To: Michael Desmond, Chief Counsel

From: Monte Jackel

Date: October 15, 2019

Subject: Recent Guidance on Cryptocurrency

*Introduction*

I write to express some confusion on the holding of Revenue Ruling 2019-24 (the ruling) that, when there is an air drop of new cryptocurrency as a result of a hard fork, the recipient has gross income as “an accession to wealth”. I also write to express my objection to the use of FAQs (frequently asked questions posted on the IRS website), when it is very far from clear whether those FAQs constitute “authority” under regulation §1.6662-4(d)(3)(iii) (defining types of authority when determining whether a substantial underpayment penalty is warranted).

*Facts of the Ruling*

Situation 2 of the ruling posits the factual scenario as follows:

B holds 50 units of Crypto R, a cryptocurrency. On Date 2, the distributed ledger for Crypto R experiences a hard fork, resulting in the creation of Crypto S. On that date, 25 units of Crypto S are airdropped to B's distributed ledger address and B has the ability to dispose of Crypto S immediately following the airdrop. B now holds 50 units of Crypto R and 25 units of Crypto S. The airdrop of Crypto S is recorded on the distributed ledger on Date 2 at Time 1 and, at that date and time, the fair market value of B's 25 units of Crypto S is $50. B receives the Crypto S solely because B owns Crypto R at the time of the hard fork. After the airdrop, transactions involving Crypto S are recorded on the new distributed ledger and transactions involving Crypto R continue to be recorded on the legacy distributed ledger.

*Analysis and Conclusion in the Ruling*

The ruling then posits the following in arriving at its conclusion that B had an income inclusion under section 61.

Section 61(a)(3) provides that, except as otherwise provided by law, gross income means all income from whatever source derived, including gains from dealings in property. Under §61, all gains or undeniable accessions to wealth, clearly realized, over which a taxpayer has complete dominion, are included in gross income. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).... B received a new asset, Crypto S, in the airdrop following the hard fork; therefore, B has an accession to wealth and has ordinary income in the taxable year in which the Crypto S is received. See §§61 and 451. B has dominion and control of Crypto S at the time of the airdrop, when it is recorded on the distributed ledger, because B immediately has the ability to dispose of Crypto S. The amount included in gross income is $50, the fair market value of B's 25 units of Crypto S when the airdrop is recorded on the distributed ledger. B's basis in Crypto S is $50, the amount of income recognized. See §§ 61, 1011 and 1.61-2(d)(2)(i)..... A taxpayer has gross income, ordinary in character, under §61 as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency.

*Several Points and Observations about the Ruling*

Several points should be noted, and observations made, about the above language from the ruling:

● There is no statement of facts in the ruling indicating whether the legacy cryptocurrency, R, either (1) lost value as a result of the airdrop of the new cryptocurrency, or (2) whether its value remained static after the air drop, or (3) whether it actually had an increase in value after the air drop. Despite the seemingly powerful citation in the ruling’s analysis to *Glenshaw Glass,* that case involved punitive damages that clearly was an accession to wealth under the facts of the case. However, in the case of a stock dividend or a return of capital, *Eisner v. McComber,* 252 U.S. 189 (1920), the distribution is viewed as akin to a return of capital and not as a return on capital. The former is a capital transaction. The latter is an income transaction.

● Isn’t it true that one needs to know the effect of the air drop on the legacy cryptocurrency, R, before one concludes there is an accession to wealth on the distribution of S, the new cryptocurrency? After all, if in the ruling the legacy cryptocurrency, R, declined in value in an amount equal to the fair market value of the air dropped new cryptocurrency, S, then the distribution would more properly be viewed as a return of capital and not as an accession to wealth?

● The facts of the ruling give no indication of what the taxpayer did or did not do to receive the new S cryptocurrency; i.e., was there a quid pro quo or not? If the distribution had been because of a gift for income tax purposes factually arising from “detached and disinterested generosity”, *Commissioner v. Duberstein,* 363 U.S. 278 (1960), then wouldn’t that have been a non-taxable gift under section 102 and not gross income under section 61?

● The ruling inconsistently cites two separate provisions of section 61. First, regulation §1.61-2(d)(2)(i) is cited and that provision relates to income from services under section 61(a)(1) even though there are no facts in the ruling about any services being rendered. However, the ruling also cites section 61(a)(3), which relates to gains derived from dealings in property. The relevant regulation for that provision, regulation §1.61-6, deals with gains from sales or exchanges of property. There are no facts in the ruling dealing with sales or exchanges of property either. You could also add “accession to wealth” as interpreted in *Glenshaw Glass,* as a third section 61 category in the ruling.

● And so, since there are no facts indicating a sale or exchange and the air drop could not be such an exchange based on the facts of the ruling, and there are no facts indicated compensation for services rendered, was the inclusion in gross income in the ruling (1) for services, or (2) due to a sale or exchange of property, or (3) was it a non-taxable gift, or (4) was it, as the ruling posits, just an accession to wealth for no reason whatsoever?

