Cooley

IRS Releases Long-Awaited Guidance on Taxation of Cryptocurrency Transactions

October 16, 2019

On October 9, 2019, the Internal Revenue Service (IRS) released Revenue Ruling 2019-24, which addresses the US federal income tax treatment of two unsettled areas of tax law regarding "hard forks" and "airdrops" of cryptocurrency, units of which are often called tokens. Revenue Ruling 2019-24 and a number of updates to the IRS's frequently asked questions page on virtual currency transactions represent the first significant guidance on cryptocurrencies that the IRS has issued in more than five years. In addition, on October 10, 2019, the IRS released a draft Schedule 1 to IRS Form 1040 requiring taxpayers to inform the IRS whether they received, sold, sent, exchanged or otherwise acquired a financial interest in a virtual currency in 2019.

Background

In 2014, the IRS issued Notice 2014-21, which explained that convertible virtual currencies are treated as property (rather than foreign currency) for US federal income tax purposes. As a result, under general tax principles, transactions involving tokens generally are taxable events. For instance, a person receiving tokens in exchange for services would owe tax (at ordinary income rates) on the fair market value of such tokens in the year received. In addition, a person paying for services with tokens would owe tax on the amount by which the fair market value of the tokens sold exceeded such holder's adjusted tax basis in those tokens.

Following the release of Notice 2014-21, taxpayers and their advisers raised questions about many common transactions involving tokens. In particular, guidance was requested as to whether certain events occurring on blockchain networks, which typically take place without any affirmative actions by token holders, would be taxable events. Revenue Ruling 2019-24 addresses two such events: hard forks and airdrops.

Hard forks

Since the release of Notice 2014-21, several well-known blockchain networks have been subject to hard forks, in which a change to the protocol's consensus rules results in a permanent split of the network and potentially in the creation of new "forked" tokens. Following a hard fork, transactions involving the historic tokens will continue to be recorded on the distributed ledger maintained by the legacy network, while transactions in the new tokens will be recorded on a distributed ledger maintained on a new network. For example, as a result of a debate relating to the preferable block size of the Bitcoin blockchain, the network underwent a hard fork in which the Bitcoin cash blockchain split from the Bitcoin blockchain.

Airdrops

Airdrops, as described by the IRS in Revenue Ruling 2019-24, are a means of distributing tokens to the wallets (public key addresses) of existing token holders. Blockchain projects may carry out airdrops to ensure a wide distribution in order to attempt to seed a new blockchain, to incentivize network adoption as a reward for existing token holders or, as described in Revenue Ruling 2019-24, to distribute new forked cryptocurrency to the holders of a legacy cryptocurrency.

Revenue Ruling 2019-24

Revenue Ruling 2019-24 addresses two situations involving hard forks and airdrops. In Situation 1, an existing distributed ledger undergoes a hard fork, but the new tokens created by the hard fork are not airdropped or otherwise transferred to an account owned or controlled by holders of legacy tokens. In Situation 2, an existing token holder receives new tokens created by the hard fork through an airdrop to the holder's distributed ledger address and has the ability to sell the new tokens immediately after such airdrop.

The IRS ruled that because the legacy token holder in Situation 1 does not receive a new token (either through an airdrop or otherwise), the token holder does not recognize gross income as a result of the hard fork.

By contrast, in Situation 2, because the holder actually receives new tokens, the holder recognizes gross ordinary income equal to the value of the new tokens at the time the holder has control over the tokens. This typically will be when the airdrop is recorded on the distributed ledger, but that may occur at a later time if, for example, the new tokens are deposited into a digital wallet on a cryptocurrency exchange that does not support the new tokens. In that case, the holder would be treated as receiving the new tokens when he or she acquires the ability to transfer, sell, exchange or otherwise dispose of them.

Analysis

The IRS' view that the creation and distribution of a new token, either through an airdrop or another means of crediting a token holder's account with the new token, constitutes a taxable event is unsurprising. Because the IRS views tokens as property, traditional US federal income tax principles tend to support the position that tokens give rise to taxable income when they are received and under the recipient's control.

However, Revenue Ruling 2019-24 leaves many questions unanswered. For instance, the ruling does not provide clear guidance on how significant the changes resulting from a fork must be in order to rise to the level of taxability. The facts of the ruling describe a hard fork in which the new token is materially different from a legacy token, and these differences support treating the issuance of the new token as the receipt of new property. The ruling does not address the tax treatment of "soft forks," which involve changes to consensus rules of a protocol (such as upgrades to protocol functionalities) that are "backward compatible," meaning that nodes running the original software client will still be able to recognize as valid blocks being mined using the new software client, so that (unlike a hard fork) a split in the network is avoided. Soft forks may alter how the token is used, enhance the tokens' utility or create new markets for the token and thus arguably could be considered to constitute the creation of new property for tax purposes given that the tokens differ materially in kind or extent. Soft forks are addressed instead in Question 29 of the new FAQs, which states that, because soft forks do not result in the diversion of the ledger and receipt of new tokens, the holder does not have income.

Revenue Ruling 2019-24 also does not explicitly address the tax consequences if an existing token becomes unusable as a result of a hard fork (for example, because of fundamental software changes to an existing platform) and the new token is designed to replace the existing token. In that case, does the holder have taxable income and an offsetting loss?

Revenue Ruling 2019-24 does not specify an effective date, so apparently it can be applied retroactively as well as to current and future tax years. For those who received new tokens as a result of hard forks that occurred before 2019 and did not report the receipt of these new tokens as income, Revenue Ruling 2019-24 provides no safe harbor. The release of the draft Schedule 1 to IRS Form 1040 also indicates the IRS' interest in more closely monitoring token transactions going forward.

Helpfully, the revised set of FAQs clarifies certain questions that have interested token holders and their tax advisers, such as permitting specific identification in accounting for sales of tokens acquired at different times and with different basis amounts and mandating the use of the "first in, first out" method for tokens that are not specifically identified on sale. For purposes of determining the holder's fair market value basis in tokens, the FAQs describe valuation methods in a variety of circumstances. Where tokens are received in a peer-to-peer or other transaction not facilitated by a cryptocurrency exchange, the IRS will accept as evidence of fair market value the value determined by a "blockchain explorer" that analyzes worldwide indices of a cryptocurrency and calculates its value at an exact date and time.

While clarifying certain aspects of token transactions, Revenue Ruling 2019-24 and the FAQs leave a number of US federal income tax questions regarding tokens unresolved, and token holders and exchanges should continue to consult with tax advisers to ensure compliance with applicable tax laws.

Overseas tax treatment

Tax authorities overseas have also been focusing on tokens – in particular in the UK, where detailed guidance has been published on the tax treatment of cryptoassets for individuals. This guidance addresses the treatment

of hard forks and airdrops. However, like Revenue Ruling 2019-24, it also leaves some questions unanswered. Non-US token holders and non-US token exchanges should also continue to consult with tax advisers to ensure compliance with applicable tax laws.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as "Cooley"). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction, and you should not act or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. When advising companies, our attorney-client relationship is with the company, not with any individual. This content may have been generated with the assistance of artificial intelligence (AI) in accordance with our AI Principles, may be considered Attorney Advertising and is subject to our legal notices.

Key Contacts

William Corcoran **Boston**	**wcorcoran@cooley.com** **+1 617 937 2420**
Eileen Marshall Washington, DC	emarshall@cooley.com +1 202 728 7083
David Wilson London	dwilson@cooley.com +44 (0) 20 7556 4473
Patrick Sharma Santa Monica	psharma@cooley.com +1 310 883 6464

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.