

A Duty to Answer: Six Basic Questions and Recommendations for the IRS on Crypto Taxes

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Abstract

U.S. taxpayers lack answers to basic questions about the federal tax and reporting effects of transactions involving cryptocurrencies. Although the Internal Revenue Service has been examining issues related to the taxation of “virtual property” and “virtual currencies” for over a decade, it has only issued one piece of guidance about them. That guidance, published in early 2014 and applicable only to “convertible” virtual currency, fails to answer basic questions like:

1. How should taxpayers distinguish between convertible and non-convertible virtual currency, and what is the significance of that distinction?
2. How should taxpayers determine the fair market value of their cryptocurrency?
3. How should taxpayers calculate the basis of cryptocurrency dispositions?
4. How should taxpayers substantiate the value of cryptocurrency donations?
5. How should taxpayers account for tokens they receive from a network fork or airdrop?
6. How should taxpayers account for cryptocurrency when filing information returns?

Numerous stakeholders within and without the government have noted the 2014 guidance’s failure to address these and other basic tax questions, and have made repeated requests to the IRS for additional clarity. This report adds to that body of exhortation and recommends actions the IRS could take to resolve these open questions. Rather than indicating any intention to provide additional guidance, the IRS seems to be ramping up enforcement activities against taxpayers who “misreport” the tax consequences of their cryptocurrency transactions.

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About Coin Center

Coin Center is a non-profit research and advocacy center focused on the public policy issues facing open blockchain technologies such as Bitcoin. Our mission is to build a better understanding of these technologies and to promote a regulatory climate that preserves the freedom to innovate using blockchain technologies. We do this by producing and publishing policy research from respected academics and experts, educating policymakers and the media about blockchain technology, and by engaging in advocacy for sound public policy.

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The advent of cryptocurrencies has given rise to many interesting, and often complex, policy questions about how existing regulatory regimes ought to be applied to, or adapted to, this new and disruptive technology. Federal agencies have made significant progress in addressing some of these questions, such as when digital assets are securities for purposes of U.S. securities law and what types of activities qualify a cryptocurrency user as a Money Service Business in the eyes of the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN). In other areas there has been disappointingly little progress in spite of repeated requests for clarity from within and without the government. One such area is the federal tax treatment of cryptocurrencies.

Housed within the U.S. Department of the Treasury, the Internal Revenue Service (IRS) is tasked with "help[ing] the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share."¹ Operating under authority of the Internal Revenue Code of 1986 (IRC), the IRS administers and supervises the execution and application of federal tax law.

The IRS has been aware of the tax ambiguities of virtual currencies, and the concomitant need for clear guidance, for over a decade. In 2008, the agency's Taxpayer Advocate Service identified "emerging issues such as those arising from 'virtual worlds'" as one of "the most serious problems encountered by taxpayers" in its annual report to Congress.² Although blockchain-based cryptocurrencies like Bitcoin did not yet exist, the growth of significant economic activity within video games such as World of Warcraft and Second Life prompted the Taxpayer Advocate to recommend that the IRS provide clear guidance on many of the tax ambiguities that still plague cryptocurrency users today, such as:

[I]s a person subject to tax each time he or she acquires virtual property? How about when the person exchanges one virtual property for another, or for virtual currency? How about when the user sells the virtual property or his or her account (and avatar) for real money? What, if any, information reporting, withholding, backup withholding, and recordkeeping requirements apply to these transactions?⁵

The Taxpayer Advocate ends with a piece of advice that is particularly relevant today, and which we hope the IRS will heed:

As the tax administrator, the IRS has a duty to answer all of the basic questions about transactions undertaken regularly by significant numbers of taxpayers, such as those involving virtual items (described above), especially if the questions are difficult for taxpayers to answer on their own. It may be unfair to expect the IRS to answer these questions before state property and contract

¹ Internal Revenue Service, "The Agency, its Mission, and Statutory Authority," *IRS website* (Feb. 6, 2019) <https://www.irs.gov/about-irs/the-agency-its-mission-and-statutory-authority>.

² Internal Revenue Service, "National Taxpayer Advocate: 2008 Annual Report to Congress (Volume 1)," *IRS Publication 2104 (Rev. 12-2008)* (Dec. 31, 2008) p.216, https://www.irs.gov/pub/tas/08_tas_arc_intro_toc_msp.pdf.

³ *Id.* at p.218.

laws have evolved far enough to provide clear guidance about when a transfer of virtual items is a transfer of property rights. These very difficulties, however, support the conclusion that the IRS should issue guidance. If the tax experts at the IRS cannot figure out what the rules are or should be, unsophisticated taxpayers who participate in the virtual economy have little hope of doing so. The IRS could at least make an administrative pronouncement about how taxpayers should treat these transactions in the interim as it studies the issue and the state law rules evolve.

More broadly, the IRS needs to produce specific early guidance on difficult issues confronted by taxpayers on a regular basis in emerging areas of economic activity. Otherwise, it risks turning these taxpayers into unintentional tax cheats, establishing noncompliance norms in the industry, and leaving IRS employees without clear guidance about how to do their jobs.⁴

In 2008, World of Warcraft had about 2.5 million subscribers in North America;⁵ Second Life is not subscription-based and does not routinely publish active user statistics, but is generally believed to have peaked at around 1 million monthly active users worldwide in 2013.⁶ A recent survey of U.S. consumers by the Federal Reserve Bank of New York's Center for Microeconomic Data found that "[a]round 5 percent of respondents reported that they currently or previously owned cryptocurrency and an additional 15 percent reported that they were considering buying cryptocurrency."⁷ Taking into account that there are roughly 250 million adults living in the United States,⁸ cryptocurrency users likely constitute a larger portion of the current population than Word of Warcraft and Second Life players did in 2008 when the Taxpayer Advocate indicated that they made up "significant numbers of taxpayers," and, as such, that the agency had "a duty to answer all of the basic questions about transactions undertaken regularly by [them.]"⁹

Following a 2013 report from the U.S. Government Accountability Office (GAO) recommending the IRS "find relatively low-cost ways to provide information to taxpayers . . . on the basic tax

⁴ *Id.* at p.225 (footnotes omitted).

⁵ Blizzard, "World of Warcraft Reaches New Milestone: 10 Million Subscribers," *Press Release* (Jan. 22, 2008) <http://eu.blizzard.com/en-gb/company/press%20/pressreleases.html?id=10014593>.

⁶ Samuel Axon, "Returning to Second Life," *Ars Technica* (Oct. 23, 2017) <https://arstechnica.com/gaming/2017/10/returning-to-second-life/>; Linden Lab, "Infographic: 10 Years of Second Life," *Press Release* (Jun. 20, 2013) <https://www.lindenlab.com/releases/infographic-10-years-of-second-life>.

⁷ Sean Hundtofte, Michael Lee, Antoine Martin, and Reed Orchinik, "Deciphering American's Views on Cryptocurrencies," *Liberty Street Economics, Federal Reserve Bank of New York* (Mar. 25, 2019) <https://libertystreeteconomics.newyorkfed.org/2019/03/deciphering-americans-views-on-cryptocurrencies.html>.

⁸ U.S. Census Bureau, "2005-2009 American Community Survey 5-Year Estimates," *American FactFinder Database* (accessed Apr. 2, 2019) available at https://factfinder.census.gov/bkmk/table/1.0/en/ACS/17_5YR/S0101.