● Further, in *Palmer,* 302 U.S. 63 (1937), the court looked to the reason for a bargain purchase in determining whether the purchasers of the property from a corporation in which they were shareholders received a taxable corporate dividend under sections 61 and 301 (or their predecessors), or merely made a purchase of property which would have to await a later sale by the shareholders to be taxable. See and compare regulation §1.301-1(l) (transfers for less than fair market value by a corporation to a shareholder).

If I was a law professor grading a student paper in the form of the ruling, the ruling would fall well below an A. Better than an F, maybe a C or D, but not that much better. But, I am a hard grader, which is probably why no rational student would want me as a professor.

*The FAQs*

And, what of the use of the FAQs in this case? Regulation §1.6662-4(d)(3)(iii), relating to types of authority, only lists “Internal Revenue Service information or press releases”. The regulation also lists “other administrative pronouncements published by the Service in the Internal Revenue Bulletin”.

The following points and observations can be made about the FAQs:

● The FAQs accompanying the ruling will not be published in the Internal Revenue Bulletin. And although there was an IRS press release on the ruling which contained an internal link to the FAQs, it is very far from being clear that the FAQs can count as authority.

● In fact, the initial guidance on cryptocurrencies, Notice 2014-21, 2014-16 I.R.B. 938, contained questions and answers in the notice itself, and a “notice” is listed as authority under the section 6662 regulations. So, why provide guidance that can be changed without public notice and comment and that apparently cannot even provide penalty protection as the 2014 notice does?

● This same regulation under section 6662 says that conclusions reached in treatises, legal periodicals, or legal opinions are not authority but, the regulation also states, the authorities underlying that conclusion as so expressed may be authority.

● Of note, the IRS is given a significant head start in the authority analysis because revenue rulings are accepted as authority on their face.

● However, it is stated at regulation §1.6662-4(d)(3)(ii) that “An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts”, and “The weight accorded an authority depends on its relevance and persuasiveness and the type of document providing the authority”.

● Based on the preceding analysis here, I would say that the ruling would not be accorded significant weight in the analysis but, as we all know, the IRS can assert what it asserts and is not penalized, as are taxpayers, for taking positions lacking substantial authority if placed in a revenue ruling, revenue procedure, notice or regulation. Is that really appropriate or fair?

*The Effective Date of the Ruling*

There is also the issue of whether a revenue ruling was the appropriate vehicle to provide this cryptocurrency guidance. In this regard, the following should be noted.

● Section 7805(b)(8) states, in effect, that unless a revenue ruling states that it will not be applied retroactively, then the ruling applies retroactively if it does not state an effective date. The ruling at issue does not express an effective date.

● Had the ruling at issue been a regulation, unless it was issued “to prevent abuse”, or the taxpayer elected to apply the regulation retroactively, section 7805(b)(1) would provide that the regulation could not apply any sooner than the date it was filed with the Federal Register; meaning, it would be prospective only and would leave prior periods not addressed by the regulation. The best the IRS could have done then is to say “there is no inference as to prior law” in the regulation preamble or that it was a “clarification” of prior law, or words to that effect.

*The Policy Statement*

Was issuance of the revenue ruling in compliance with the *Policy Statement On The Tax Regulatory Process,* 2019 TNT 44-12 (Mar. 5, 2019)?

The Policy Statement has this to say relating to sub-regulatory guidance, such as the ruling at issue here[[1]](#footnote-1):

When proper limits are observed, sub-regulatory guidance can provide taxpayers the certainty required to make informed decisions about their tax obligations. Such guidance cannot and should not, however, be used to modify existing legislative rules or create new legislative rules. The Treasury Department and the IRS will adhere to these limits and will not argue that sub-regulatory guidance has the force and effect of law. In litigation before the U.S. Tax Court, as a matter of policy, the IRS will not seek judicial deference under Auer v. Robbins, 519 U.S. 452 (1997) or Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), to interpretations set forth only in sub-regulatory guidance.

In deciding whether to issue regulations or sub-regulatory guidance, the Treasury Department and the IRS must consider the content and nature of the interpretation or position being announced. Factors to be considered include the intended effect on taxpayers' rights or duties, the need for public comments, the form and content of prior positions, the significance of the issues, the statutory framework, and whether the interpretation or position is of short-term or long-term value. After weighing relevant factors, if the intended interpretation or position would have the effect of modifying existing legislative rules or creating new legislative rules on matters not addressed in existing regulations, the interpretation or position will generally be issued through notice-and-comment rulemaking, absent exceptional circumstances. Where the Treasury Department and the IRS intend to provide only an interpretation of existing law applied to a limited set of facts, a statutorily prescribed form of relief, a statement of agency procedure or practice, a public announcement of intent to issue proposed legislative rules, or an announcement that has only immediate or short-term value, the intended interpretation or position will generally be issued as sub-regulatory guidance rather than through notice-and-comment rulemaking.

