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IRS RELEASES GUIDANCE ON TAXATION OF VIRTUAL CURRENCIES

To Our Clients and Friends:

On October 9, 2019, the Internal Revenue Service ("IRS") released Rev. Rul. 2019-24, addressing two scenarios involving the taxation of virtual currencies. The ruling marks the first published guidance from the IRS in this area since 2014,[1] aside from the warning letters the IRS began sending to taxpayers in July 2019 to encourage voluntary compliance (Letter 6173, Letter 6174, and Letter 6174-A).

Rev. Rul. 2019-24 analyzes whether a taxpayer holding cryptocurrency recognizes gross income as a result of a "hard fork" and subsequent "airdrop" to the holder's blockchain address.

A "hard fork" occurs when the there is a change in a cryptocurrency's protocol that causes the blockchain to split into two: the "new" chain with the latest protocol and the old chain. Following a hard fork, holders of the forked cryptocurrency will generally receive an automatic distribution of the new cryptocurrency (commonly referred to as an "airdrop"). Importantly, an airdrop is automatic and provides each holder with access to an address for the holder's pro rata share of the new cryptocurrency units, regardless of whether the holder has consented to the airdrop.

The two scenarios addressed by the ruling involve hard forks. In the first scenario (Situation 1), the taxpayer receives no airdrop following the hard fork, while the second scenario (Situation 2) includes an airdrop after the hard fork.

In Situation 1, the taxpayer holds units of one cryptocurrency and the protocol for that cryptocurrency experiences a hard fork, resulting in a new cryptocurrency. The taxpayer does not receive an airdrop or other transfer of the new cryptocurrency following the hard fork. The IRS concludes that the taxpayer does not have taxable income because the taxpayer did not "receive" units of the new cryptocurrency. For these purposes, the IRS defines "receipt" as the ability to "exercise dominion and control" over the virtual currency.[2] The IRS further notes that, where the address for cryptocurrency is held in a wallet managed through a cryptocurrency exchange and a hard fork with respect to the blockchain for that cryptocurrency creates a new cryptocurrency that is not supported by the exchange, the taxpayer will not be treated as having "dominion and control" over the new cryptocurrency.[3]

The IRS reached a different conclusion in Situation 2, which has a similar fact pattern as Situation 1, except that the taxpayer receives an airdrop of units of the new cryptocurrency after the hard fork that are immediately disposable. The IRS concludes that, because the taxpayer immediately has the ability to dispose of the new cryptocurrency, the taxpayer has "dominion and control" over it. Accordingly, the taxpayer is required to include in gross income the fair market value of the units as of the time that the airdrop is recorded on the blockchain.

Notably, the IRS did not address other virtual currency tax issues, such as the treatment of proof of stake protocols and "staking rewards." The IRS also released a question and answer document alongside Rev. Rul. 2019-24, supplementing their reporting guidance from 2014 and incorporating the implications of this new ruling.

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[1] Notice 2014-21, 2014-16 IRB 938.

[2] *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

[3] However, the IRS noted that "dominion and control" could arise later if the taxpayer "acquires the ability to transfer, sell, exchange, or otherwise dispose of the [new] cryptocurrency."

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Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the Tax Practice Group, or the following authors:

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