⁹ Internal Revenue Service, "National Taxpayer Advocate: 2008 Annual Report to Congress (Volume 1)," *IRS Publication 2104 (Rev. 12-2008)* (Dec. 31, 2008) p.225, https://www.irs.gov/pub/tas/08_tas_arc_intro_toc_msp.pdf.

reporting requirements for transactions using virtual currencies,”¹⁰ the IRS issued Notice 2014-21, *Virtual Currency Guidance*, in early 2014.¹¹ The IRS also established a Virtual Currency Issue Team in December 2013.¹²

Drawing from FinCEN’s 2013 virtual currency guidance,¹³ Notice 2014-21 defines “virtual currency” to be “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value . . . but it does not have legal tender status in any jurisdiction.”¹⁴ It further defines “convertible” virtual currency to be a virtual currency that “has an equivalent value in real currency, or that acts as a substitute for real currency” and identifies that “Bitcoin is one example[.]”¹⁵ It then specifies that the guidance only applies to convertible virtual currencies. The notice’s substantive guidance is a 16-question FAQ section providing certain basic information about the federal tax treatment of virtual currencies.

While some guidance is better than none, Notice 2014-21 fails to resolve many ambiguities related to virtual currency taxation. In 2016, the Treasury Inspector General for Tax Administration (TIGTA) found that:

Although the IRS issued Notice 2014-21, Virtual Currency Guidance, and established the Virtual Currency Issue Team, there has been little evidence of coordination between the responsible functions to identify and address, on a program level, potential taxpayer noncompliance issues for transactions

¹⁰ James R. White, et al., “Virtual Economies and Currencies, Additional IRS Guidance Could Reduce Tax Compliance Risks,” *Government Accountability Office Report to the Senate Committee on Finance (GAO-13-516)* (May 2013) <https://www.gao.gov/assets/660/654620.pdf>.

¹¹ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

¹² Treasury Inspector General for Tax Administration, “As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance,” *TIGTA Report No. 2016-30-083* (Sep. 21, 2016) at p.3, <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf> (“According to IRS management, the Large Business and International Division’s Offshore Arrangements Practice Network Steering Committee established the Virtual Currency Issue Team (VCIT) in December 2013 to get a better understanding of how virtual currencies may affect international taxable transactions. Specifically, the original focus of the VCIT was the identification of international underreporting strategies using virtual currency to facilitate tax avoidance/evasion schemes. In April 2015, the VCIT’s focus was expanded to act as a forum for interested individuals from various IRS offices and functions to meet and share knowledge on virtual currency. The VCIT includes members from the IRS’s Office of Chief Counsel and Criminal Investigation as well as the Large Business and International Division and the Small Business/Self-Employed Division. The VCIT’s current efforts are to: 1) determine if virtual currencies are being used as a method to hide income and avoid U.S. taxation; 2) be a vehicle to share virtual currency knowledge across the IRS; and 3) identify audit techniques that can be used to determine if taxpayers using virtual currencies in transactions, especially in offshore arrangements, are attempting to conceal income and avoid U.S. taxation.”).

¹³ U.S. Department of the Treasury, Financial Crimes Enforcement Network, “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies,” *Guidance FIN-2013-G001* (Mar. 18, 2013) <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

¹⁴ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

¹⁵ *Id.*

involving virtual currencies. None of the IRS operating divisions have developed any type of compliance initiatives or guidelines for conducting examinations or investigations specific to tax noncompliance related to virtual currencies. . . . Although the IRS requested comments to Notice 2014-21 from the public, no actions were taken to address the comments received. TIGTA reviewed all the comments and found several examples of information requested by the public that would be helpful in understanding how to comply with the tax reporting requirements when using or receiving virtual currencies.¹⁶

In light of these findings, TIGTA recommended that the IRS “should take action to provide updated guidance to reflect the documentation requirements and tax treatments needed for the various uses of virtual currencies.”¹⁷ In a response, the IRS “agreed that additional guidance would be helpful,” but also “conveyed that guidance allocation decisions are based on available resources and other competing organizational and legislative priorities.”¹⁸ TIGTA noted that “the IRS’s current guidance related to virtual currencies is insufficient. To help taxpayers voluntarily comply with their tax obligations, the IRS should devote some of its efforts to provide adequate direction in this new and complex area.”¹⁹

The IRS has not released further guidance since Notice 2014-21, and the TIGTA report above notes “[d]uring discussions with IRS management, our auditors were told that no changes to the IRS guidance would be made based on the comments received from the public.”²⁰ The IRS has, however, signaled a more aggressive enforcement stance towards taxpayers that misreport their virtual-currency-related tax obligations. In late 2016, the Department of Justice, on behalf of the IRS, requested permission from the U.S. District Court for the Northern District of California to serve a “John Doe summons” on Coinbase, a large virtual currency exchange based in San Francisco, directing the exchange to produce records identifying all U.S. taxpayers who had used its services at any point in 2013, 2014, or 2015, as well as documentation of those taxpayers’ virtual currency transactions.²¹ Brian Armstrong, the CEO of Coinbase, noted at the time that the request would cover millions of consumer accounts and that “[a]sking for detailed transaction information on so many people, simply for using digital currency, is a violation of

¹⁶ Treasury Inspector General for Tax Administration, “As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance,” *TIGTA Report No. 2016-30-083* (Sep. 21, 2016) at p.3 (“Highlights: What TIGTA found”), <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf>.

¹⁷ *Id.* at p.11.

¹⁸ *Id.* at p.11.

¹⁹ *Id.* at p.12.

²⁰ *Id.* at p.11.

²¹ The request was later narrowed significantly, to only include documentation of Coinbase customers that had transacted more than \$20,000 over the course of a year. *See*: Department of Justice, “Court Authorizes Service of John Doe Summons Seeking the Identities of U.S. Taxpayers Who Have Used Virtual Currency,” *DOJ Press Release No. 16-1404* (Nov. 30, 2016) <https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used>.

their privacy, and is not the best way for [Coinbase and the IRS] to accomplish our mutual objective [for all U.S. users of virtual currency to pay their taxes].”²²

In March 2018, the IRS published a news release, “IRS reminds taxpayers to report virtual currency transactions,” stating, in part:

Taxpayers who do not properly report the income tax consequences of virtual currency transactions can be audited for those transactions and, when appropriate, can be liable for penalties and interest.

In more extreme situations, taxpayers could be subject to criminal prosecution for failing to properly report the income tax consequences of virtual currency transactions. Criminal charges could include tax evasion and filing a false tax return. Anyone convicted of tax evasion is subject to a prison term of up to five years and a fine of up to \$250,000. Anyone convicted of filing a false return is subject to a prison term of up to three years and a fine of up to \$250,000.²³

And, on July 2, 2018, the IRS announced a compliance campaign focusing on virtual currencies that “will address noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations . . . Taxpayers with unreported virtual currency transactions are urged to correct their returns as soon as practical.”²⁴

In its 2018 General Report, released in October, the IRS’s Information Reporting Program Advisory Committee (IRPAC) wrote, “[w]hile we acknowledge and thank the IRS for publishing Notice 2014-21 . . . many industry and tax practitioners still question other tax consequences of cryptocurrency transactions . . . Therefore, IRPAC recommends that the IRS issue further guidance on the tax consequences of cryptocurrency transactions.”²⁵ The IRS Advisory Council (IRSAC), which released its 2018 Annual Report in November, also highlighted the need for the agency to do a better job providing guidance on the taxation of virtual currencies. The group’s first recommendation on the matter states:

Consider the Proposals and Comments Received. Notice 2014-21 was issued four years ago. Considering the increased prevalence of virtual currency, Notice 2014-21 does not adequately address many tax issues arising from such transactions. In addition to the public comments, several tax-related

²² Brian Armstrong, “Coinbase and the IRS,” *Medium* (Jan. 14, 2017) <https://medium.com/@barmstrong/coinbase-and-the-irs-c4e2e386e0cf>.