The following should be noted relating to the Policy Statement.

● Given the uncertainty in the proper tax treatment of hard forks and cryptocurrency[[2]](#footnote-2), it would seem that the ruling at issue is creating a new legislative rule not addressed in existing regulations.

● As such, it appears that issuing this guidance as a revenue ruling and not as a regulation deprived the public of notice and comment and also set forth a retroactive effective date that would not otherwise be allowed by section 7805(b).

● Is this action challengeable under the Administrative Procedure Act? If yes, how and in what forum? If no, is there ever any penalty for the IRS violating the Policy Statement?[[3]](#footnote-3) It seems to me that there ought to be a pre-enforcement challenge available to this kind of action. However, as I understand administrative law, the law has not advanced to the stage yet where revenue rulings and revenue procedures, like regulations, are treated as legislative rules subject to notice and comment from the public in all cases[[4]](#footnote-4) before the guidance is issued in final form.

VIII. *Conclusion*

I am not arguing for the non-taxation of cryptocurrency in all cases or in any particular case for that matter. Far from it. I am just saying that after the long wait after preliminary guidance in Notice 2014-21, 2014-16 I.R.B. 938, the guidance issued recently on cryptocurrency does not appear to be either cogently reasoned and analyzed or issued in the appropriate form.

1. For a subsequent Chief Counsel Notice on the deference to sub-regulatory guidance issue, see CC-2019-006, 2019 TPR 37-12 (Sept. 17, 2019) (referencing other authority outside of *Auer* and *Chevron* where deference can be argued. But, see Sean Atkins, *Clutching to Fiat: The IRS’s Continued Pursuit of Judicial Deference,* 164 Tax Notes Federal 225 (Sept. 30, 2019) (arguing that the chief counsel notice was nothing more than an attempted disguised attempt to circumvent the Policy Statement). [↑](#footnote-ref-1)
2. See, e.g., Ted Stotzer, *Are Central Bank Cryptocurrencies Currency For U.S. Tax Purposes,* 165 Tax Notes Federal 223 (Oct. 14, 2019), and *A Look Ahead: Virtual Currencies-Gaps, Questions and Pitfalls,* 161 Tax Notes 1463 (Dec. 17, 2018); Nelson Yates II, *Stock or Livestock? Hard Fork Basis Allocation,* 162 Tax Notes 61 (Jan. 7, 2019); Mary Voce and Pallav Raghuvanshi, *Blockchain and Cryptocurrency: Federal Income Tax Issues,* 161 Tax Notes 1077 (Nov. 26, 2018); Stevie Conlon, Anna Vayser, and Robert Schwaba, *If a Crypto-Tree Falls in a Digital Forest, Can It Give Rise to Tax Evasion?,* 161 Tax Notes 701 (Nov. 5, 2018), *Bitcoin, and Wash Sales, and Straddles: Oh My!,* 160 Tax Notes 505 (July 23, 2018), and *Taxation of Bitcoin, Its Progeny, and Derivatives: Coin Ex Machina,* 158 Tax Notes 1001 (Feb. 19, 2018); Jill-Marie Harding, Michael Haun, Noah Metz, and Daniel Stellenberg, *Tax Considerations in Structuring Initial Coin Offerings,* 160 Tax Notes 333 (July 26, 2018); James Brown and Franziska Hertel, *Virtual Currency and the Commodity Trading Safe Harbor,* 159 Tax Notes 1731 (June 18, 2018); Andrew Velarde, *ABA Seeks Safe Harbor on Cryptocurrency Splits,* 158 Tax Notes 1854 (Mar. 26, 2018); D. Larry Crumbley, Joseph Wall, Lewis Kilbourne, and Caleb Blair, *Cryptocurrencies Are Taxable and Not Free From Fraud,* 158 Tax Notes 225 (Jan. 8, 2018); Selva Ozelli, *Virtual Currency: U.S. Tax Considerations and Fraudulent Activity Amid a Growing Global Market,* 88 Tax Notes Int’l 257 (Oct. 26, 2017); David Shakow, *The Tax Treatment of Tokens: What Does It Betoken?,* 156 Tax Notes 1387 (Sept. 11, 2017). [↑](#footnote-ref-2)
3. A former associate of mine once told me that IRS revenue procedures are “aspirational” and not mandatory even if they are stated in mandatory terms. Is that the case with the Policy Statement as well? [↑](#footnote-ref-3)
4. See, e.g., *Bullock v. Rettig,* 84 Exempt Org. Tax Rev 292 (Sept. 1, 2019). [↑](#footnote-ref-4)