IRS Issues New Guidance on Cryptocurrency: Hard Forks and Other Utensils Are Taxable

by Christopher A. Karachale & Peter Banyai

After sending cryptocurrency enforcement letters in the summer of 2019, the IRS recently issued Revenue Ruling 2019-24 and an accompanying frequently asked questions (FAQs) with additional guidance on the taxation of cryptocurrency. The Revenue Ruling addresses the tax treatment of cryptocurrency "hard forks", where one version of the currency is split from its original ledger and a new version of the currency is created with a new ledger. The FAQs address other issues involving virtual currency transactions and advise taxpayers to apply general tax principles to the most common transactions involving virtual currency.

The new guidance comes five years after the IRS issued Notice 2014-21, where the IRS adopted the position that trading or exchanging cryptocurrency should be treated as transfers of property rather than actual currency exchanges. Revenue Ruling 2019-24 provides an analysis of specific situations in which changes to a cryptocurrency's underlying code through a hard fork may create a taxable event for holders of the currency.

Hard Forks and Airdrops

Hard forks of cryptocurrency can occur for a variety of reasons, including upgrades to improve security of the currency and the addition of new functions. For example, in August 2017, Bitcoin experienced a hard fork that created Bitcoin cash, allowing more transactions to be processed.

Revenue Ruling 2019-24 states that when a hard fork occurs and a new currency is created, taxpayers will be subject to tax at the time the new currency is delivered to the taxpayer (i.e. the new currency is "air dropped") and that taxpayer has dominion over the new currency. If the taxpayer does not have control of the new currency, the hard fork does not create a taxable event. For example, if the hard fork delivers the new currency to a wallet managed through a cryptocurrency exchange, but the currency is not credited to the taxpayer's account (because the cryptocurrency exchange does not yet support the new currency), no taxable event occurs.

Example: SzentendreCoin and VizslaCoin

Assume that Christopher is a rogue Hungarian cryptocurrency

developer. He has created a new cryptocurrency called "SzentendreCoin" intended to appeal to high-end dog breeders. Peter, a renowned dog breeder, purchases 1,000 units of SzentendreCoin worth $1,000 knowing that he can sell his next litter in exchange for SzentendreCoin.

Christopher, realizing that SzentendreCoin contains potential hacking vulnerabilities, decides to alter the underlying blockchain through a hard fork. The goal is to correct designs in the software to close the threats. SzentendreCoin undergoes a protocol change, and a new currency, "VizslaCoin", is created on a new distributed ledger. Because of the hard fork, SzentendreCoin is not compatible with VizslaCoin.

Christopher has two options. First, he can let Peter and other SzentendreCoin users figure out a way to upgrade to VizslaCoin on their own. In such a case, Revenue Ruling 2019-24 makes clear that the simple hard fork from SzentendreCoin to VizslaCoin does not create a taxable event for Peter.

But presumably, Christopher wants to ensure that Peter and the other SzentendreCoin users upgrade to VizslaCoin and continue to use the currency with the improved security. So Christopher airdrops 100 units of VizslaCoin (worth $1000) to Peter to replace his (now incompatible and presumably valueless) SzentendreCoin. Revenue Ruling 2019-24 provides that on receipt of the 100 VizslaCoin units, Peter has income of $1000, even though he has not traded or exchanged any coins and the new coins are only intended to upgrade his previous version of the same blockchain technology.

Like the taxation of cryptocurrency generally, such a result is clearly inequitable. The VizslaCoin does not represent new "property." It is simply a replacement of the original SzentendreCoin. But the IRS's position that cryptocurrency is property leaves the Service no other choice than to treat such a transaction as taxable. Until the IRS changes its position on how to tax cryptocurrency, taxpayers who hold, trade, or exchange such cryptocurrency will continue to be subject to this nonsensical tax regime.

Conclusion

The new IRS Revenue Ruling and FAQs come at a time when the IRS is clearly ramping up its efforts to police the taxation of cryptocurrency. While perpetuating a position that seems increasingly impractical, the new guidance gives taxpayers and their advisors new information on the tax treatment of cryptocurrency transactions.

Tax attorneys at Hanson Bridgett LLP can provide guidance to both taxpayers and their advisors regarding cryptocurrency taxation. Taxpayers or their representatives with questions should contact Christopher Karachale or Peter Banyai at Hanson Bridgett.

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