²³ Internal Revenue Service, “IRS reminds taxpayers to report virtual currency transactions,” *IRS News Release IR-2018-71* (Mar. 23, 2018) <https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions>.

²⁴ Internal Revenue Service, “IRS Announces the Identification and Selection of Five Large Business and International Compliance Campaigns,” *IRS News Release* (Jul. 2, 2018) <https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-five-large-business-and-international-compliance-campaigns>.

²⁵ Dana Flynn, et al., “Information Reporting Advisory Committee Public Report,” *IRS Publication 5315*, Catalog Number 71819H (Oct. 2018) at p.8, <https://www.irs.gov/pub/irs-pdf/p5315.pdf>.

professional organizations proposed areas of guidance relating to virtual currency needed by taxpayers and tax professionals. The IRSAC has reviewed the recommendations for guidance submitted by the American Institute of CPAs (AICPA) and the American Bar Association (ABA) Taxation Section and strongly supports these recommendations. The IRSAC also recommends the IRS identify guidance relating to virtual currency on its upcoming 2018-2019 Priority Guidance Plan.²⁶

In the same month as that report was published, the IRS and Treasury Department jointly released the 2018-2019 Priority Guidance Plan, which identifies 239 guidance projects that will be the focus of the 12-month period from July 2018 through June 2019. Virtual currency guidance is not among the projects so identified.²⁷

In some ways, the IRS's reticence in providing clear virtual currency tax guidance is understandable. After all, the tax code and its implementing regulations are notoriously complex, some of the tax questions raised by virtual currencies are complicated and novel, and regulatory agencies generally are reluctant to make public statements that may later need to be modified or walked back in light of changes in the underlying facts and circumstances (and/or in light of changes in the agency's understanding of those facts and circumstances). However, until the IRS provides clarity on how taxpayers should account for virtual currency activity when filing their tax returns, it would be unjust for it to begin cracking down on them for failing to do so.

This paper describes what virtual currency tax questions Notice 2014-21 answered, identifies several pressing ambiguities that remain, and recommends solutions to those ambiguities. It is focused on individuals who participate in the cryptocurrency ecosystem in a personal capacity—it does not delve into state tax, corporate tax, or issues faced by brokers, dealers, and professional traders in securities and commodities, although there are certainly open questions in those areas as well.

Open Questions and Recommendations for Guidance

Notice 2014-21 states that “[f]or federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.”²⁸ While the notice addresses the general classification of convertible virtual currencies as property for federal income tax purposes, it fails to provide sufficient specificity for one to determine which particular “general tax principles” should be applied to them. This may have been reasonable at the time the notice was issued; however, federal income tax consequences will, with few exceptions, depend upon a more specific classification of virtual

²⁶ Dennis Ventry, Jr., et al., “Information Reporting Advisory Committee Public Report,” *IRS Publication 5316*, Catalog Number 71824A (Nov. 2018) at pp. 75-76, <https://www.irs.gov/pub/irs-pdf/p5316.pdf>.

²⁷ David Kautter, Charles P. Rettig, and William M. Paul, 2018-2019 Priority Guidance Plan,” Department of the Treasury Office of Tax Policy and Internal Revenue Service (Oct. 31, 2018) https://www.irs.gov/pub/irs-utl/2018-2019_pgp_initial.pdf.

²⁸ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) at p.2, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>. (Q-1: “How is virtual currency treated for tax purposes?”).

currency as being, for purposes of the particular section of the IRC and its implementing regulations at hand, money, commodity, security, a subcategory of one of the foregoing, or something else. The IRC (and implementing regulations) is an immense body of law; it contains many highly specific sections and subsections, each of which addresses a particular aspect of the particular taxation principles that apply to particular types of property and, in doing so, ascribes either explicitly or implicitly to its key terms the definitions which are most appropriate for its purposes. Frequently with high-level terms like “property,” “money,” “commodity,” or “security,” different sections of the IRC (and implementing regulations) provide conflicting definitions for a particular term (or provide definitions for subsets of a term which include items that fall outside other sections’ definitions of that term) while others use the term without indicating what definition is meant.²⁹ For guidance on cryptocurrency taxation to be meaningful, it must acknowledge this complexity and specifically classify how cryptocurrencies fit within it or, better yet, provide a framework for doing so. What follows are Coin Center’s recommendations for such guidance on several open questions about the taxation of cryptocurrency transactions.

Open Question 1: How should taxpayers distinguish between convertible and non-convertible virtual currency, and what is the significance of that distinction?

It is important to note that the guidance in Notice 2014-21 applies *only* to “convertible virtual currency.” According to the guidance,

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like ‘real’ currency—i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance—but it does not have legal tender status in any jurisdiction.³⁰

A subset of virtual currency is “convertible” virtual currency, which the guidance states is “[v]irtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency[.]”³¹ In Notice 2014-21, the IRS gives one example of a convertible virtual currency—Bitcoin—and stresses that “[n]o inference should be drawn [from this notice] with

²⁹ For example, 26 U.S.C. § 351(e)(1)(B) specifies that, for its purposes, the term “stock and securities” includes “money” and “foreign currencies,” and 26 U.S.C. § 6045(g)(3)(B) states that, for its purposes, “specified security” includes “any commodity, or contract or derivative with respect to such commodity, if the Secretary determines that adjusted basis reporting is appropriate for purposes of this subsection[.]” 26 U.S.C. § 731(c)(1)(A), on the other hand, says that, for its purposes, the term “money” includes “securities,” contingent on several qualifications. Meanwhile 26 U.S.C. § 317 defines “property” as “money, securities, and any other property[.]” There is one section of the IRC, 26 U.S.C. § 614(a), titled “definition of property.” It begins: “For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term ‘property’ means means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.”

³⁰ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) at p.1, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

³¹ *Ibid.*

respect to virtual currencies not described in this notice.”³² It seems likely this definition would include cryptocurrencies like Ethereum and Zcash, both of which did not yet exist at the time of Notice 2014-21 but which are broadly similar to Bitcoin. It is unclear, however, whether Notice 2014-21 applies to substantially different types of digital assets such as those having attached voting or payment rights or other contractual rights or obligations, algorithmic stablecoins, airline rewards miles, and video game currencies for which there are official fiat markets—e.g., Second Life’s Linden Dollars—as well as video game currencies that are not meant to be traded for fiat but for which secondary black markets nevertheless exist—e.g., World of Warcraft Gold.

