WHAT THE FORK?: NEW IRS GUIDANCE ON CRYPTOCURRENCY TRANSACTIONS MAY CONFUSE TAXPAYERS, BUT MAKES SENSE WHEN TERMINOLOGY IS TRANSLATED

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The Internal Revenue Service ("IRS") recently issued guidance to help taxpayers properly report transactions involving cryptocurrencies and, in particular, hard forks and airdrops. This guidance is crucial to understanding the U.S. federal income tax treatment of these transactions, but accurately applying it requires an understanding and interpretation of existing law and how that shapes the IRS's intent regarding these highly technical events.

What is the new guidance?

The new guidance includes two documents intended to help taxpayers better understand their reporting obligations for specific transactions involving virtual currencies, including cryptocurrencies. Revenue Ruling 2019-24 (the "Revenue Ruling") addresses the tax treatment of a cryptocurrency hard fork, while a set of frequently asked questions (the "FAQ") addresses a wide range of issues surrounding soft forks, basis, fair market value, gains, or losses in certain transactions, how to determine which cryptocurrency is involved in a transaction, and information reporting involving virtual currencies. These documents build on Notice 2014-21, which was released in 2014, and an FAQ previously published on the IRS website.

What does the new guidance say?

At a basic level, the guidance states that a "hard fork" of a cryptocurrency is generally not a taxable event. However, receipt of any cryptocurrency in an "airdrop"—including in connection with a hard fork—is a taxable event. Put another way, if following a hard fork or airdrop event a taxpayer ends up holding both the original cryptocurrency and also a new cryptocurrency created by the hard fork, or by an airdrop event, the taxpayer will generally be taxed on the value of the new cryptocurrency that the taxpayer did not own before the hard fork or airdrop event. The IRS uses the terms hard fork and airdrop in the new guidance in ways that differ from common understandings of those terms in the cryptocurrency space, which appears to have initially confused many commentators.

Some translation may help here.

The Revenue Ruling defines a hard fork as occurring "when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are

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recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger." While this is mostly true, it should be noted that there is no requirement that transactions continue or cease on the legacy ledger.

The Revenue Ruling defines "airdrop" for this purpose as "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers." This is also generally true. However, not all transactions in which a taxpayer receives new cryptocurrency without tendering other property are referred to as airdrops. In addition, the rest of the IRS explanation in the Revenue Ruling confusingly describes as an airdrop an event that is not commonly referred to as an airdrop. Specifically, the Revenue Ruling states that "[a] hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency. However, a hard fork is not always followed by an airdrop."

Based on the rest of the Revenue Ruling and content of the FAQs, it appears that the IRS is trying to say that a taxpayer will be subject to taxation on the fair market value of new cryptocurrency (in other words, coins to which the taxpayer did not previously have any right) that the taxpayer can "exercise dominion and control" over following a hard fork or some other event in which the taxpayer did not exchange other property. (See below for what exercising dominion and control means.) In addition, the income that the taxpayer must include in income is ordinary and not capital gain (whether long- or short-term). To avoid further confusion about the IRS use of the term "airdrop," the remainder of this document refers to the cryptocurrency over which a taxpayer can exercise dominion and control after a hard fork or another event in which the taxpayer does not exchange other property as "New Coins."

When does a person earn income as a result of receiving New Coins?

The Revenue Ruling indicates that a person will be subject to tax on the value of any New Coins as of the *later* of two dates: (1) the date on which the New Coins are recorded on the applicable distributed ledger, and (2) the date on which the taxpayer can "exercise dominion and control" over the New Coins. Exercising dominion and control is a time-tested concept in the federal income tax law. The IRS' application of it here is helpful because it provides a framework for determining when a taxpayer has become subject to federal income taxation. But what does it mean in the context of cryptocurrency?

