Hard Forks and Airdrops: IRS Issues New Guidance on Virtual Currency Taxation

by Ryan Firth, CPA, CCFC

Ryan Firth, CPA, CCFC, is the founder and president of Mercer Street Personal Financial Services, an independent RIA firm based in Houston, Texas, that serves small business owners, young professionals, entrepreneurs, and growing families in the wealth-building phase of their lives.

After a five-year hiatus, the IRS issued Revenue Ruling 2019-24 and frequently asked questions (FAQ) on virtual currency transactions on Oct. 9, 2019.[1] Prior to Rev. Rul. 2019-24, the only formal guidance taxpayers had on the tax treatment of these transactions was IRS Notice 2014-21, which declared that virtual currency—also called cryptocurrency, or crypto, for short—is to be treated as property for federal tax purposes.

One item not specifically addressed in Notice 2014-21 was how taxpayers should report virtual currency they received from a hard fork or airdrop (defined below). Specifically, Rev. Rul. 2019-24 states that virtual currency received from a hard fork or airdrop is to be reported by the taxpayer as gross income, which will generally be treated as ordinary income, and thus subject to the taxpayer's highest marginal tax rate.

What's a Hard Fork and an Airdrop?

A hard fork occurs when a cryptocurrency's network protocol (the rules that describe how the network should operate) changes such that one group of network participants adopts the new protocol, while another group of network participants follows the old protocol, or one that is substantially different from the new protocol. In other words, the two protocols are incompatible with each other, and thus by extension, so are the networks. (A hard fork is also commonly referred to as a "chain split" because there are now two cryptocurrencies post the fork event.)

Typically, crypto holders who held coins or tokens prior to the hard fork retain those same coins in the same crypto wallet and can claim the new coins in a new wallet from the new crypto network equal to the number of coins they held at the moment of the chain split. In some respects, hard forks are analogous to a corporate spin-off; though not for tax reporting purposes, of course.

Airdrops are typically crypto tokens or coins that are distributed gratis to individuals who participate in a community. For example, the individual might be a crypto newsletter subscriber or a user of a messaging application. Airdrops are primarily used for marketing and promotional purposes to raise awareness of a cryptocurrency. Contrary to what is written in Rev. Rul. 2019-24, airdrops and hard forks are mutually exclusive events, usually. Semantics aside, the tax result is the same whether a taxpayer receives virtual currency via an airdrop or a hard fork: it's all treated as gross income.

A Recent Example

Perhaps the most prominent hard fork to date was Bitcoin Cash (BCH), which was spun off from Bitcoin (BTC) in August 2017. Bitcoin holders received one BCH coin for one BTC coin. At the time of the fork, one BTC was worth approximately $2,800 and one BCH was worth approximately $340.[2] Applying the guidance in Rev. Rul. 2019-24, a taxpayer who held one BTC at the time of the hard fork would recognize $340 of ordinary income, but only if the taxpayer was able to "exercise dominion and control" over the BCH. A taxpayer has dominion and control over the cryptocurrency if he has the ability to "transfer, sell, exchange, or otherwise dispose of the cryptocurrency."

If any one of these criteria is met, then the taxpayer has constructively received the cryptocurrency, and his tax basis would be established based on the fair market value of the crypto at that time. If the taxpayer cannot exercise dominion and control over the newly created cryptocurrency (which commonly happens when virtual currency is held at a cryptocurrency exchange), then the taxpayer does not recognize gross income until he constructively receives the cryptocurrency.

Once the taxpayer is able to exercise dominion and control (typically when the cryptocurrency exchange credits the taxpayer's account with the new cryptocurrency) then the taxpayer must recognize income on the date the crypto was constructively received based on the fair market value of the crypto at that time. Using the BCH example again, if the taxpayer custodied his one BTC coin at a crypto exchange that did not credit his account until Dec. 20, 2017, then he would recognize approximately $4,355 of income, which was the price of BCH on that date.[3] That's a nearly $4,000 difference from the date of the hard fork. As a point of reference, in early December of 2019, BCH was trading at around $215.