As noted above, the IRS appears to have drawn from FinCEN’s 2013 guidance for Notice 2014-21’s definition of “virtual currency” generally and “convertible virtual currency” as a specific subset thereof.³³ FinCEN’s mandate is to “safeguard the financial system from illicit use, combat money laundering, and promote national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence.”³⁴ Distinguishing between convertible and non-convertible virtual currencies makes sense in that context: FinCEN is concerned with the movement of funds through the financial system and will naturally take more interest in virtual currencies that can readily be converted to and from fiat—i.e., “convertible” virtual currencies—than it will in virtual currencies that are illiquid. In contrast, it is not readily apparent why such a distinction is important in the context of federal income taxes. To our knowledge, the IRS has not explained why it decided to bifurcate virtual currency tax guidance in this way, nor has it issued any guidance on the taxation of non-convertible virtual currencies.³⁵

³² *Ibid.*

³³ *Supra* note 13.

³⁴ Financial Crimes Enforcement Network, “Mission,” *FinCEN Website* (accessed Apr. 2, 2019) <https://www.fincen.gov/about/mission>.

³⁵ A number of other federal agencies have weighed in on virtual currency issues without restricting their statements’ applicability to only convertible virtual currency or to only non-convertible virtual currency. See, e.g., Consumer Financial Protection Bureau, “Risks to consumers posed by virtual currencies,” *CFPB Consumer Advisory* (Aug. 2014) https://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf (describing “virtual currencies,” without reference to “convertibility,” as, in part, “a kind of electronic money” that “[isn’t] regular money,” and is “not issued or backed by the United States or any other government or central bank. No one is required to accept them as payment or to exchange them for traditional currencies. . . .”); Commodity Futures Trading Commission, “An Introduction to Virtual Currency,” https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_aivc0218.pdf (noting “[s]ome virtual currencies have an equivalent value in other currencies, such as U.S. dollars or Euros, or can be traded for other virtual currencies. These are referred to as convertible virtual currencies. Bitcoin is an example of a convertible virtual currency,” but not making further use of the distinction.); Commodity Futures Trading Commission, “CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets” (Jan. 4, 2018) https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf (providing an overview of CFTC’s jurisdiction over, and approach to regulating, virtual currencies as commodities without making any distinction between convertible and non-convertible virtual currency.).

Separately, It is also unclear what the tax treatment of Bitcoin (or other convertible virtual currency) would be if a foreign nation passed a law making it legal tender, which could disqualify it from Notice 2014-21's requirement that, for the notice's purposes, virtual currency "not have legal tender status in any jurisdiction."³⁶

Beginning with the next section and continuing through the rest of this report, we will use the term "virtual currency" in the same sense that the IRS uses it in Notice 2014-21: "virtual currency" means "convertible virtual currency," which means Bitcoin and, potentially, some additional set of sufficiently similar virtual currencies. We will also use "cryptocurrency" to denote the same.³⁷

Recommendation: In addition to the other recommendations below, which reflect needed clarification to the guidance in Notice 2014-21, the IRS should do one of the following:

- If the distinction between convertible and non-convertible virtual currencies is consequential for federal tax purposes, provide guidance on the tax consequences of non-convertible virtual currency as well as guidance on how taxpayers should determine if a given virtual currency is convertible or non-convertible; or,
- If the distinction is not consequential, clarify that Notice 2014-21 (as well as any additional clarifying guidance from the IRS) applies to the use of both convertible and non-convertible virtual currency.

Fair Market Value of Virtual Currency and Tax Basis of Virtual Currency Dispositions

This set of open questions bears on the methods taxpayers are permitted or required to use in calculating capital gains and losses resulting from virtual currency transactions and in determining the fair market value of tax-deductible virtual currency donations.

For a given property transaction made by a taxpayer, there are two tax determinations that need to be made: (1) whether the transaction resulted in a gain or a loss for the taxpayer, and (2) whether that gain or loss is a long-term capital gain/loss, a short-term capital gain/loss, or an ordinary gain/loss.

To determine whether a property transaction causes a gain or a loss, one must take the amount realized from the transaction—that is, the fair market value in U.S. dollars of the money and/or

³⁶ Internal Revenue Service, "IRS Virtual Currency Guidance," *IRS Notice 2014-21* (Apr. 14, 2014) at p.1, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>. Indeed, several foreign jurisdictions are considering the adoption of blockchain-based currency as legal tender. *See, e.g.*: Central Bank of The Bahamas, "Project Sand Dollar: The Central Bank Identifies Preferred Technology Solutions Provider for Bahamas Digital Currency," *Press Release* (Mar. 1, 2019) <https://www.centralbankbahamas.com/news.php?cmd=view&id=16540>; Daniel Palmer, "Eastern Caribbean Central Bank to Test Blockchain Legal Tender," *CoinDesk* (Mar. 6, 2019) <https://www.coindesk.com/eastern-caribbean-central-bank-takes-step-toward-digital-currency-roll-out>.

³⁷ For clarity, in addition to using its definition of "virtual currency," we also adopt Notice 2014-21's assumptions that "the taxpayer's functional currency is [] the U.S. dollar, the taxpayer [] use[s] the cash receipts and disbursements method of accounting and the taxpayer is [not] under common control with any other party to a transaction." Internal Revenue Service, "IRS Virtual Currency Guidance," *IRS Notice 2014-21* (Apr. 14, 2014) at p.2, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

other property the taxpayer receives from the sale or exchange—and subtract from it the taxpayer’s adjusted basis in the property being sold or exchanged.³⁸ The adjusted basis of an asset is, as one might expect, the asset’s basis as adjusted by various provisions of the tax code.³⁹

In general, the unadjusted basis of property is the cost thereof—the amount paid for the property in cash and/or other property.⁴⁰ When a taxpayer receives property in exchange for their services as an employee or contractor, the taxpayer is obliged to include the fair market value of the property as income in the year they receive it, and their basis in the property is equal to the recognized income.⁴¹

The determination of whether a gain/loss is a capital gain/loss depends on whether the property in question is a “capital asset” in the hands of the taxpayer. If it is a capital asset, then it will usually generate capital gains or capital losses; otherwise, it will generate ordinary gains or losses. In the tax code, capital assets are defined by exclusion—everything is a capital asset unless it falls under an excluded category such as inventory or accounts receivable for a taxpayer’s business.⁴²

As mentioned above, this report is focused on individuals’ use of Bitcoin and sufficiently similar cryptocurrencies. In that context, the virtual currency is unlikely to fall under an exclusion and, as a result, will be a capital asset in the hands of the taxpayer.⁴³ Such an asset generates either long-term or short-term capital gains or losses, depending on how long the property was held by the taxpayer before its sale or exchange. If the property was held for more than one year, it generates long-term capital gain/loss, which is subject to more favorable tax rates; if it was held for less than one year, it generates short-term capital gain/loss, which is taxed at the same rate as ordinary income.⁴⁴

³⁸ 26 U.S.C. § 1001(a).

³⁹ 26 U.S.C. § 1011 defines adjusted basis; several basis adjustments are codified at 26 U.S.C. § 1016 and implemented by regulation under 26 C.F.R. § 1.1016-1-6 & 1.1016-10.

⁴⁰ 26 U.S.C. § 1012. Basis is calculated differently for property included in inventory, acquired from a decedent, or acquired by gifts and transfers in trust (IRC 1013, 1014, and 1015 respectively).

⁴¹ 26 U.S.C. § 83(a). Technically, the fair market value of such property must be included in gross income in the year in which the rights of the taxpayer having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, or, by election, at an even earlier date. 26 U.S.C. § 83(b). Further, the gross income recognized must be reduced by the fair market value of any money or property the taxpayer paid for the received property. 26 U.S.C. § 83(a). For clarity of presentation, these nuances are omitted above.