The IRS provides a useful example of when a taxpayer cannot exercise dominion and control over New Coins, and, therefore, is not yet subject to federal income taxation. Specifically, when "the address to which [New Coins are credited] is contained in a wallet managed through a cryptocurrency exchange that does not support the [New Coins] such that the [New Coins are] not immediately credited to the taxpayer's account at the cryptocurrency exchange." Other complications may arise if the New Coins are obtained in a peer-to-peer transaction or some other transaction not facilitated by a cryptocurrency exchange because the FAQ indicates that, in that case, the taxpayer will be treated as receiving the New Coins either when the transaction is recorded on the distributed ledger or would have been recorded on the ledger if it had been an on-chain transaction. This may create a timing issue, particularly if there is a significant delay in recording the transaction on the distributed ledger or there is a question of which ledger is meant.

The upshot is that if the taxpayer—without doing more—can use the New Coins in a transaction, then the taxpayer will be subject to tax on the fair market value of the New Coins. If the taxpayer would have to do more—for example, transfer the New Coins to another wallet in order to use them in a transaction—then the taxpayer will

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not be subject to tax on the New Coins until the taxpayer takes that extra step OR something else changes such that the taxpayer can use the New Coins in a transaction.

Confused? Uncertain about when a taxpayer must report income? You are not alone. Cryptocurrency market participants and industry observers have noted several scenarios in which an airdrop might cause a taxpayer to unwillingly become subject to taxation. For example, an airdrop to a wallet (not on an exchange) for which the taxpayer has the key but does not have the software to spend the cryptocurrency could—in some circumstances—result in taxation and tax reporting obligations even though the taxpayer does not have dominion over and control of the cryptocurrency in a practical sense. As a result of this and other uncertain situations, some observers have questioned whether the IRS understands cryptocurrency transactions well enough to tax them. However, when viewed through the lens of available tax law, the principle of dominion and control may be the best fit for cryptocurrency transactions.

How much tax will be due?

Unsurprisingly, income tax on New Coins is based on the fair market value of the New Coins on the day on which a person obtains the New Coins, as discussed above. The Revenue Ruling does not address valuation of New Coins, but several explanations in the FAQ could be applied by analogy. For example, the FAQ states that cryptocurrency received "through a cryptocurrency exchange" has whatever value the exchange records for the relevant transaction in U.S. dollars, if the cryptocurrency was received in an on-chain transaction. If, for whatever reason, the transaction was not recorded on a ledger, then the fair market value of the cryptocurrency is equal to the amount it was trading for on the applicable exchange at the date and time the transaction would have been recorded if it had been on-chain.

What about soft forks?

The FAQ clearly states that a soft fork does not give rise to tax. This conclusion is based on the IRS' assumption that a taxpayer that owns virtual currency on a ledger that experiences a soft fork will not receive New Coins as a result of the soft fork. The IRS defines a soft fork for this purpose as occurring "when a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger." This is generally true. For example, soft forks have been used to implement new and upgraded functionalities while permitting blocks from both upgraded and non-upgraded nodes to be recognized. However, it is important to note that if a majority of mining power ceased to recognize the soft fork, a hard fork would ensue and the guidance set forth in the Revenue Ruling would apply. Nonetheless, when a soft fork becomes a hard fork—and therefore, when a person becomes subject to taxation and reporting—is not addressed in the Revenue Ruling or the FAQ.

What about other cryptocurrency transactions?

The FAQs address a number of other transactions involving cryptocurrency. Comfortingly, the conclusions reached are consistent with generally applicable tax law as it applies to routine property transactions. For example, when a taxpayer purchases virtual currency using fiat currency, the taxpayer's basis will be the cost to the taxpayer including fees, commissions, and other acquisition costs in U.S. dollars. When a taxpayer exchanges any property other than fiat currency for virtual currency (including exchanges of one virtual currency for another virtual currency), the taxpayer will recognize gain on the difference between the taxpayer's basis[1] in that property and the fair market value of the virtual currency. That gain may be capital or ordinary based on general income tax principles. When a taxpayer exchanges virtual currency for other property, e.g., a cup of coffee, the taxpayer will recognize gain equal to the taxpayer's basis in the virtual currency and the purchase price of the

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property. Finally, taxpayers working for companies that have or will issue virtual currencies as salary or other compensation should be aware that any virtual currency received as compensation will be treated as ordinary income that will generally be subject to employment or self-employment taxes. All of these transactions—and others not covered here—again require thinking about when a taxpayer becomes subject to tax and how to measure the fair market value of the cryptocurrency at that time.

