

ISSUE BRIEF **04.10.20**

Did You Report Your Bitcoin Income to the IRS?

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Although the Department of Treasury delayed the tax filing deadline to July 15 in response to the Covid-19 pandemic, many taxpayers may have noticed that the IRS included a question on Schedule 1 of Form 1040¹ for the first time, asking taxpayers if they received, sold, sent, exchanged, or otherwise acquired any financial interest in virtual currency during 2019. Virtual currencies, such as Bitcoin and Ethereum, are a fairly recent development, and it is highly likely that the IRS will continue to ask taxpayers to report virtual currency-related income and may even expand the reporting requirements in subsequent years. Asking taxpayers to separately identify income related to virtual currency indicates that the IRS is aware of the importance and prevalence of virtual currency transactions. This issue brief discusses current guidance and open questions related to virtual currency tax reporting and potential approaches to improve virtual currency-related income tax compliance.

THE VIRTUAL CURRENCY WILD, WILD WEST

Virtual currencies have grown in popularity in recent years, especially since 2017. Although there are more than 5,000 known virtual currencies to date,² the trading volume, price, and market capitalization are unevenly distributed. On the one hand, many virtual currencies are thinly traded and comprise a small portion of the virtual currency universe; on the other hand, the three virtual currencies with the

highest market capitalization³—Bitcoin (BTC), Ethereum (ETH), and Ripple (XRP)—command approximately 80% of the market value. Among them, Bitcoin has the dominant share of market capitalization exceeding 60% since its inception.⁴ There have also been substantial price fluctuations for these virtual currencies. For instance, in January 2017, each unit of Bitcoin was worth about \$900, but by December 2017, the price of each unit peaked at \$20,000, a 2,000% increase in price within a year. From there, a roller coaster-shaped price chart brought the price down to \$3,800 in December 2018, resulting in an 80% decrease in value from its peak in December 2017, and then it rebounded to \$12,000 in July 2019. In March 2020, each unit was trading at around \$7,500.⁵

TAX FEATURES OF VIRTUAL CURRENCY

Despite the name, virtual currency is not currency from a tax perspective because it is not considered a form of legal tender in any jurisdiction. The IRS defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value.”⁶ Because some virtual currencies can be converted into real currencies (such as U.S. dollars), they are considered property for U.S. federal income tax purposes, similar to a car or a house. In its 2014 guidance, the IRS indicated that general tax principles applicable to property transactions govern transactions related to virtual currency.⁷



In 2019, the IRS released a revenue ruling regarding how taxpayers should report income from their virtual currency holdings under "hard fork" and "airdrop" related scenarios. Practitioners believe the guidance still leaves many questions unanswered.

The IRS launched a virtual currency compliance campaign in 2019 that sought to improve the compliance process through education, outreach, and examinations. It also enhanced its data collection mechanism.

Three types of transactions are the most common when it comes to taxing virtual currency-related income.⁸ First, taxpayers can accept virtual currency as payments for work performed. Second, taxpayers can purchase goods with virtual currency, which may create capital gains. Finally, taxpayers can use virtual currency as an investment, which may also generate capital gains.

For workers who provide services and receive virtual currency as payments, these payments are considered taxable income and are subject to applicable withholding and information reporting requirements. For workers with employee status, their employers need to report any virtual currency income on Form W-2 (Wage for Employees). For independent contractors, employers record these payments on Form 1099 (Self-employment Income for Independent Contractors), and recipients typically report this income on Schedule C (Profit or Loss from Business) of Form 1040.

When a taxpayer acquires virtual currency, the cost basis is determined as the price she paid for the units of virtual currency. If she purchases a tangible item with these units of virtual currency at a later date, the market price fluctuation of the virtual currency may result in capital gains or losses. For instance, if a taxpayer obtains virtual currency for \$1,000, and she purchases a piece of furniture after several months when the units are worth \$1,200, this transaction will result in \$200 of reportable capital gains when the purchase is made.

Similar procedures apply when a taxpayer holds virtual currency as an investment. A taxpayer needs to calculate capital gains when he disposes the investment, similar to when he sells stocks or bonds. These reportable capital gains transactions are typically recorded on Schedule D (Capital Gains and Losses) of Form 1040 and Form 8949 (Sales and Other Dispositions of Capital Assets).

