

Digital Assets and the IRS

July 17, 2019

Within the past year, the IRS has not changed its position on the way they are treating the taxation and reporting of digital token transactions. This alert serves as an update to last year's rundown of cryptocurrency taxation.

Digital tokens are still treated as property, with capital gains and losses realized when they are used in a transaction or converted into normal currency. It is still a "best practice" to track the value of the digital assets at every transaction (i.e., the mining, purchase and sale of each token) to track gains and losses. The IRS is expected to publish guidelines soon regarding the effects of "forks" of digital tokens on taxes. Additionally, the U.S. House of Representatives is considering a bill, but has not passed it, that would bring back 1031 "like kind" exchanges and reduce tax requirements for non-cash exchanges of digital tokens.

Digital Tokens Tax Status Generally

The IRS published guidelines in 2014 relating to the taxation of digital tokens. The 2014 guidelines are the most recent authority from the IRS on this topic. These guidelines apply specifically to "convertible" digital tokens, virtual currency that can be exchanged for real or other virtual currencies. Notice 2014-21, IRS, § § 2-3, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> (hereinafter "*Notice*"). Digital tokens are treated by the IRS as property and not as a currency. *Id.* at A-1. They are subject to general tax principles for property transactions. *Id.* In most cases tokens will be treated as a capital asset, with capital gains and losses, unless they are being used for non-capital purposes, such as when property is held for sale to customers in the course of a trade or business. *Compare id.* at A-7, with IRS Pub. 544 at 53 (2018) (showing that most categories of noncapital assets - the exceptions to capital assets - simply don't apply to digital assets). If the tokens acquired are held for a year or more before capital gains are realized, they will be taxed at long-term capital gains rates. If held for less than a year, they will be taxed at short-term rates.

Taxation of Exchanges and Transactions

Transactions involving the conversion of digital assets to cash, to another digital assets, or in exchange for goods or services are taxable events according to the IRS. Notice at § 3. It is not considered an "exchange" of currency because digital assets are not a currency; rather, they are property. Therefore, when digital assets are used in a transaction, they are actually being sold for a certain value; therefore, they have capital

gains or losses realized from that sale. *Id.* at A-6. When a taxpayer converts the digital assets into cash, capital gains or losses are calculated by subtracting the value of the digital assets at the time of the transaction from the taxpayer's adjusted basis; a negative outcome is a loss and a positive one is a gain. *Id.* at A-4. When a taxpayer is purchasing goods or services, the value of goods or services received is subtracted from the taxpayer's adjusted basis of the digital assets used, resulting in either a gain or a loss. *Id.* at A-6. When digital assets are exchanged for something of value, the transaction must be reported to the IRS. Deidre A. Leidel, *The Taxation of Bitcoin: How the IRS Views Cryptocurrencies*, 66 Drake L.R. 107, 121 (2018); IRS Pub. 525 at 4 (2017).

To determine the value of digital assets (in fiat) as of the date of a transaction, one must determine their fair market value by referring to digital asset exchanges. *Notice* at A-5. However, for many digital assets there are multiple exchanges with varying values, varying as much as 10%. *Taxation of Bitcoin*, 66 Drake L.R. at 122. The IRS has given no guidance for this variation, other than mandating that any conversions done on these exchanges be done in a "reasonable manner consistently applied." *Id.* at A-5. Lawmakers have asked the IRS for clarification of the terms "consistent and reasonable", but no answer has been given yet. *Letter from Representative Tom Emmer to Commissioner Charles Rettig*, (April 11, 2019).

Tax Code 1031 "like-kind" exchanges are unavailable for digital assets exchanges made after 2017, due to changes made by the Tax Cuts and Jobs Act of 2017. While it was posited that crypto-to-crypto exchanges themselves would not be taxed (at least, until the newly acquired digital assets are converted into real currency), because they are of the same "nature and character" this is no longer true because 1031 exchanges are now limited to real property. *Koch v. Commissioner of Internal Revenue*, 71 T.C. 54, 65 (1978).