How to Guide Clients

As a financial planning practitioner, how can you help clients who may have an "accession to wealth" resulting from a hard fork or airdrop of cryptocurrency?

Ask your clients if they have ever transacted in virtual currency, because the IRS will most likely be asking taxpayers on Schedule 1 of Form 1040 for 2019,[4] and because the agency has issued letters to taxpayers who may have transacted in virtual currency in the past.[5] You'll probably want to know about your clients' crypto transactions before the IRS does.

For those clients that have transacted in virtual currency, determine if they need to file an amended tax return for any prior years. Help them determine whether they've constructively received cryptocurrency as a result of a hard fork or airdrop. Be aware that the Bitcoin network has had several hard forks, as have other cryptocurrencies.

Ensure taxpayers are properly tracking the cost basis of their crypto holdings (per FAQ A36, specific identification is allowed as a cost basis tracking methodology). Many online basis tracking software tools are available to both taxpayers and tax professionals that aid in tax lot optimization strategies.

Utilize tax loss harvesting to offset capital gains. Because virtual currency is deemed property, and not a security, the wash sale rules likely do not apply should your client desire to purchase the same crypto asset within the 30-day window.

Explore with your clients who want to invest in cryptocurrencies the possibility of using a tax-advantaged vehicle such as a self-directed IRA, thereby reducing the burden of basis tracking and tax uncertainty surrounding virtual currencies. Don't forget about prohibited transactions in an IRA, though.

Educate your clients about using cryptocurrency with unrealized losses to purchase personal-use property such as a home or car, because then the cryptocurrency might not qualify for capital asset treatment, thus your clients might not be able to take a capital loss deduction. Best practice would be to sell the cryptocurrency and then use the proceeds from the sale to purchase the personal-use property.

If your client is charitably inclined and wants to donate crypto, help him or her identify crypto assets that will offer the highest charitable deduction possible, being mindful that crypto held for one year or less receives a deduction that is equal to "the lesser of the taxpayer's basis in the virtual currency or the virtual currency's fair market value at the time of the contribution." Also, remember that charitable deductions are subject to AGI limitations, and a qualified appraisal is required for donations greater than $5,000 in value.

Much like blockchain technology and cryptocurrencies, the taxation of virtual currency is multi-faceted and ever-changing. Financial planners who stay abreast of regulatory developments with respect to virtual currency, such as IRS Revenue Ruling 2019-24, can add a great deal of value to clients who transact in cryptocurrencies. ■

Endnotes

1. For the full text, visit irs.gov/pub/irs-drop/rr-19-24.pdf. For the FAQ, see irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.
2. Access historical data for Bitcoin at coinmarketcap.com/currencies/bitcoin/historical-data/?start=20170801&end=20170801. And access historical data for Bitcoin Cash at coinmarketcap.com/currencies/bitcoin-cash/historical-data/?start=20170801&end=20170801.
3. See this historical data at coinmarketcap.com/currencies/bitcoin-cash/historical-data/?start=20171220&end=20171220.
4. According to irs.gov/pub/irs-dft/f1040s1--dft.pdf.
5. For more on this, see irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts.

LEARN MORE

Learn more about virtual currencies and related tax and financial planning considerations with the following resources:

Virtual Currencies and IRS Revenue Ruling 2019-24
AICPA podcast with Ryan Firth and Shehan Chandrasekera
aicpa.org/interestareas/personalfinancialplanning/cpeandevents/learning-library

Cryptocurrencies: What Every Tax Practitioner and Financial Planner Should Know
TXCPA Houston article by Ryan Firth
houstoncpa.org/news/details/2018/12/13/cryptocurrencies-what-every-tax-practitioner-and-financial-planner-should-know

Cryptocurrencies: Issues and Best Practices
Journal of Financial Planning article by Ryan Firth
FPAJournal.org

Should Cryptoassets Be a Part of a Client's Portfolio?
Journal of Financial Planning article by Ryan Firth, Bobby Henebry, and Tyrone V. Ross Jr.
FPAJournal.org

Tax Implications of Investing, Trading, and Transacting in Cryptocurrencies
Mercer Street blog post by Ryan Firth
mercerst.com/blog

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