⁴² 26 U.S.C. § 1221(a).

⁴³ As IRS Publication 544 notes, “almost everything you own and use for personal purposes, pleasure, or investment is a capital asset.” Noncapital assets include business inventory (property held mainly for sale to customers) and assets used by a business to perform its trade or business. *See*: Internal Revenue Service, “Sales and Other Dispositions of Assets (For use in preparing 2018 returns),” *IRS Publication 544*, Cat. No. 15074K (Feb. 28, 2019) at p.22, <https://www.irs.gov/pub/irs-pdf/p544.pdf>.

⁴⁴ 26 U.S.C. § 1222 & 1223.

Open Question 2: How should taxpayers calculate the fair market value of virtual currency?

In many instances of the scenarios described above, the taxpayer needs to know the fair market value (FMV) of the property they are receiving or exchanging. This brings us to our next open question: How should taxpayers determine the FMV of virtual currency? Notice 2014-21 provides the following response to that question:

For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. Therefore, taxpayers will be required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt. If a virtual currency is listed on an exchange and the exchange rate is established by market supply and demand, the fair market value of the virtual currency is determined by converting the virtual currency into U.S. dollars (or into another real currency which in turn can be converted into U.S. dollars) at the exchange rate, in a reasonable manner that is consistently applied.⁴⁵

This is a helpful start, but there are three significant gaps that need to be filled. First, most cryptocurrencies can be traded on more than one exchange, and the exchange rates across the different exchanges for a given cryptocurrency are not uniform. What should a taxpayer do when faced with different exchange rates at different exchanges? Second, taxpayers need more guidance on what the IRS will consider “a reasonable manner that is consistently applied.” Last, what does the IRS mean when they specify that taxpayers must determine the fair market value “as of the date of payment or receipt”? Cryptocurrency exchange rates often have significant intra-day volatility, and it is not immediately clear how the IRS expects, or will permit, taxpayers to calculate the FMV “as of the date of payment or receipt.”

Recommendation: The IRS should allow taxpayers to, for each cryptocurrency they use or possess, use either the exchange rate data from one exchange, averaged exchange rate data from a fixed set of exchanges, or a third-party exchange rate index, so long as they consistently use the same exchange, exchanges, or index to calculate the exchange rate for that cryptocurrency going forward. Taxpayers should also have the option to, for each cryptocurrency they possess, use an overall daily average exchange rate, a snapshot exchange rate taken at the same time of day each day, or the exchange rate at the time of transaction for each transaction, again so long as they consistently use their chosen methodology going forward.

These recommendations only bear on how the IRS interprets its existing guidance—adopting them would, arguably, not even require the publication of additional guidance. It is quite possible that a clearly articulated explanation of what the existing guidance means by

⁴⁵ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) at p.3 (“Q-5: How is the fair market value of a virtual currency determined?”) <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

“reasonable manner that is consistently applied” and “as of the date of payment or receipt” would be sufficient to resolve the current uncertainty facing virtual currency-using taxpayers.

Open Question 3: How can taxpayers determine the cost basis of virtual currency dispositions?

In addition to clear guidance on what fair market valuation methods are acceptable, taxpayers need clarity on what tax lot relief⁴⁶ methods are available to them. A plain reading of the tax code and regulations suggests that the only permissible method for virtual currencies is specific identification, meaning that taxpayers need to, for each unit of virtual currency they possess, keep track of the date on which they acquired that virtual currency as well as their adjusted basis in it.⁴⁷ Then, every time the taxpayer transacts with virtual currency they must identify the specific unit of virtual currency with which they are transacting and use that specific unit’s adjusted basis, alongside its fair market value at the time or day of the transaction, to determine their gain or loss. Further, if the gain or loss is a capital gain or loss, then the taxpayer will need to compare the date on which they acquired that specific unit of virtual currency with the transaction date to determine whether their capital gain or loss is short-term or long-term.

In the case of Bitcoin, different bitcoins technically are nonfungible. In order to transfer ownership of a bitcoin to someone else, a user must create and broadcast a transaction to the network that uses, as its inputs, one or more specific previous transaction(s) in which the user received the bitcoin they wish to transfer. Keeping track of every unspent transaction they have received, the date they received it, and their basis in it, and then cross-referencing that information for every transaction they engage in is an incredibly onerous but technically feasible task for a Bitcoin user that holds their own private keys and uses a software wallet to transact. For those that use a hosted wallet, where the wallet provider has custody of the user’s private keys and transacts on their behalf, it may be effectively impossible for the taxpayer to adequately identify which specific previous transaction(s) a given transaction used as input(s), even if such identification is technically the only permissible method of determining the cost basis of the virtual currency disposition.⁴⁸

Treasury Regulation (Treas. Reg.) 1.1012-1 specifies that stocks and certain other securities are eligible for tax lot relief methods other than specific identification, such as FIFO (first-in,

⁴⁶ When a taxpayer has acquired multiple “lots” of the same asset over time, then the tax basis of each of those “tax lots” will be different to the extent that the fair market value of the asset changed in between purchases. When the taxpayer later disposes of some amount of that asset, in order to determine their basis in the asset they must first determine *which* tax lot the asset they sold came from. “Tax lot relief methods” refers to the different ways to go about making that determination.

⁴⁷ As noted above, this report is focused on taxpayers that use or invest in cryptocurrencies in a personal capacity. There are alternative methods of basis calculation available to other types of taxpayers. For example, businesses for which the virtual currency is classified as inventory can use the inventory methods of accounting under 26 U.S.C. § 471-475.

⁴⁸ Some other cryptocurrencies that may be subject to IRS Notice 2014-21 have technical differences that may impact this analysis as well. For example, Ethereum uses an account-based system rather than an unspent transaction output (UTXO) system.

first-out), but the IRS's current characterization of virtual currency does not appear to allow taxpayers to take advantage of them.⁴⁹ Treas. Reg. 1.6045-1 requires brokers and barter exchanges to file information returns on their customers' transactions in "covered securities."⁵⁰ In doing so, brokers are required to use various lot relief methodologies depending on the types of transactions in question and, in some instances, whether the customer has notified the broker of their election to use a different permissible lot relief method. The definition of "covered securities" used in Treas. Reg. 1.6045-1 is, essentially, any "specified security" that was acquired after a specified date.⁵¹ "Specified security" is, in turn, defined to consist of specific categories of stocks, debt instruments, options, and securities futures contracts.⁵² It is unlikely that a virtual currency would meet the definition of any of these categories.

