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Is the IRS HODLing* Out on Us? IRS Issues Additional Cryptocurrency Guidance Addressing Hard Forks, Soft Forks, and Airdrops

The cryptocurrency landscape has changed considerably since the mysterious introduction of bitcoin in 2008. Today, the magic Internet money can be used to order pizza, pay employees, day trade, and serve as collateral for loans.

The IRS has been notably slow to react. It has issued very limited guidance so far on how it intends to treat cryptocurrency transactions, but even in the absence of such guidance, it has recently begun ramping up its cryptocurrency transaction enforcement efforts. In 2014, the IRS issued Notice 2014-21, confirming its view that "convertible virtual currencies" are treated as property and thus subject to general tax principles that apply to transactions in property (and not to certain special rules that apply to transactions in currencies). In 2018, the IRS included noncompliance with tax laws relating to the use of cryptocurrencies as one of its new compliance campaigns. (See prior coverage here.)

The IRS recently issued new guidance in Rev. Rul. 2019-24 and an updated set of frequently asked questions addressing the tax treatment of cryptocurrencies that undergo a hard fork and the treatment of a subsequent airdrop.

Background

Cryptocurrencies use distributed ledger, or "blockchain," technology to verify and secure transactions between users. Each transaction is recorded in a block of transactions, which are linked to all prior and subsequent blocks on the blockchain. A blockchain runs on a specific protocol that dictates its rules. Certain protocol changes can cause "soft forks" and "hard forks" of the blockchain.

A "soft fork" occurs when a protocol change is made to update a feature of the blockchain and does not result in a valid parallel blockchain. A soft fork does not create a new cryptocurrency since the blockchain on the old protocol becomes invalid and does not persist. On the other hand, a "hard fork" occurs when a protocol change is made that *does* result in the creation of a valid parallel blockchain. Sometimes a hard fork will simply update a feature of the

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blockchain and the parallel blocks created after the fork will no longer be followed as all users update to the new protocol. Other times, the parallel blockchains will persist and a new "forked cryptocurrency" is created. In this case, each owner of the legacy cryptocurrency should be able to claim the forked cryptocurrency in an amount equal to his or her holdings in the legacy cryptocurrency.

A "wallet" is where cryptocurrency is stored. It can be in the form of either software or hardware. Wallets have both public keys and private keys. To send cryptocurrency to a specific wallet, a user must have the wallet's public keys. To move money out of a wallet, a user must have the wallet's private keys. To claim a forked cryptocurrency, the owner of the legacy cryptocurrency must configure a compatible wallet with the private keys of the wallet that held the legacy cryptocurrency at the time the blockchain underwent the hard fork. Cryptocurrencies are, essentially, bearer instruments like cash; instead of holding bills and coins, owners of cryptocurrencies maintain exclusive possession of the private keys. Many are of the view that if you hold cryptocurrency on an exchange that does not provide you with the private keys to the wallet, you do not actually "own" the cryptocurrency. The popular mantra "not your keys, not your crypto" was coined to reflect this view.

An "airdrop" occurs when a cryptocurrency is deposited, for free, into a compatible wallet in an effort to bring awareness to a new cryptocurrency, increase its ownership, and jumpstart its circulation. Generally, airdrops are employed when a cryptocurrency is created by means other than a hard fork. This is because a hard fork itself is a way to market and distribute new coins. A cryptocurrency created in a hard fork *could* be part of an airdrop, but that would be separate from the new cryptocurrency received as a result of the hard fork.

Individuals can sign up for airdrops without ever holding another cryptocurrency. However, some cryptocurrencies are airdropped to existing compatible wallets (such as those that hold cryptocurrency on the Ethereum blockchain) without the wallet owner's solicitation. Likewise, an individual may purchase cryptocurrency in anticipation of a hard fork as a means to acquire the forked cryptocurrency. But all owners of a cryptocurrency on a blockchain that undergoes a hard fork should be able to claim the forked cryptocurrency, even if they did not actually want the forked cryptocurrency or were unaware that the hard fork occurred.

New guidance

The Revenue Ruling focuses on hard forks and describes two scenarios. The first scenario provides that the owner of a legacy cryptocurrency that undergoes a hard fork that creates a new cryptocurrency, but who does not receive any of the forked cryptocurrency, will not have taxable income. The second scenario provides that the owner of a legacy cryptocurrency who receives (by airdrop) a forked cryptocurrency following a hard fork that creates a new cryptocurrency will have taxable ordinary income equal to the fair market value of the new cryptocurrency when the airdrop is recorded. For purposes of the Ruling, a taxpayer "receives" the cryptocurrency from a hard fork when he or she can exercise dominion and control over the cryptocurrency, meaning he or she can transfer, sell, exchange, or otherwise dispose of the cryptocurrency.

Because a hard fork that creates a new cryptocurrency necessarily results in all owners of the legacy cryptocurrency receiving the forked cryptocurrency, the first scenario appears to be implausible. However, the Ruling indicates that this scenario may be directed toward individuals who own cryptocurrency through an exchange. Often individuals who hold their cryptocurrency in an exchange account do not hold the private keys to the wallet where their crypto is stored. Following the "not your keys, not your crypto" mantra, it is actually the exchange that holds the wallet's private keys and can access the forked cryptocurrency, not the "owner." The Ruling clarifies that in this case, the owner will not be in receipt of the forked cryptocurrency until the exchange transfers the forked cryptocurrency so that the owner has dominion and control over it.

Questions remain about the tax treatment of airdrops generally because the Ruling only addresses airdrops that follow a hard fork. Recent public statements by IRS officials indicate that the Ruling does not apply to "marketing" airdrops, raising further questions about what exactly the IRS considers an "airdrop."

In line with the treatment of cryptocurrency in the Ruling, the FAQs state that because a soft fork does not result in the receipt of new cryptocurrency, a soft fork does not create taxable income. The FAQs also explain that a taxpayer's basis in forked cryptocurrency is equal to the amount included in taxable income. Methods for determining a cryptocurrency's fair market value are also provided for on- and off-exchange transactions.

The IRS allows taxpayers to specifically identify cryptocurrency blocks for disposition, and if no specific identification is made, units are deemed to be sold on a first in, first out (FIFO) basis. As a practical matter, FIFO may be difficult for many taxpayers to effectively track—we are discussing crypto*currency*, after all. It would be helpful if other methods were permitted, such as a last in, first out (LIFO) or average basis.

Recent public statements from Financial Crimes Enforcement Network (FinCEN) officials also announced that cryptocurrency held on foreign exchanges are not subject to FBAR reporting, but it remains unclear whether such cryptocurrency must be reported on a taxpayer's IRS Form 8938, "Statement of Specified Foreign Financial Assets."

Those who have given up hope of their cryptocurrency of choice going "to the moon" might take solace (if any is to be had) in recognizing that the IRS is focused on providing additional, much-needed guidance in this area.

For more information, please contact Blake Estes at 212.210.9415, Danny Reach at 704.444.1272, or April McLeod at 212.210.9487.

**HODL is slang used in the cryptocurrency community to refer to holding, as opposed to selling, units of cryptocurrency.*

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