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By [Robert W. Wood]

IRS Hunts Crypto, Hard Forks, Tax Returns And More

Bitcoin and other cryptocurrencies are volatile, but they are fun too, until you start thinking about taxes. Back in 2014, in Notice 2014-21, the IRS said it would tax crypto as property (not currency). That has a staggering array of tax impacts. It can mean each transfer—even each swap of one crypto for another—is taxed. As the vast wild frontier of different coins, exchanges, forks and hard forks has been percolating, the digital community has been anxious for more IRS guidance.

The IRS has issued two new pieces of guidance. These rules are IRS interpretations of existing law, which means the IRS could apply them to prior tax years. They do not specifically tell you to amend prior tax returns, but it is reasonable to read the guidance as retroactive, no matter how unfair that may seem. Whether you want to try to amend any past returns, you certainly should consider these rules for the future.

The IRS issued Revenue Ruling 2019-24 and some frequently asked questions. FAQs are a way the IRS is hoping to get informal guidance out faster and in more user-friendly ways. Technically, though, FAQs are not legal authority. The new revenue ruling addresses common questions about a cryptocurrency hard fork, and some FAQs address crypto as a capital asset. The topics include how to determine basis, how to determine gain or loss on a sale of exchange of crypto, and how to determine the fair market value of virtual currency.

Revenue Ruling 2019-24 addresses the tax treatment of hard forks of crypto in which no new crypto is received from an airdrop following the hard fork. It also covers the tax treatment of crypto hard forks that *are* followed by an airdrop of units of a new crypto. A hard fork occurs when a cryptocurrency on a distributed ledger undergoes a protocol change, resulting in a permanent diversion from the legacy or existing distributed ledger. Thinking stock dividend, perhaps? Not exactly.

A hard fork may create a new crypto on a new distributed ledger, in addition to the legacy crypto on the legacy distributed ledger. Following a hard fork, transactions involving the new crypto are recorded on the *new* distributed ledger. Transactions involving the legacy crypto continue to be recorded on the legacy distributed ledger.

An airdrop is a means of distributing units of crypto to the distributed ledger addresses of multiple taxpayers. A hard fork followed by an airdrop results in the distribution of units of the new crypto to addresses containing the legacy crypto. However, a hard fork is not always followed by an airdrop. If you are worried about your taxes, you need to know what happened.

Revenue Ruling 2019-24 says a hard fork *not* followed by an airdrop of units of a new crypto is *not* taxable to the owners of the original crypto. So far, so good. However, if a hard fork *is* followed by an airdrop of units of a new crypto, then that *is taxable* to the recipients of units of the new crypto. Sure, you may not have asked for it, and maybe had no control. But taxes are taxes, says the IRS.

A soft fork occurs when a distributed ledger undergoes a shift that does *not* result in the creation of a new cryptocurrency. A soft fork will not result in income. If you are not dizzy already, the IRS FAQs clarify additional points too.

What about your tax returns? The IRS is aware that some people failed to report their crypto. The IRS is actively hunting in crypto audits, including mailing letters to more than 10,000 taxpayers who may have reported transactions involving virtual currency incorrectly or not at all. In some cases, the IRS could go criminal, gulp.

The IRS covers a good bit else. If you transfer crypto from one wallet, address, or account you own to another you own, no tax. It's like moving something from one pocket to another. But if you transfer to someone *else*, you trigger tax in most cases. For services, for example, you paid someone, so the recipient has income. If the person is an independent contractor, that means income tax, plus self-employment tax.

The value *then* in dollars is what counts, so keep track of it. If the crypto is not traded on an exchange and does not have a published value, use the fair market value of the property or services when the transaction occurs. What if you pay for services (or goods) using crypto? When you make the payment, you will have a capital gain or loss. Your gain or loss is the difference between the fair market value of the services you received, and your adjusted basis.

If you receive crypto as a gift, you don't pay income tax, or gift tax. The *giver* may have to pay gift tax, but not you. But you could have *income* tax later, when you sell, exchange, or otherwise transfer the crypto. To figure your gain, you need your tax basis. What's your tax basis in the crypto you get as a gift?

The donor's basis, the amount the donor paid before giving it to you. It sounds ungrateful, but you should ask. Be careful later if that tax basis is tiny. It could mean big taxes for you later. Can you claim a loss? Maybe. For that purpose, your basis is equal to the *lesser* of the donor's basis or the fair market value of the crypto when you received the gift.

What if you can't substantiate the donor's basis? IRS says your basis is zero. How about computing if gain is long-term v. short-term? You get to count the time your donor held the crypto in your holding period. But once again, if you have no records, you can't. In that case, your holding period begins the day after the gift.

Got records? You better. The IRS says you must have excellent records for positions you take on your tax return. Speaking of returns, the IRS is rolling out a new question on draft 2020 tax returns. Did you do crypto in 2019, yes or no? Sound like the foreign account question that netted the IRS billions? It should.

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