However, the statutory language under which Treas. Reg. 1.6045-1 was written includes in the definition of specified security "any commodity . . . if the Secretary [of the Treasury] determines that adjusted basis reporting is appropriate for purposes of this subsection."⁵³ The Commodity Futures Trading Commission (CFTC), which oversees commodity futures markets, determined in late 2014 that virtual currencies are commodities.⁵⁴ It is likely that the IRS has statutory authority to, if it so chose, create information reporting requirements for virtual currency transactions of customers of brokers and barter exchanges that use, or permit, tax lot relief methods other than specific identification. Such an action would likely require a notice-and-comment rulemaking. The implementing regulations define "commodity" as "[l]ead, palm oil, rapeseed, tea, tin, or an interest in the foregoing[,]" "[a]ny type of personal property or an interest therein (other than securities as defined in paragraph (a)(3)) the trading of regulated futures contracts in which has been approved by the Commodity Futures Trading Commission[,]" and "[a]ny other personal property or an interest therein that is of a type the Secretary [of the Treasury] determines is to be treated as a 'commodity' under this section, from and after the date specified in a notice of such determination published in the Federal Register."⁵⁵ Virtual currency obviously does not fall under the first category. The second category is also problematic. Although there are regulated Bitcoin futures, none of them have been "approved" by the CFTC. Rather, they have gone through the CFTC's self-certification process, in which a "designated contract market" that plans to offer a new futures products files a "product self-certification submission" with the CFTC stating that the product does not violate any provision of the Commodities Exchange Act or the CFTC's regulations adopted

⁴⁹ 26 C.F.R. § 1.1012-1.

⁵⁰ 26 C.F.R. § 1.6045-1.

⁵¹ 26 C.F.R. § 1.6045-1(a)(15). The relevant date varies depending on the type of specified security being considered.

⁵² 26 C.F.R. § 1.6045-1(a)(14).

⁵³ 26 U.S.C. § 6045(g)(3)(B)(iii).

⁵⁴ See, e.g.: Commodity Futures Trading Commission, "CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets," *CFTC Office of Public Affairs Release* (Jan. 4, 2018) https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf.

⁵⁵ 26 C.F.R. § 1.6045-1(a)(5).

thereunder.⁵⁶ Barring an objection from the CFTC, the designated contract market may then list the new product as soon as one day later without any need for explicit CFTC approval.⁵⁷ In order to expand the information reporting requirements of Treas. Reg. 6045-1, then, the IRS could look to the third category and publish a Federal Register notice stating that the Secretary of the Treasury has determined virtual currency is to be treated as a “commodity” for purposes of I.R.C. 6045 and Treas. Reg. 6045-1. Alternatively, the IRS could undertake a rulemaking to update the second category to reflect the existence of the self-certification process in such a way that causes Bitcoin to be included in the definition of “commodity” for purposes of I.R.C. 6045 and Treas. Reg. 6045-1, although this option would continue to exclude other, similar virtual currencies that the IRS may otherwise want to treat in the same manner as Bitcoin but for which there are not currently CFTC-approved futures contracts.

Recommendation: Given the difficulties of applying specific identification to virtual currency, and the fact that taxpayers conducting transactions in essentially any other commonly traded financial instrument have a variety of tax lot relief methods available to them, the IRS should allow taxpayers to use tax lot relief methods other than specific identification for virtual currency transactions. Taxpayers should be permitted to, if they so choose, elect to use different lot relief methods for each of their cryptocurrency “accounts”⁵⁸ in the same way they can select differing lot relief methods for eligible non-cryptocurrency accounts. This could be implemented through a rulemaking as described above, or through informal or formal guidance to taxpayers. If the IRS elects to accept this recommendation in a manner that requires notice in the Federal Register, we recommend both publishing a notice that virtual currency is to be

⁵⁶ See, e.g., Commodity Futures Trading Commission, “Self-Certification Filing Procedures,” *CFTC Website* (accessed April 2, 2019)

<https://www.cftc.gov/IndustryOversight/ContractsProducts/ListingProcedures/index.htm>; Commodity Futures Trading Commission, “CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products,” Fact Sheet (Dec. 1, 2017)

https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet_120117.pdf.

⁵⁷ Commodity Futures Trading Commission, “CFTC Backgrounder on Self-Certified Contracts for Bitcoin Products,” Fact Sheet (Dec. 1, 2017)

https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/bitcoin_factsheet_120117.pdf.

⁵⁸ The concept of a cryptocurrency “account” makes sense when a taxpayer uses a custodial wallet provider to secure their cryptocurrency, but breaks down when one considers cryptocurrencies that are self-custodied. Although there are technically no “accounts” in such a scenario, taxpayers should still be able to select different lot relief methodologies for different groups of assets. The ability to choose different tax lot relief methods on an account-by-account basis can be extended to the context of virtual currency by allowing the taxpayer to group, into one or more sets, the unspent transaction outputs (UTXOs) for which they control the private key. (Or, for more complex UTXOs, those for which they control a sufficient number of the associated private key(s) to create a transaction using the UTXO as an input.) So long as such grouping is done in a reasonable and consistently applied manner, we see no policy reason not to consider each grouped set to be an “account” for purposes of selecting lot relief methodologies. *For a technical treatment of Bitcoin transactions and UTXOs, see: Andreas M. Antonopoulos, Mastering Bitcoin: Unlocking Digital Currencies* at ch. 5. Sebastapol, CA: O’Reilly, 2014, available at <https://www.oreilly.com/library/view/mastering-bitcoin/9781491902639/ch05.html>.

treated as a “commodity” for purposes of I.R.C. 6045 and Treas. Reg. 6045-1 *and* undertaking a rulemaking to update the regulations to reflect the existence of the self-certification process.

Open Question 4: Do charitable donations of virtual currency resulting in a deduction of \$5,000 or more require a qualified appraisal?

Like other property, taxpayers that donate virtual currency to a charity are generally permitted to deduct the fair market value of the virtual currency or other property at the time of donation from their income that year.⁵⁹ However, this deduction is generally capped at \$500 unless the taxpayer satisfies certain documentation and substantiation requirements.⁶⁰ Donations for which the taxpayer claims a deduction of more than \$5,000 also require the documentation and submission of a qualified appraisal prepared by a qualified appraiser in accordance with generally accepted appraisal standards and other regulatory requirements.⁶¹ The tax code provides an exception to this appraisal requirement for certain “readily valued property” such as cash, stocks or other property held as inventory or primarily for sale to customers in the ordinary course of a trade or business, and securities for which market quotations are readily available on an established securities market.⁶²

As Notice 2014-21 recognizes, virtual currencies like Bitcoin are widely traded on a variety of exchanges from which pricing data is readily available. In this way, virtual currency is similar to the categories of “readily valued property” listed above. From a policy perspective, we should want a virtual currency donor to substantiate the fair market value of their donation using readily and widely available exchange data, which can be acquired at essentially no cost, rather than through a costly appraisal process.

However, most taxpayers are not engaged in a trade or business that entails, in its ordinary course, the sale of virtual currency to customers. In light of Notice 2014-21’s holding that virtual currency is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes, it is also unlikely that virtual currency would be considered cash for purposes of the appraisal exception.⁶³ Additionally, a prudent taxpayer would probably not decide to risk their deduction of more than \$5,000 being rejected by the IRS by attempting to use the appraisal exception afforded to “securities for which market quotations are readily available on an established securities market.”⁶⁴

Recommendation: We submit that the IRS should provide taxpayers with guidance explicitly allowing them to use readily available exchange data to value virtual currency donations in the

⁵⁹ 26 C.F.R. § 1.170A-1(a)-(c). There are a great many exceptions, adjustments, and caveats to this general statement that are not particular to virtual currency and which we do not discuss here.

⁶⁰ 26 U.S.C. § 170(f)(11)(A) and (B).

⁶¹ 26 U.S.C. § 170(f)(11)(C) and (D), and 26 C.F.R. § 1.170A-11(c).

⁶² 26 U.S.C. § 170(f)(11)(A)(ii)(I), 26 U.S.C. § 1221(a)(1), 26 U.S.C. § 6050L(a)(2)(B). “Readily valued property” also includes certain patents and other intangible property, as well as certain automobiles.