IRS REVENUE RULING — “HARD FORK” AND “AIRDROP”

Virtual currency generally resides on a distributed ledger commonly known as blockchain. A hard fork takes place when the developer of a certain blockchain substantially changes its protocol and creates two incompatible versions of distributed ledgers.⁹ Generally, a hard fork leads to the creation of a new virtual currency; transactions involving the new virtual currency after a hard fork will be recorded on the newly forked ledger, whereas transactions conducted with the existing virtual currency will be recorded on the old ledger.¹⁰ An airdrop is a distribution of virtual currency to existing virtual currency users, usually free of charge. Although a hard fork frequently precedes an airdrop, they do not have to happen in conjunction with each other. Instead, an airdrop can happen for many reasons, and a hard fork is just one of them. An airdrop is also commonly used as a way of marketing new virtual currencies to promote their usage and circulation.

In October 2019, the IRS released its second guidance, a revenue ruling regarding how taxpayers should report income from their virtual currency holdings under two specific scenarios:¹¹ first, whether taxpayers need to pay taxes after hard forks where taxpayers do not receive any new virtual currency, and second, whether taxpayers need to pay taxes in cases of airdrops when units of new virtual currency are distributed after hard forks. The IRS concludes there is no tax due in the first case because taxpayers do not receive any virtual currency. In the second case, because taxpayers receive units of new virtual currency, they have taxable income.

OPEN QUESTIONS

Some industry stakeholders and tax practitioners commended the IRS for taking initiatives to clarify the taxability issue but believed that the 2019 guidance still left many questions unanswered.¹² For example, they indicated that the two scenarios described are oversimplified and unrealistic. As several congressional members stated in a letter to the IRS Commissioner, without clear and accurate scenarios that reflect industry practices, it is difficult for taxpayers to measure their taxable events against IRS policies.¹³

Additional issues occur regarding when taxpayers are deemed to have received their virtual currency-related income, including how to calculate these gains and what value taxpayers should report. Based on the revenue ruling, the IRS considers a taxpayer to have dominion and control over the underlying virtual currency assets when a hard fork and the subsequent airdrop take place. However, some practitioners disagree with the IRS position, and on certain issues there are disagreements among practitioners regarding the tax characteristics of hard-forked virtual currency.

Some practitioners indicate a hard fork should be treated as a division of property, so the virtual currency holders can allocate their existing cost basis between the original virtual currency and airdropped virtual currency when calculating capital gains taxes.¹⁴ Others disagree with this view and suggest that taxpayers should characterize forked and airdropped virtual currencies as unsolicited property, similar to samples or promotional items received.¹⁵ This characterization essentially means that to trigger tax consequences, taxpayers need to affirmatively claim, or demonstrate their intention to claim, these currencies. In other words, the mere occurrence of a hard fork or an airdrop does not mean taxpayers have control of the virtual currency. Therefore, if a taxpayer never exercises control or accepts the virtual currency, there will be no federal income tax consequences.¹⁶ Supporters of this view also point out that after a hard fork or an airdrop, virtual

currency could have a near zero value at the time of a fork or drop; the value only materializes when an exchange supports the wallets associated with the currency.

Besides major open issues associated with control, whether the rules of the Foreign Account Tax Compliance Act (FACTA) apply to virtual currency-related transactions is also not entirely clear.¹⁷ The FACTA, part of the Hiring Incentives to Restore Employment (HIRE) Act in 2010,¹⁸ requires taxpayers and foreign financial institutions to report to the IRS any financial assets held by U.S. taxpayers overseas. The IRS has not published any statistics or guidance regarding FACTA compliance associated with virtual currencies.

COMPLIANCE ENHANCEMENT

IRS Enforcement Efforts

The IRS launched a virtual currency compliance campaign in 2018 that sought to improve the compliance process through education, outreach, and examinations. To date, the agency's actions range from gentle reminders informing taxpayers about available resources and giving them a chance to correct previous mistakes, to enforcement-oriented approaches such as audits and criminal investigations.

To enhance compliance, the IRS has been sending individual "educational letters" to taxpayers.¹⁹ There are different versions of this letter (Letters 6173, 6174, and 6174-A) that either inform taxpayers that they may have a delinquent account, request that taxpayers either confirm their previous positions or file amended returns to correct past under- or un-reported income related to virtual currency, or direct them to review appropriate reporting rules and IRS resources.

