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INSIGHT: IRS 'Forks up' New Cryptocurrency Guidance

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According to new IRS guidance in Revenue Ruling 2019-24, a taxpayer has ordinary gross income under tax code Section 61 as a result of a hard fork followed by an airdrop of new cryptocurrency. The IRS has previously issued guidance in 2014 in which it characterized convertible virtual currencies as "property" for U.S. tax purposes, with attendant tax consequences on disposal.

Cryptocurrency is a virtual currency that utilizes a decentralized recording system, known as a distributed ledger, to digitally record and store transactions. The term "hard fork" refers to the event of a cryptocurrency splitting off from an existing distributed ledger. While this split may result in new cryptocurrency on a new distributed ledger, it is not a certainty. The IRS has indicated it intends to treat only a hard fork followed by an airdrop (*i.e.*, distribution) of new cryptocurrency as income to the taxpayer.

In Revenue Ruling 2019-24, the IRS cites to the Supreme Court case of *Commissioner v. Glenshaw Glass Co.*, specifying that hard forks, followed by a controllable airdrop of new cryptocurrency, are "undeniable accessions to wealth, clearly realized, over which a taxpayer has complete dominion." The IRS states that the key tax-triggering event is the taxpayer's receipt of cryptocurrency via an airdrop that they are able to fully manage, transfer, sell, and exchange.

This new guidance, combined with the issuance of a draft updated Form 1040, Schedule I, further indicates the commitment of the IRS to bring the virtual transactions of cryptocurrency squarely within its taxing authority. A draft of the updated Form 1040, Schedule I, includes a new triggering question, which reads:

The two main parts of the schedule, "Additional Income" and "Adjustments to Income," appear below the new draft question. The wording closely parallels the wording on Schedule B, Part III, concerning foreign accounts, which has evolved over time. The 2018 version of Schedule B, Part III now asks:

Beginning Oct. 11, 2019, the IRS will accept comments regarding Schedule I of the draft Form 1040 via email at IRS.gov/formscomments for a 30-day comment period. The location of the question on a non-mandatory schedule is likely to create the same issues with respect to cryptocurrency that practitioners have faced in the FBAR context, where failure to check the box (or worse, an incorrect entry made inadvertently or through misunderstanding of the question) can be used by the IRS as the basis for significant penalties. Thus, comments raised in support of an improved location of this question (as well as the foreign accounts question) would be helpful to taxpayers.

This new Revenue Ruling and Schedule I adjustment have been issued against the backdrop of the IRS virtual currency letter campaign, which many practitioners view as being motivated by the perceived lack of compliance by the taxpayers. In late summer of 2019, the IRS began sending out letters to some 10,000 taxpayers as a warning that they might not be in compliance with their tax filing obligations with respect to their cryptocurrency trading activity or investments.

Depending on the IRS's perception of the taxpayer's specific cryptocurrency transaction, different versions of the letter (Letters 6174, 6174-A, and 6173) were sent to taxpayers. Specifically, Letter 6174 purports to have an educational component for taxpayers that the IRS believes have or had convertible virtual currency (CVC) transactions, explaining that the transactions mandated reporting. Letter 6174 included language indicating that the taxpayer may not have known of the requirements.

In contrast, Letter 6174-A includes elevated language that CVCs may not have been properly reported, and indicates that the IRS "might" send correspondence

about potential enforcement activity in the future. Taxpayers who received either version of the letter are advised to review their transactions involving CVCs.

The third letter—Letter 6173—coveys more urgency to the recipients as this particular version of the letter is being sent to taxpayers whom the IRS believes have not met their reporting obligations. These taxpayers are being required to either (1) provide an explanation as to why they believe that they have properly complied with their reporting obligations, or (2) file amended or delinquent tax returns. Unlike Letter 6174 and Letter 6174-A, Letter 6173 contains a date by which the recipients are required to respond under penalties of perjury.

The implication of the IRS sending out these letters is clear: the IRS will not tolerate the loss of tax dollars due to tax treatment of CVCs.

It is strongly advisable that the recipients of the letter, especially those who received Letter 6173, take it seriously. It is recommended that they seek counsel from both an accountant and an attorney who have experience with CVCs, particularly as it is clear that getting current with reporting obligations is not enough. When you simply amend a tax return to report previously undisclosed transactions, the IRS retains the right to assess interest and significant penalties. If you (or your client) has virtual transactions that needed to be reported but have not been, the situation should be rectified as soon as possible even if you were not among the first 10,000 taxpayers who received the August letters from the IRS.

Last but not least, there still remains confusion as to whether certain CVC interests (such as those maintained in foreign ''crypto accounts'') are reportable for FinCEN 114 (also known as ''FBAR'') purposes. U.S. citizens, lawful permanent residents, person with substantial presence in the U.S., and U.S. entities must file FBARs with FinCEN if the person's financial assets (loosely defined for purposes of this article), held abroad, in aggregate, exceed $10,000 at any time during the calendar year. The confusion on the reportability of CVCs in the context of FBAR results from the aforementioned IRS's characterization of CVCs as ''property,'' not currency, as well some interesting FinCEN guidance. FBAR reporting normally does not require reporting of foreign properties (such as real estate), but CVCs held in crypto wallets look, in substance, similar to currencies held in foreign bank accounts. In the meantime, recipients of the letter are advised to include in the discussion with their accountants and attorneys, this looming possibility of FBAR reporting of their exact CVCs interest, as the penalty risk for FBAR noncompliance is more than fully confiscatory.

The IRS reports that, as yet, they are not contemplating a voluntary disclosure program specifically to address tax and reporting non-compliance involving virtual currency, despite the confusion.

Taxpayer confusion aside, the IRS has indicated a clear commitment to bring cryptocurrency transactions squarely within its taxing authority. The implications of the cryptocurrency compliance letters, coupled with the new IRS guidance, signals that the IRS is no longer willing to tolerate the leakage of tax dollars through purported holes of uncertainty in the tax treatment of cryptocurrency.

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