Recent Developments: Cryptocurrency
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John Oliver said that cryptocurrency is “everything that you don’t understand about money combined with everything you don’t understand about computers.” More precisely, a cryptocurrency is a type of virtual currency that can be used either as a medium of exchange (e.g., U.S. Dollar) or as a storage of value (e.g. numismatic gold coins). According to CoinMarketCap, over twenty cryptocurrencies are valued at over one billion dollars, with BitCoin now valued at over $184 billion. In response to the rapid rise in value and the perceived threat of taxpayers not reporting their cryptocurrency transactions, the IRS recently released some guidance.

Background

Although each cryptocurrency is different, the basic structure is the same: a particular piece of property (the unit of cryptocurrency) is recorded on a distributed ledger (a blockchain), which is validated by computer network participants (nodes). Unlike fiat currency, like the U.S. dollar, that is issued and backed by a central government, cryptocurrency is not issued or overseen by any central organization. Instead, the cryptocurrency is controlled by its protocol, which sets out the terms for the software (e.g., how a transaction will be verified by nodes, how many nodes are required to change the protocol, and how large a block in the blockchain can be). Each block in the blockchain is validated by the nodes, and once validated, attaches to the previous block. No one can change to the block after it attaches to the blockchain.

Anyone is free to buy or sell a cryptocurrency or verify a transaction according to the protocol of that cryptocurrency. Additionally, many cryptocurrencies, like Bitcoin, are open source, meaning that the cryptocurrency protocol can be modified by anyone. This decentralization means that developers or nodes may disagree with each other and change the structure of the cryptocurrency by creating a “fork.”

2019 Income Tax Reporting Obligation

Starting with the 2019 tax year, taxpayers will need to state, under penalties of perjury, whether they engaged in a transaction involving cryptocurrency. The instructions to Schedule 1 of Form 1040 clarify that a transaction includes all of the following:

- The receipt 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.

Revenue Ruling 2019-24

In October 2019, the IRS released a revenue ruling that describes two situations involving a cryptocurrency that has undergone a fork. In Situation 1, a cryptocurrency experienced a "hard fork" that resulted in a new blockchain but did not result in any additional unit of cryptocurrency. Such a scenario can occur when there is a security problem with a cryptocurrency and developers want to fix the problem by starting a new chain so that the old, less secure chain dies off. The IRS said that this form of hard fork is not taxable.

Situation 2 involved a "hard fork followed by an airdrop." The IRS said that an airdrop is "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple addresses." Before the hard fork, the taxpayer only had one unit of cryptocurrency A. After the hard fork, the taxpayer had one unit of cryptocurrency A and one unit of cryptocurrency B. The IRS said that if an airdrop follows a hard fork, a taxpayer has gross income if the taxpayer has dominion and control over the cryptocurrency that was airdropped.

The IRS also released a number of FAQs along with the revenue ruling that, among other things, clarified the following income tax consequences of cryptocurrencies:

- <u>Cryptocurrency is Property</u>: Cryptocurrency is treated like any other intangible asset, so the usual property rules regarding holding period and capital gains treatment similarly apply.
- <u>Donations</u>: Cryptocurrency can be donated to charity, provided that the cryptocurrency holder receives a qualified appraisal to substantiate their donation.
- <u>Bona Fide Gift</u>: Cryptocurrency can be gifted, provided that the donor provides the gift out of "detached and disinterested generosity." The donee would not recognize income from the gift.

Nevertheless, several unsettled areas remain, including the tax treatment of contentious hard forks (like the hard fork of Bitcoin and Bitcoin Cash in 2018) and the situs of cryptocurrency assets.

Tax Planning Considerations

If you have a client who holds appreciated or depreciated cryptocurrency, consider talking to an IPB attorney about tax planning strategies:

- *CRTs*: Diversify cryptocurrency holdings by placing appreciated cryptocurrency into a charitable remainder trust.
- *Losses*: Consider whether the cryptocurrency is a "security" and whether the wash sale rules apply.
- *Situs*: If a cryptocurrency is not U.S. situs, consider whether U.S. resident has FBAR filing obligations or whether non-citizen non-residents can gift those units of cryptocurrency.

- *Pre-2019 Income Tax Filing obligations*: Determine whether your client exchanged cryptocurrency before 2019 and did not report the transaction on a tax return. Also consider whether section 1031 treatment applies if your client exchanged one cryptocurrency for another before 2018.
- *Donations*: Obtain a qualified appraisal and file a Form 8283 to ensure that you can get an income tax deduction for donation of cryptocurrency to a qualified charity.