The IRS has also targeted currency exchanges. For instance, the IRS asked Coinbase,²⁰ a U.S. based cryptocurrency exchange, to turn over information about U.S.-based customers with transactions exceeding \$20,000 based on the agency's belief that this group of individuals may have failed to comply with tax rules. As a result, Coinbase submitted data from 13,000 customers to the IRS in 2018.

To promote compliance with virtual currency income reporting, it would be most efficient for the IRS to provide clear guidance to digital currency exchanges about information reporting requirements and to focus enforcement efforts on these exchanges rather than on individual taxpayers.

Information Reporting

From an enforcement perspective, the IRS's biggest challenge is that it has limited data on tax compliance for virtual currency-related transactions. And, because one cannot improve what one cannot measure,²¹ a good starting point is to enhance the current information reporting mechanism to reinforce data collection.²²

Historically, the IRS relies heavily on information reporting to ensure tax compliance. When there is third-party withholding or information reporting, taxpayers underreport a much lower percentage of income subject to these requirements. In the IRS's most recent analysis measuring the difference between the actual tax liability for a given tax year and the amount that is paid on time (the gap between what the taxpayers should pay and what they actually paid, commonly referred to as the "tax gap"), they found that the increased visibility generated by information reporting has a substantial impact on compliance. The misreporting of income is approximately 1% when there are requirements both for information reporting and withholding, as in the case of Form W2 reporting for wages and salaries. When income is subject to substantial information reporting but not withholding, as in the case of interest and dividend income, misreporting of income is about 5%. However, for income that is subject to limited information reporting, such as sole proprietor income as well as rents and royalties, 55% of income is misreported.²³

The lack of information reporting in part is because third parties, including financial institutions and virtual currency exchanges, are unclear about whether they need to report income associated with virtual currency transactions. Some virtual currency exchanges send information returns to the IRS and taxpayers, while others do not. However, according to the IRS's intent of classifying virtual currency as property and its recent guidance, these institutions are supposed to issue information returns such as Form 1099-K or 1099-B if the issuing criteria are met.

Inadequate information reporting also impairs taxpayers' ability to follow tax rules. Some taxpayers may not intentionally underreport virtual currency-related income and are simply bad record keepers. For instance, an active virtual currency investor may engage in a large number of transactions per year and may struggle to manage and document the cost basis, the fair market value, and the dates of purchasing and selling for each transaction. Or he may be unaware of the reporting requirements until a later date. Therefore, providing clear guidance to the currency exchanges about the information reporting requirements and monitoring their adherence to the regulations have great potential to significantly improve compliance. This would be a win-win proposal. Taxpayers will have more documentation to assist them through the reporting process, and it is more cost-effective for the IRS to investigate whether a virtual currency exchange correctly reports information than going after hundreds of thousands of taxpayers on an individual basis. If an audit is initiated, the information also provides the IRS with the necessary records to sustain its position.

CONCLUSION

The realm of virtual currency is quickly evolving. The rates at which technological changes occur and new transactional types proliferate are impossible for tax authorities to keep up with, let alone get ahead of. One promising trend in this burgeoning area is that industry participants and the IRS appear to have an amiable relationship. On the one hand, the IRS is educating taxpayers about the tax rules applicable to virtual currency to enhance accurate self-reporting instead of leading with the costly audit approach. On the other hand, industry operators are also educating the IRS about their operations so the agency can provide guidance that better matches the virtual currency industry's ecosystem.

The IRS is aware of the increasing virtual currency compliance challenges and has begun to collect data on virtual

currency transactions. The Department of Treasury has also listed issuing guidance regarding information reporting on virtual currency transactions as one of its priorities for the year.²⁴ Although the schedule for issuing guidance has been pushed back because of the Covid-19 pandemic, to promote compliance reporting, it would be most efficient for the IRS to provide clear guidance to digital currency exchanges about information reporting requirements and to focus enforcement efforts on these exchanges rather than on individual taxpayers.

ENDNOTES

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4. “Crypto Market Overview – Total Market Cap,” CoinCodex, accessed March 20, 2020, <https://coincodex.com/market-overview/>.
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17. Some practitioners question whether the like-kind exchange rules apply to virtual currency. Historically, the like-kind exchange rules in Section 1031 of the Internal Revenue Code allow taxpayers to delay paying capital gains tax from the sale of real or personal property as long as proceeds are used to purchase a similar property within a certain time frame. The Tax Cuts and Jobs Act of 2017 limited the deferral treatment to only real property, effective in 2018. As such, the magnitude of this issue is expected to decrease over time.

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