broad enough to potentially require reporting of all cryptocurrency owned through or via an exchange established overseas.

The applicability of exchange of information requirements to cryptocurrency has led the OECD to look into how the common reporting system might apply to that currency. In a recent Tax Talk, officials said that as cryptocurrency increasingly becomes an alternative to traditional financial products, it's crucial to ensure that it's subject to adequate transparency. They added that the OECD is working on a due diligence, reporting, and exchange framework inspired by the common reporting system and the work of the Financial Action Task Force.

Conclusion

The IRS is caught between a rock and a hard place on cryptocurrency. On the one hand, there's an urgent need for it to issue guidance; on the other, it risks creating rules that are outdated or fail to reflect marketplace realities. And while holistic treatment of that novel asset would be better for both the market and compliance, it's difficult to develop comprehensive guidance when taxpayers demand answers yesterday. In the meantime, taxpayers are left to their own devices, which aren't likely to benefit the fisc. ■

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