Receiving Digital Assets: Transactions, Wages, or Self-Employment Income

One who receives digital assets as payment for goods and services must include it in his or her gross income reporting. *Notice* at A-3. Recipient must additionally include the value of the digital assets they receive (unlike normal cash transactions, where such value is obvious on its face), at fair market value. *Id.* at A-4. They may realize gains or losses upon liquidation, as described in Section II.

This is the normal rule for wages received as an employee as well, where the value of digital assets is calculated from the date of receipt. Those who receive digital assets as a form of payment for jobs as independent contractors also must calculate the value of the digital assets as of the date of receipt, though this is considered self-employment income. *Id.* at A-10. However, this should be differentiated from direct purchases, with government-backed currency, of digital assets which is not a reportable event. *Taxation of Bitcoin*, 66 Drake L.R. at 117-18. Payments using digital assets exceed \$600 and are made to independent contractors or to make payment of fixed and determinable incoming must be reported. *Notice* at A-12, A-13.

Digital asset miners must include the fair market value of any mined digital assets in their gross income, valued at the date of receipt. *Id.* at A-8. If the mining is carried on regularly as a trade or business, then certain business expenses can be deducted. Depreciation of mining equipment is a deductible expense. IRS Pub 535 at 6.

Effects of Forks in Digital Assets

A digital assets fork occurs when the software underlying the digital asset is changed or updated by a collective of digital asset developers and miners. They decide to alter the rules of how the digital assets are created and verified by all who use it. Occasionally, this will result in a "fork" where a new version of the digital assets, using new rules, is created while the old version still exists. This can sometimes even result in "hard forks" where the new and old version are not compatible, creating new digital assets altogether. At the time of the fork, all holders of the soon-to-be changed digital assets will get a new version of the digital assets they had, as well as retaining the old one. This is where the question of taxes comes in, because it is unclear how these new digital assets that was received should be taxed.

The IRS has given no explicit guidance on the effect of forks of digital assets. Commissioner Rettig, on May 16, 2019, issued a letter in response to Congressional requests stating an intent to clarify aspects of digital assets taxation, specifying tax treatment of forks as a particular issue. Letter from Commissioner Charles Rettig to Representative Tom Emmer (May 16, 2019). Commentators hypothesize that digital assets resulting from a fork may just be treated as ordinary income, with gains realized on sale of the new coin. Jim Calvin, *Adequately Identifying Bitcoin Dispositions for Federal Income Tax Purposes*, 58 Tax Management Memorandum 1, 3 (2017). Alternatively, such digital assets may just be divided property, with the basis being split between the old digital assets and the new one. *Id.* Or, they might be found property, with normal capital gains, under the treasure trove doctrine. Matt Metras, *Cryptocurrency: Hard Forks and Airdrops*, MDM Financial Services (Oct. 24, 2018).

Future Developments in Digital Assets Taxation

Congress is currently considering H.R. 2144, the Token Taxonomy Act of 2019, which promises to allow IRC § 1031 "like-kind" exchanges of digital assets and disallow taxation of gains under \$600 from the sale or exchange of digital assets. H.R. 2144, 116th Cong. (2019). Congress would allow for "like-kind" exchanges by amending the language of IRC § 1031 to include exchanges of virtual currency. *Id.* at § 9. The bill says that exchanges of virtual currency should be treated like exchanges of real property. *Id.* Presently, exchanges of real property have no gains or losses recognized if the exchanges are for property of "like-kind". IRC § 1031(a)(1). The proposed bill would be retroactively effective, beginning on January 1, 2017, nullifying the changes mentioned above which limited like-kind exchanges to real property. H.R. 2144 at § 9 (c).



Additionally, when there is a sale or exchange of digital assets that is not for cash, the proposed bill would not include any gains or losses that are \$600 or less from that sale in a taxpayer's gross income. *Id.* at §139G.

[1] Basis is calculated as the cost it took to acquire the tokens, including taxes and fees associated with the purchase. *Topic Number 703 - Basis of Assets*, Internal Revenue Service (May 16, 2019), <https://www.irs.gov/taxtopics/tc703>.