

# Avoiding IRS Trouble in the Wild World of Cryptocurrency

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**Cryptocurrency is a hot topic right now. When we originally decided to write about it, I had a hard time figuring out how it applied to the average business owner. Then Congress started talking about taxing digital assets, and companies like JP Morgan announced they were planning to launch an investment fund based on cryptocurrency, and suddenly, that gee-whiz topic we talked about last winter was hotter than Vegas in June. With so many changes on the horizon, it is worth looking at where we are now and how the IRS treats virtual currency so you can make sure there aren't any surprises later.**

**U**ntil a few months ago, Congress had taken a wait-and-see position with legislation, reporting, and taxation of virtual currency and digital assets.

Now that they are taking an active interest in virtual currency, it's a good time to review some of the basic uses of virtual currency and how the IRS handles them right now.

The first thing to know about crypto, or virtual, currency is that it is generally treated as property.

Although it's been around for a while, we are still very early in the process of establishing virtual

currency as a standard form of payment.

Except for hackers holding companies' data hostage, and El Salvador, which recently became the first country to classify Bitcoin as a currency, most people do not know where to buy

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it, how to store it, or how to use it.

In **Notice 2014-21** the IRS specifically states, “For federal tax purposes, virtual currency is treated as property” and not a

foreign currency.

This makes sense because when you strip away the idea that crypto is an actual legal tender, it is easy to wrap your head around the idea that using virtual currency to make a purchase is no different

from Jack trading the family cow for magic beans.

As we all know, whether you make a profit or take a loss, any time you trade a capital asset (stocks, bonds, or other property) for

something of value, the government wants you to report it on Schedule D when you file your taxes. (see **Publication 544, Sales and Other Dispositions of Assets**)

Most of this is straightforward.

If you use virtual currency worth \$600 or more to pay an independent contractor for services, you would report it just like a standard cash payment with a 1099-MISC.

Along the same line, if you pay an employee's wages with virtual currency, it would be subject to the same standard withholding and employer reporting as when you pay an employee with US dollars. Continuing that theme, anyone who is self-employed and mines virtual currency as their occupation has the same reporting and tax standards as anyone else required to report self-employment income.

This part is simple. In most situations, the IRS expects you to report and pay taxes as you normally would when you exchange something of value for something of value.

*The confusion comes in when you get away from simple, clear-cut transactions and look at things like hard forks and airdrops.*

## **In most cases, using virtual currency to pay for products or services falls under the same guidelines as a regular cash transaction.**

In October 2019, the IRS released **Revenue Ruling 2019-24** and an update to the **Frequently Asked Questions on Virtual Currency Transactions** to address questions about hard forks and airdrops. (NOTE: Frequently Asked Questions are not considered official IRS guidance and should not be used as a definitive resource for IRS policy or procedure.)

Revenue Ruling 2019-24 tackled two questions.

1. Does a taxpayer have gross income, under § 61 of the Internal Revenue Code, as a result of a hard fork of a cryptocurrency the taxpayer owns, if the taxpayer does not receive units of a new cryptocurrency?
2. Does a taxpayer have

gross income, under § 61, as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency?

In the absence of any other regulation specific to virtual currency, the IRS took a logical approach to both situations.

For the first scenario where the taxpayer **did not** receive units of the new currency, the answer comes down to an understanding of what happens when a virtual currency hard forks.

*A hard fork happens when the peer network that controls the blockchain that manages the currency changes the original blockchain protocols and the change splits the*

### ***currency into two separate blockchains.***

There is no definitive rule that states people who own currency in the first blockchain will receive new currency after the fork.

They could, but they could also continue to maintain it as usual with the original blockchain.

With that in mind, the question becomes whether they received units of the new cryptocurrency.

In this example, the answer is no, and the IRS determined the fork did not generate gross income.

The second question is a little trickier because ***the taxpayer may not control whether they receive an airdrop.***

An airdrop is a marketing ploy that deposits into an existing crypto wallet or account to generate interest in a new currency.

It's kind of like sending someone a dollar bill in the mail with the hope the recipient will try their product.

The person can't control if it's mailed to them and they don't know it's there until they open the envelope.

In that context, whether a taxpayer has gross income from an airdrop comes down to dominion and control.

***If the taxpayer can manage, control, or dispose of the property, then they have dominion and control and have gross income.***

As you can see, the IRS has stuck to the tried-and-true approaches for profit, loss, and reporting of transactions involving virtual currency.

### **This is changing.**

Governments are looking for new ways to raise tax dollars to fund COVID-19 recovery programs and virtual currency is an untapped market.

In July 2021, Congress announced a plan to tax cryptocurrency to help fund a portion of the proposed infrastructure bill. (H.R.22 - Build America Act of 2021)

When you consider that the United States is not the only player, and countries such as Japan, the United

## **Key Terms & Definitions**

**Cryptocurrency:** A digital currency created to be "decentralized" to avoid the fluctuations of specific markets or economies. It is independent and is neither controlled nor guaranteed by any specific nation.

**Blockchain:** Blockchain is a program that both secures cryptocurrency and creates a ledger that provides a history for each block of a currency's transactions.

Note: Blockchain is thought to be virtually unhackable, but as the recent Coinbase robbery illustrates, anyone who wants to get in, will find a way.

Kingdom, and Canada all have similar bills or requirements on the books, *it's safe to assume that sweeping changes to the industry are forthcoming.*

This likelihood is reinforced when you look at companies like **Morgan Stanley** and **JP Morgan** that have started offering clients the opportunity to invest in virtual currency.

With major players like these in play, the crypto market will undoubtedly gain legitimacy in the eyes of the government.

While **Notice 2014-21** and **Revenue Ruling 2019-24** are easy to digest by IRS standards, you can expect the rules for reporting virtual currency transactions to become

more involved once Congress passes new laws and interpretations of those laws are tested.

As always, be sure to keep good records and work closely with your tax accountant or attorney to stay abreast of changing reporting requirements so you don't get caught short at tax time. ✓

## Miscellaneous IRS Guidance & Publications used for reporting virtual currency

- Notice 2014-21
- Publication 544, Sales and Other Dispositions of Assets)
- Publication 551, Basis of Assets
- Publication 525, Taxable and Nontaxable Income
- Revenue Ruling 2019-24

## Key Terms & Definitions

**Hard Fork:** A fork is a tech term to describe when a program's code is split so another team can take the program's design in a different direction without changing the original program. In the crypto world, a hard fork happens when the people who manage the blockchain decide to change the protocol. That change splits the chain into a separate entity and creates a new currency.

**Airdrop:** Airdrops happen when a company *drops* free cryptocurrency in someone's account. This is usually a marketing ploy to encourage people to buy the new currency created by a hard fork.