⁶³ Internal Revenue Service, “IRS Virtual Currency Guidance,” *IRS Notice 2014-21* (Apr. 14, 2014) at p.2 (“Q-2: Is virtual currency treated as a currency for purposes of determining whether a transaction results in foreign currency gain or loss under federal tax laws?”) <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

⁶⁴ 26 U.S.C. § 6050L(a)(2)(B).

same way taxpayers are expected to use such data to calculate the fair market value of their virtual currency every other time they transact with it.

Forks and Air Drops

Bitcoin and similar cryptocurrencies are, fundamentally, a network of peers running software that executes a protocol to maintain and update a distributed ledger of transactions. If some subset of the network participants (Group A) begins to run software that is not compatible with the software being run by the rest of the network (Group B)—*i.e.*, if the protocol Group A now uses would consider some transactions valid that Group B would consider to be invalid—then the cryptocurrency network will “fork” into two separate networks with two different distributed ledgers. After a fork, there would be two cryptocurrency networks, and two underlying cryptocurrencies. Anyone who owned units of the original network’s cryptocurrency would now own an equivalent number of tokens on *each* of the resulting networks.⁶⁵

In 2017, such a fork occurred on the Bitcoin network.⁶⁶ Disagreement over proposed technical changes to the Bitcoin core protocol resulted in a situation where a subset of the network changed their software in a way that was not backwards-compatible while the rest of the network did not. The two cryptocurrencies that resulted from this fork are Bitcoin (the branch of the fork that is generally considered to be the continuation of the original network) and Bitcoin Cash (the branch of the fork that is considered to be a new cryptocurrency that shares a common pre-fork history with Bitcoin). Anyone holding bitcoins prior to the fork would, after the fork, have an equivalent amount of both Bitcoin and Bitcoin Cash. By running software that implemented the unchanged Bitcoin protocol, they could transact with their bitcoin balance on the Bitcoin blockchain without any effect on the Bitcoin Cash blockchain; by running software that implemented the altered Bitcoin protocol, they could transact with their bitcoin cash balance on the Bitcoin Cash blockchain without any effect on the Bitcoin blockchain.

The fork that resulted in Bitcoin Cash received significant news coverage and attention, and it is unlikely that a typical Bitcoin user would have been unaware of its occurrence and, consequently, of the fact that post-fork they would have two distinct cryptocurrencies instead of one.⁶⁷ There are many forks, however, for which this is not the case. Developers frequently create forks of the Bitcoin (and other cryptocurrency networks’) blockchain to try out experimental features, to create a more customized version for a specific application, or to create a network with lower usage and, as a result, lower transaction costs.⁶⁸ Taxpayers who

⁶⁵ For a general discussion of how new cryptocurrency projects fork off from older ones, see: Peter Van Valkenburgh, “What are Forks, Alt-coins, Meta-coins, and Sidechains?” *Coin Center* (Dec. 8, 2015) <https://coincenter.org/entry/what-are-forks-alt-coins-meta-coins-and-sidechains>.

⁶⁶ “Bitcoin divides to rule,” *The Economist* (Aug. 5, 2017) <https://www.economist.com/finance-and-economics/2017/08/05/bitcoin-divides-to-rule>.

⁶⁷ Pete Rizzo, “Will Bitcoin Cash Impact the Bitcoin Price? Traders Split on Possible Fork,” *CoinDesk* (Jul. 31, 2017) <https://www.coindesk.com/will-bitcoin-cash-impact-bitcoin-price-traders-split-possible-fork>.

⁶⁸ See, for example, *Litecoin*: Danny Bradbury, “Litecoin: Origins and potential of the world’s second largest cryptocurrency,” *CoinDesk* (Jul. 23, 2013) <https://www.coindesk.com/litecoin-founder-charles-lee-on-the-origins-and-potential-of-the-worlds-second-largest-cryptocurrency>.

have owned a well-known cryptocurrency such as Bitcoin for any length of time have the ability, if they download the appropriate software for the forked network in question, to sell or spend tokens on multiple cryptocurrency networks resulting from forks in the Bitcoin blockchain that have occurred in the time they have been holding bitcoin. Many of those tokens would be worth very little, and the taxpayer likely has no idea that most of them exist, but they inarguably represent value that can only be accessed by the taxpayer.

A distinct but similar concept to a network fork is an “airdrop.”⁶⁹ Suppose you are a developer with a great idea for a cryptocurrency network. The protocol you envision for your new cryptocurrency uses public-private key pairs, like Bitcoin, but is otherwise very different. You want to get your cryptocurrency into the hands of users to drive network effects. One way you could do this is to fork the Bitcoin blockchain—that way, everyone who had bitcoin at the moment of the fork would, after the fork, also have tokens on your new network. You could also try to sell the tokens, or you could give them away for free. One way to give away tokens for free is via an airdrop. In an airdrop, the developers of a (usually new) cryptocurrency network download a copy of the Bitcoin (or other cryptocurrency network) blockchain, add up how many bitcoin are currently held at each public address on the Bitcoin network, and then, for each such public address, allocate a commensurate amount of tokens to that address on the blockchain of the network they are developing. This allows the developers to widely distribute the tokens to people who they know are cryptocurrency users without forking any extant network. Some airdrops are opt-in, where there is a period of time during which persons wanting to receive airdropped tokens must affirm that fact, and then the airdrop is performed by distributing new tokens in proportion to the relative Bitcoin balances of those who have opted in. Other airdrops are done without any input, and often without any awareness, of the token recipients.

Open Question 5: What is the tax treatment of virtual currency tokens received from network forks and air drops?

In many cases, for a given fork or airdrop and a given Bitcoin user, the user may be wholly unaware of the existence of the new network and the coins on that network over which they have control. Other times, the recipient might decide to dispose of the token immediately by, *inter alia*, selling it for fiat on a custodial exchange. Or, the recipient might hold on to the token for a period of time before disposing of it. In other words, there are four main scenarios to consider:

1. Recipient is aware of new token, and promptly uses their private key to take control of it and sell it.
2. Recipient is aware of new token, but decides to hold onto it until a future date. On that future date, they sell the token.
3. Recipient is initially unaware of the token; on a later date, recipient becomes aware of the token and sells it.

⁶⁹ Although the description of airdrops here captures the important concepts for the topic at hand, it omits significant technical details and should not be relied upon more broadly.

4. Recipient never accesses the new token.

In each situation, there are several pertinent tax questions:

1. What is the recipient's basis in the tokens received?
2. When is the recipient allowed, and when are they required, to recognize income as a result of receipt of the new tokens?
3. What type of income is realized?
4. To the extent that the type of income realized is a capital gain, what date should the recipient use to calculate whether or not the capital gain is long- or short-term?

Recommendation: If the recipient does not exercise dominion over and dispose of the tokens, there should be no tax effect. If the recipient does take control of and disposes of the tokens, income should generally be recognized at the time of disposition. The type of gain realized should depend on the classification of the asset in the hands of the taxpayer, but would generally be a short-term capital gain. For tokens received as the result of a network fork, the taxpayer should be allowed to distribute their adjusted basis in the pre-fork token between the two resulting post-fork tokens. For purposes of calculating the holding period of the post-fork tokens to determine if a gain is short- or long-term, the taxpayer should include the time they held the pre-fork token. If a taxpayer holds their cryptocurrency with a custodial exchange, any actions that the exchange takes regarding airdropped or forked tokens should not affect the taxpayer unless such actions were undertaken at the direction of the taxpayer.

