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IRS Issues Guidance on Taxation of Virtual Currency

The IRS issued guidance on specific transactions involving virtual currency. Revenue Ruling 2019-24 (https://www.irs.gov/pub/irs-drop/rr-19-24.pdf) addresses questions regarding the tax treatment of a cryptocurrency hard fork. The IRS also released a new set of frequently asked questions (FAQs) about virtual currency transactions (https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions).

A “hard fork” occurs when a cryptocurrency on a distributed ledger (such as blockchain) undergoes a protocol change resulting in a permanent diversion from the existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger, and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.

An airdrop is a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers. A hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency. However, a hard fork is not always followed by an airdrop.

Revenue Ruling 2019-24 involves two factual situations. In Situation 1, the taxpayer had 50 units of Crypto M. On Date 1, the distributed ledger for Crypto M experienced a hard fork, which resulted in the creation of Crypto N. Crypto N was not airdropped or otherwise transferred to an account owned or controlled by A. In this situation, the IRS found that the taxpayer did not receive units of the new cryptocurrency, Crypto N, from the hard fork. Therefore, the taxpayer did not have an accession to wealth and did not have gross income under Section 61 as a result of the hard fork. (Section references are to the Internal Revenue Code of 1986, as amended.)

In Situation 2, the taxpayer had 50 units of Crypto R. On Date 2, the distributed ledger for Crypto R experienced a hard fork, which resulted in the creation of Crypto S. Also on Date 2, 25 units of Crypto S were airdropped to the taxpayer’s distributed ledger address, and the taxpayer could dispose of Crypto S immediately following the airdrop. The taxpayer received Crypto S solely because the taxpayer owned Crypto R at the time of the hard fork. After the airdrop, transactions involving Crypto S were recorded on the new distributed ledger and transactions involving Crypto R continued to be recorded on the legacy distributed ledger. The IRS found that in this situation, the taxpayer received a new asset, Crypto S, in the airdrop following the hard fork. Therefore, the taxpayer had an accession to wealth and had ordinary income when the taxpayer received Crypto S.

The FAQs address various virtual currency topics for taxpayers who hold virtual currency as a capital asset. The new FAQs expand upon the examples provided in Notice 2014-21 (https://www.irs.gov/pub/irs-drop/n-14-21.pdf) and apply the same tax principles to additional situations. They note, for example, that:

- A taxpayer selling virtual currency must recognize capital gain or loss on the sale (FAQ 4), and virtual currency received in exchange for performing services is ordinary income. (FAQ 8)

- A taxpayer receiving virtual currency in exchange for performing services must report income equal to the fair market value of the virtual currency (in U.S. dollars) when the currency is received. In a cryptocurrency transaction that occurs on the blockchain (an on-chain transaction), virtual currency is received on the date and time the transaction is recorded on the distributed ledger.

- In an arm's length transaction, a taxpayer's basis in virtual currency received in exchange for services is the fair market value of the virtual currency (in U.S. dollars) when the virtual currency is received. (FAQ 12) The basis of property exchanged for virtual currency is the fair market value of the property at the time of the exchange. (FAQ 17)

- When exchanging property for virtual currency, the gain or loss is the difference between the fair market value of the virtual currency when received and the adjusted basis of the property exchanged. (FAQ 19)

IRS Issues Proposed Reliance Regulations on Phase-out of Interbank Offered Rates

On July 27, 2017, the U.K. Financial Conduct Authority, the U.K. regulator tasked with overseeing the London interbank offered rate (LIBOR), announced that all currency and term variants of LIBOR, including U.S.-dollar LIBOR, may be phased out after the end of 2021. These interbank offered rates (IBORs) are frequently referred to in the terms of debt instruments and non-debt contracts. In response, the IRS has issued proposed reliance regulations (REG-118784-18 (https://www.federalregister.gov/documents/2019/10/09/2019-22042/guidance-on-the-transition-from-interbank-offered-rates-to-other-reference-rates)) that provide guidance on the tax consequences of the transition to the use of reference rates other than IBORs in debt instruments and non-debt contracts. The proposed regulations address the possibility that an alteration with a new reference rate of the terms of a debt instrument or a modification of the terms of other types of contracts to replace an IBOR to which the terms of the debt instrument or other contract refers could result in the realization of income, deduction, gain or loss for federal income tax purposes or could result in other tax consequences.

IRS Issues Final Regulations on Partnership Recourse Liabilities

The IRS issued final regulations (T.D. 9877) (https://www.irs.gov/pub/irs-drop/td9877.pdf) addressing when certain obligations to restore a deficit balance in a partner's capital account are disregarded and how "bottom dollar payment obligations" are treated.

The final regulations add a list of factors to indicate when a plan to circumvent or avoid a deficit restoration obligation exists. The following nonexclusive factors indicate a plan to circumvent or avoid a deficit restoration obligation: (1) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

The final regulations revise the assumption of liability rules to provide that if a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability under Treasury Regulation Section 1.752-2 immediately after the assumption.

The final regulations revise the definition of a bottom dollar payment obligation to specifically address capital contribution obligations and deficit restoration obligations. Treasury Regulation Section 1.752-2(b)(3)(ii)(C)(1)(iii) provides that a bottom dollar payment obligation includes, with respect to a capital contribution obligation and a deficit restoration obligation, any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account.

The regulations require taxpayers to disclose bottom dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the tax year in which a bottom dollar payment obligation was undertaken or modified. The final regulations provide that identifying the payment obligation with respect to which disclosure is made includes stating whether the obligation is a guarantee, a reimbursement, an indemnity or a deficit restoration obligation.

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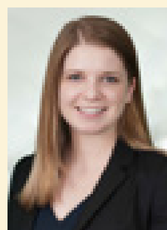
IRS Restores Prior Rules on Allocating Partnership Liabilities in Disguised Sales

IRS has issued final regulations (T.D. 9876) (https://www.irs.gov/pub/irs-drop/td9876.pdf) under Section 707 regarding allocations of partnership liabilities for disguised sale purposes. The regulations withdraw and remove earlier proposed and temporary regulations issued in 2016 and reinstate the final regulations that previously were in effect. In determining a partner's share of a partnership liability for disguised sale purposes, the regulations prescribe separate rules for a partnership's recourse liability and a partnership's nonrecourse liability (i.e., a liability for which no partner or related person bears the economic risk of loss). Under the regulations, a partner's share of a partnership's recourse liability equals the partner's share of the liability under Section 752 and the regulations thereunder. The regulations also provide that a partner's share of a partnership's nonrecourse liability was determined by applying the same percentage used to determine the partner's share of the "excess nonrecourse liabilities" under Treasury Regulation Section 1.752-3(a)(3).

In October 2016, IRS issued final, temporary and proposed regulations concerning the allocation of liabilities for Section 707 purposes. In general, the temporary regulations adopted a new approach under which (1) a partner had to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treasury Regulation Section 1.752-3(a)(3) in determining the partner's share of all partnership liabilities for disguised sale purposes; and (2) a partner's share of a partnership liability for Section 707 purposes could not exceed the partner's share of the partnership liability under Section 752 and applicable regulations. In 2017, President Donald Trump adopted Executive Order 13789, "Executive Order on Identifying and Reducing Tax Regulatory Burdens," which directed the Treasury secretary to review all significant tax regulations issued on or after Jan. 1, 2016, and to take concrete action to alleviate the burdens of regulations that (1) impose an undue financial burden on U.S. taxpayers, (2) add undue complexity to the federal tax laws or (3) exceed the IRS's statutory authority. The temporary regulations described above were among those identified in Notice 2017-38 as meeting these criteria.



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