In the FAQ, the IRS also identifies several methods for determining fair market value. As with the examples of when a taxpayer recognizes income or gain in regard to a cryptocurrency transaction, these methods are generally consistent with tax treatment of routine property transactions. One quirk is that all of the methods require identifying whether the transaction occurs on-chain or off-chain and whether and when an exchange is involved. In particular, in the case of a transaction that occurs outside of an exchange, the IRS provides what amounts to a safe harbor for taxpayers that use an explorer to determine the fair market value of the relevant virtual currencies. Otherwise, the taxpayer must make a good faith effort to establish and document the fair market value of the relevant virtual currencies. Also, if the virtual currency is not traded—or example, because an ICO has not yet occurred—and a taxpayer receives the virtual currency in exchange for property or services, the fair market value of the virtual currency will be treated as the fair market value of the property or services exchanged. While the examples and explanations in the FAQ are helpful, interpreting and applying them will still require careful analysis and deep understanding of generally applicable tax law.

The FAQ also addresses gains and losses as they relate to gifts and charitable donations. These provisions are generally consistent with otherwise applicable gift and charitable donation rules.

Finally, the FAQ describes how to identify which cryptocurrency assets are being used or sold by reference to ordering rules that are commonly used in the sale of assets not purchased at the same time, as well as advice on the records taxpayers should keep to substantiate their transactions. After the FAQ was released, the IRS announced plans to revise Form 1040 to include a designated line to report cryptocurrency gains and losses.

What now?

The Revenue Ruling and FAQ are helpful, but there are gaps that should be addressed in future guidance or even legislation, as the FAQ is more in the nature of guidelines than official authority. In addition, some taxpayers may be unsatisfied with the conclusions reached.

It took the IRS five years to release a second round of cryptocurrency guidance, so it is unlikely that we will see further clarifications in the near-term, leaving taxpayers to struggle with any unanswered questions. It is important to remember that without congressional action, cryptocurrency is just property for U.S. federal income tax purposes, much as a copy of software is property. In order to get unique treatment such as that provided for corporate stock and certain derivatives, Congress must be involved.

The congressional tax committees are interested in this issue, both with respect to technical issues but also due to concerns over a perceived low rate of voluntary compliance and how a bespoke cryptocurrency information reporting regime would operate. Additional tax revenues collected from better compliance and a robust enforcement regime could be used to pay for any number of policy priorities. However, the same complexities that the IRS faced when crafting the recent guidance also plague Congress.

Taking a step back from the terminology in the Revenue Ruling and focusing on the rationale of the ruling, one may conclude that the IRS probably understands cryptocurrency well enough to appropriately tax transactions

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using it. However, to the extent the guidance is based on an imperfect understanding of the technical dynamics of currency creation, the guidance could have unfortunate effects. If taxpayers' willingness to comply with tax reporting obligations is linked to their belief that the IRS understands their activities and circumstances, a feeling that the IRS does not have a comprehensive understanding may have an adverse effect.

These circumstances provide an excellent opportunity for cryptocurrency stakeholders to provide input to the IRS and Congress to ensure an accurate understanding of industry terminology, practices, and procedures and to help shape a cryptocurrency regime that is understandable, promotes compliance, and can be administered by the IRS without undue burden on cryptocurrency investors and users. Please contact our tax and tax policy partners to assist you with this process.

NOTES

[1] A person's basis in property is generally equal to the amount they paid for the property, plus or minus certain adjustments. A person will generally be treated as having a basis in cryptocurrency that is equal to the fair market value of the cryptocurrency when received, plus or minus the same adjustments that generally apply for income tax law purposes.

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