Reports of Foreign Financial Accounts

Notice 2014-21 states that virtual currency payments are subject to the same reporting requirements as any other payment made in property.⁷⁰ Two such annual reporting requirements are the Report of Foreign Bank and Financial Accounts and the Statement of Specified Foreign Financial Assets.

Open Question 6: What are the reporting requirements for virtual currencies under FBAR and FATCA?

Under federal regulation, each United States person that has a financial interest in, or authority over, a bank account, securities brokerage account, or other financial account in a foreign country that exceeds certain thresholds is required to annually submit to the Treasury Department via the IRS FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).⁷¹ Specifically, if a United States person had a financial interest or authority over at least one financial account located outside of the United States in a tax year, and at some point during the year the aggregate value of all such foreign financial accounts held by that person

⁷⁰ Internal Revenue Service, "IRS Virtual Currency Guidance," *IRS Notice 2014-21* (Apr. 14, 2014) at p.5 ("Q-12: Is a payment made using virtual currency subject to information reporting?") <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

⁷¹ 31 C.F.R. § 1010.350.

exceeded \$10,000, then they must complete and submit FinCEN Form 114 to the IRS.⁷² Virtual currencies held in a custodial account located outside of the United States—either because they are held with a foreign financial institution or with a foreign branch of a U.S. financial institution—may or may not need to be reported under FBAR, depending on the IRS and FinCEN’s interpretation of whether such holdings constitute a “reportable account” for purposes of FBAR.⁷³

The Foreign Account Tax Compliance Act (FATCA) places various reporting and withholding requirements on financial intermediaries and requires individual taxpayers holding more than \$50,000 in “specified foreign financial assets” to report information about those assets by submitting IRS Form 8938, Statement of Specified Foreign Financial Assets, alongside their annual tax return.⁷⁴ In December 2014, the IRS requested comment on the proper treatment of virtual currencies under FATCA reporting requirements.⁷⁵ Since that 32-word request for comment, the IRS has not issued further information requests or guidance.

Broadly, the “specified foreign financial assets” in question under FATCA are made up of four types of financial assets: (1) financial accounts maintained by a foreign financial institution; (2) stocks and securities issued by someone other than a U.S. person; (3) financial instruments or contracts held for investment that have an issuer or counterparty other than a U.S. person; and (4) financial interests in foreign entities.⁷⁶ Virtually currencies held in the custody of a financial institution that is not based in the United States may meet the definition of category (1), although there is a colorable argument that they do not. Digital assets that are deemed stocks or securities for federal tax purposes, and for which the issuer is someone other than a U.S. person, likewise would qualify as specified foreign financial assets for FATCA purposes. Last, it is possible that blockchain-based derivatives, and potentially some smart contracts, would qualify as specified foreign financial assets if there is a counterparty to the transaction and that counterparty is someone other than a U.S. person.⁷⁷

Recommendation: The IRS should clarify whether and when virtual currency holdings and payments are subject to reporting requirements under FATCA and FBAR. Because such clarification would be an explanation of how existing reporting requirements apply to virtual currencies, it would likely not require a notice-and-comment rulemaking.

⁷² 31 U.S.C. § 5314. Instructions and additional information for FinCEN Form 114 are available at <https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar>.

⁷³ 31 C.F.R. § 1010.350(c).

⁷⁴ 26 U.S.C. § 6038D. In the implementing regulations, there are higher thresholds for married individuals filing a joint return and for individuals living abroad. 26 C.F.R. 1.6038D-2(1) through (4).

⁷⁵ Internal Revenue Service, “Internal Revenue Bulletin,” *IRS Bulletin No. 2014-53 (Dec. 29, 2014)* pg. 984, <https://www.irs.gov/pub/irs-irbs/irb14-53.pdf>; Reporting of Specified Foreign Financial Assets, 79 Fed. Reg. 73817 (Dec. 12, 2014) <https://www.federalregister.gov/documents/2014/12/12/2014-29125/reporting-of-specified-foreign-financial-assets>.

⁷⁶ 26 U.S.C. § 6038D.

⁷⁷ 26 C.F.R. § 1.6038D-3(b).

Conclusion

It has been over a decade since the IRS's Taxpayer Advocate noted the open questions regarding taxation of virtual worlds and economies and admonished the agency to "produce specific early guidance on difficult issues confronted by taxpayers on a regular basis in emerging areas of economic activity. Otherwise, it risks turning these taxpayers into unintentional tax cheats, establishing noncompliance norms in the industry, and leaving IRS employees without clear guidance about how to do their jobs."⁷⁸ The only piece of guidance the IRS has released to date, a six-page FAQ,⁷⁹ does not satisfy this mandate; this has been noted by stakeholders both internal, such as the Treasury Inspector General for Tax Administration⁸⁰ and the Information Reporting Program Advisory Committee,⁸¹ and external, such as the American Institute of Certified Public Accountants⁸² and the American Bar Association.⁸³ While it is understandable that the IRS has been slow to tackle these issues given their complexity and the agency's limited resources, it is unacceptable that it appears to be ramping up enforcement efforts against "[t]axpayers who do not properly report the income consequences of virtual currency transactions,"⁸⁴ without ever having made clear what it means to "properly report."

This report has laid out several of the most pressing ambiguities facing U.S. taxpayers that use cryptocurrencies as well as common-sense approaches to resolving them. Our hope is that the IRS will look to them as a starting point for additional guidance in this space, and will refrain from taking legal action against well-meaning cryptocurrency users who simply do not know how they are supposed to account for these new digital assets when they file their tax returns.

⁷⁸ James R. White, et al., "Virtual Economies and Currencies, Additional IRS Guidance Could Reduce Tax Compliance Risks," *Government Accountability Office Report to the Senate Committee on Finance (GAO-13-516)* (May 2013) <https://www.gao.gov/assets/660/654620.pdf>.

⁷⁹ Internal Revenue Service, "IRS Virtual Currency Guidance," *IRS Notice 2014-21* (Apr. 14, 2014) <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>.

⁸⁰ Treasury Inspector General for Tax Administration, "As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance," *TIGTA Report No. 2016-30-083* (Sep. 21, 2016) <https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf>.

⁸¹ Dennis Ventry, Jr., et al., "Information Reporting Advisory Committee Public Report," *IRS Publication 5316*, Catalog Number 71824A (Nov. 2018) at pp. 75-76, <https://www.irs.gov/pub/irs-pdf/p5316.pdf>.

⁸² American Institute of CPAs, "Request for Guidance Regarding Virtual Currency," *Public Interest Comment from the AICPA to the IRS* (May 30, 2018) <https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180530-aicpa-comment-letter-on-notice-2014-21-virtual-currency.pdf>.

⁸³ American Bar Association Section of Taxation, "Comments on Notice 2014-21," *Public Interest Comment from the ABA to the IRS* (March 24, 2015) <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032415comments.pdf>.

⁸⁴ Internal Revenue Service, "IRS reminds taxpayers to report virtual currency transactions," *IRS News Release IR-2018-71* (Mar. 23, 2018) <https://www.irs.gov/newsroom/irs-reminds-taxpayers-to-report-virtual-currency-transactions>.