
Cryptocurrency holders know more about what the Internal Revenue Service expects to see on their tax returns, thanks to new guidance from the agency.

The IRS released a ruling and a question-and-answer document Wednesday that tell virtual currency investors and their tax advisers how the agency expects them to report income from their holdings. The guidance is the first since 2014 and comes as tax auditors are increasingly focusing on examining individuals with cryptocurrency investments.

"It's going to encourage people who weren't in compliance to come into compliance," said James Creech, a tax lawyer in San Francisco. People are soon going to realize "you're going to have a lot of real paper for virtual currency," he said.

The IRS requires taxpayers to track their crypto transactions to prove how much they bought, so they can determine how much they owe when they sell. An investor also must document transfers of coins between two accounts, known as wallets, to prove to the IRS that the transaction is tax-free.

The guidance applies long-standing tax rules, including a requirement that assets held for less than a year are taxed at higher short-term capital gains rates. Those held for longer qualify for the 23.8% preferential rates.

The IRS has struggled to enforce tax laws on digital currencies in recent years as crypto investments gained popularity and value. Until this guidance, investors and their tax advisers had relatively little input from the IRS and had to make educated guesses about how to report income and pay taxes from virtual-currency transactions. Some taxpayers didn't report their transactions at all.

"There is a huge gap," said Guinevere Moore, a partner at law firm Johnson Moore, said. The difference between the number of crypto account holders and the number of tax forms filed reporting income is "truly staggering," she said.

'Air Drop'

The guidance says that taxpayers are required to pay taxes on income when a coin splits in a transaction known as a "hard fork" and when coins are distributed through a so-called air drop.

"One unfortunate consequence of this guidance is that third parties can now create tax reporting obligations for you by simply forking a network whose coins you own, or foisting on you an unwanted air drop," Jerry Brito, executive director of advocacy group Coin Center, said in a statement.

Taxpayers could end up owing penalties if they didn't pay taxes on some of these transactions, even though the IRS hadn't yet published instructions and taxpayers could have reasonably taken a different position, said Lisa Zarlenga, a partner at law firm Steptoe.

The IRS has focused on cryptocurrency in recent months after issuing no guidance in the area in five years. The IRS sent letters to more than 10,000 holders of cryptocurrency earlier this year warning that they may be subject to penalties for skirting taxes on their virtual investments.

"We want to help taxpayers understand the reporting requirements as well as take steps to ensure fair enforcement of the tax laws for those who don't follow the rules," IRS Commissioner Chuck Rettig said in a statement.

The IRS in 2014 classified all virtual currencies as property for tax purposes, meaning the assets -- much like a home -- can be sold at a profit and trigger tax implications.

Clients Worried

Jason Tyra, a certified public accountant in Dallas focused on cryptocurrency, said he expects to see more people seeking tax help on their investments. The IRS is showing more interest in enforcing cryptocurrency rules, which likely means more audits, he said.

"I'm just waiting for the other shoe to drop here," Tyra said. "I think we've been advising clients correctly, so I'm not really worried about it, but clients are very worried."

The rules just begin to answer the broad range of questions that cryptocurrency investors face when trying to pay taxes on an asset that's rapidly changing as technology advances. The guidance won't close the door on future questions, said [Dashiell C. Shapiro](#), counsel at Shartsis Friese LLP in San Francisco.

The IRS and Treasury will probably wait for Congress to weigh in before providing an extensive "top-to-bottom framework" for how to treat cryptocurrency, Shapiro said. Officials at IRS and the Treasury Department believe "We do need to provide guidance, but we really need to put the ball back in Congress's court," he said.

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