NEW IRS CRYPTOCURRENCY TAX GUIDANCE AND KEY HIGHLIGHTS

By Shehan Chandrasekera, CPA

The Internal Revenue Service (IRS) has not provided any guidance on crypto taxation since the Notice 2014-21 issued in 2014. After nearly five years, on October 9, 2019, the IRS issued new guidance on cryptocurrency taxation in the form of a list of FAQs and a Rev. Rul. 2019-24.

The new guidance preserves the "property" treatment for cryptocurrency for tax purposes and sheds more light into some controversial areas in this fast-changing space. It should be highlighted that this new guidance will only be applicable to taxpayers who hold cryptocurrencies as a capital asset. This article will highlight the key points you need to know.

Definition

For the first time, the IRS provides a definition for cryptocurrency in the new FAQs. Per the IRS: "Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. A transaction involving cryptocurrency that is recorded on a distributed ledger is referred to as an "on-chain" transaction; a transaction that is not recorded on the distributed ledger is referred to as an "off-chain" transaction." IRS Notice 2014-21 only defined and explained virtual currencies and convertible virtual currencies.

Forks

In the crypto world, a fork happens when a distributed ledger undergoes a protocol change and a diversion. After a hard fork, legacy users end up with a new cryptocurrency in addition to the old coins in their wallets. A soft fork is still a diversion of the legacy blockchain protocol, but the users will not end up with a new coin.

Hard Forks and Soft Forks. One of the most controversial positions described in the new guidance is that new coins received after a hard fork are taxed as ordinary income. The ordinary income realized is equal to the fair market value of the new cryptocurrency when it is received. If you do not receive new cryptocurrencies after a hard fork, you will not have any taxable income. This situation is called a soft fork.

This ruling is controversial because there are myriad scenarios in which users may face taxable income without knowing about it. For example, millions of Americans received BSV as a result of a bitcoin cash (BCH) hard fork. Due to limited liquidity and delisting of the asset on many exchanges, these taxpayers are now faced with income on this asset that is difficult for them to dispose of.

Valuation

The IRS specifies guidance on exactly how to value crypto assets for tax purposes. If you trade crypto on an exchange like Coinbase or Binance.us, the dollar value for crypto traded should be determined by the USD price at that specific exchange. This means using sources like CoinMarketCap would not be acceptable anymore in converting cryptocurrency units into USD.

If you traded crypto peer-to-peer, via a decentralized exchange or some other method that did not involve an exchange, the fair market value of the crypto traded should be determined by referring to "a blockchain explorer that analyzes worldwide indices." If you do not use a blockchain explorer value, you must establish that the value you used is an accurate representation of the cryptocurrency's fair market value.

Finally, if you receive cryptocurrency for which you cannot find a published value (very common in the crypto world), the fair market value of the crypto received is equal to the fair market value of property or services exchanged.

Following these valuation methods may be cumbersome for both taxpayers and tax practitioners in the upcoming tax season, but there are tech tools available to automate the valuation process and generate reportable amounts in USD.

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Basis

Another major update on the new guidance is that specific identification is now officially an accepted accounting method for trading crypto assets. To successfully identify a specific unit, the information must include:

- The date and time each unit was acquired;
- Your basis and the fair market value of each unit at the time it was acquired;
- The date and time each unit was sold, exchanged or otherwise disposed of; and
- The fair market value of each unit when sold, exchanged or disposed of, and the amount of money or the value of property received for each unit.

If you cannot specifically identify the units, you must default to first-in-first-out (FIFO).
Since cryptocurrency exchanges are not issuing Form 1099-B, it becomes taxpayers' and/or tax practitioners' responsibility to keep track of the above info and calculate annual gains and losses. This is an extremely tedious task. Tax practitioners should consider using a reputable provider to aid in cryptocurrency accounting.

Gifts and Donations

If you receive crypto as a gift, you will not have to recognize any income. Determining the basis of the cryptocurrency gift received follows the general rules applicable to property donations; i.e., the basis of the gift received is dependent upon the gain or loss at the time you dispose of it.

Cryptocurrency donations will not trigger a gain or loss. If you have held the asset for more than one year, you are eligible for a deduction equal to the fair market value at the date of donation. If you have held the asset for one year or less, you are eligible for a deduction equal to the lesser of the fair market value or the cost basis at the date of donation. This allows you to donate appreciated crypto assets to charities and bypass capital gains taxes.

Payments

The IRS has confirmed that if you pay somebody in cryptocurrency and/or use crypto to purchase goods and services, that will trigger a capital gain or loss. The gain/loss is equivalent to the difference between cost basis and fair market value at the date of disposition.

Transfers

Transferring crypto from one wallet (or exchange) to another is a nontaxable transfer. These transactions may be included in Form 1099-K issued by crypto exchanges, but even if you receive a 1099-K, those transactions will not be taxable. This is a great relief for taxpayers who received various tax notices (CP2000, 6173, 6174-A and 6174) related to mismatching 1099-Ks.

It is great to see the IRS bringing more clarity to cryptocurrency related transactions. The majority of the items mentioned in the new FAQs are taxpayer friendly. Solid substantiation of your crypto transactions and proper reporting based on new guidance will be extremely important for taxpayers in the future.

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