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As IRS Pursues Crypto, Some Tax Theories May Surprise

By Robert W. Wood

More than once, the IRS has made it clear that it is going after people who don't report taxes on their crypto transactions. With IRS summonses to Coinbase, Kraken, Circle and Poloniex, plus other enforcement efforts, the IRS is on the hunt. The IRS sent 10,000 letters asking for compliance, but all were nudges to try to encourage taxpayers to be compliant. The IRS is using crypto tracking software too.

Many taxpayers are amending prior returns if they have something to clean up. The IRS made its first big announcement about crypto in Notice 2014-21, classifying it as property. That has big tax consequences, accentuated by wild price swings. Selling crypto can trigger gain or loss and be taxable, and even buying something with crypto can trigger taxes. Paying employees or contractors does too.

We are already seeing crypto audits by the IRS, and by some states (notably California's Franchise Tax Board), and more are sure to follow. Everyone is trying to minimize taxable crypto gains and to defer taxes where legally possible. Still, it is easy to get confused about the tax treatment, and to take tax positions that may be hard to defend if you are caught. With that in mind, here are some things I've heard, that I'll call crypto tax myths. These might not be tax protester arguments, but some of them seem naïve or downright dangerous if you follow their lead.

Myth: You can't owe any tax on cryptocurrency transactions unless you receive an IRS Form 1099. If you did not receive a Form 1099, you can check the box on your tax return that says that you did not have any transactions with cryptocurrency.

Reality: Nope, a Form 1099 does not *create* tax where no tax was previously due. In fact, plenty of taxable income is *not* reported on Forms 1099. Don't rely on the lack of a Form 1099. Taxpayers have tried this argument in tax cases and lost.

Myth: If you hold your crypto through a private wallet instead of an exchange, you don't need to report the crypto on your tax returns.

Reality: No again. Private wallet or exchange, the tax rules are the same. The impulse to hide ownership by moving wealth to anonymous holding structures is not new. When Swiss banks began disclosing their U.S. accountholders to the IRS and U.S. Department of Justice, many U.S. taxpayers tried just about everything, but nearly everyone paid in the end, usually with big penalties. The cryptocurrency question on the IRS Form 1040 is not limited to cryptocurrency held through exchanges. If you say "no," even though you hold crypto through a private wallet, you are potentially making false statements on a tax return signed under penalties of perjury. You might be betting that you will never get caught, but there are thousands of U.S. taxpayers who had Swiss bank accounts who can attest how poorly that bet can play out.

Myth: If you hold your crypto through a trust, LLC or other entity, then you do not owe tax on the crypto transactions, and do not have to report. Besides (the myth continues), income generated through LLCs is tax-free.

Reality: Owning crypto through an entity *may* keep the income off your personal tax return. But unless the entity qualifies (and is registered) as a tax-exempt entity, the entity itself will likely have tax reporting obligations, and may owe tax. For tax purposes, LLCs are taxed as corporations or partnerships, depending on their facts and tax elections. Single member LLCs are disregarded, so the LLC income ends up on the sole owner's return. If your entity is a *foreign* entity, there are complex U.S. tax rules that can make you directly liable for certain income produced within the foreign entity.

Myth: If I structure the sale of my crypto as a loan (or some other non-sale transaction), I don't have to report the proceeds.

Reality: Consider if you are actually loaning or selling the crypto. The IRS and courts have robust doctrines to disregard sham transactions. Are you getting the same crypto back that you are loaning? Are you charging interest on the loan, and paying tax on the interest as you receive it? Some loans may not hold water. And if you sell crypto and receive a promissory note, that may complicate your taxes further with installment sale calculations.

Myth: A crypto exchange is a type of trust, since you can't unilaterally change the policies of the exchange. So you do not own the crypto in your account for tax purposes and do not have to report transactions through an exchange.

Reality: The IRS has not said any of this. In fact, IRS guidance suggests that the IRS views *taxpayers* as owning the cryptocurrency held through their exchange accounts. It seems highly unlikely that the IRS would view crypto held through an exchange account as owned by the exchange itself (as trustee), rather than owned by the accountholder. Taxpayers often own their assets through accounts held by institutions, such as bank accounts, investment accounts, 401(k)s, IRAs, etc.

In most cases, the tax law treat taxpayers as owning the money and assets held through these accounts. Some special accounts like 401(k)s and IRAs have special tax rules. And having an account treated as a trust is not necessarily a good tax result. Beneficiaries of trusts, and particularly foreign trusts, have onerous reporting obligations. Thus, before you consider crypto exchanges as trusts, be careful what you wish for. Calling something a trust does not mean income generated within the trust is exempt form income tax.

Myth: Congress's amendment to Section 1031 of the tax code that limits like-kind exchanges to real property doesn't make crypto-to-crypto exchanges taxable.

Reality: Section 1001 of the tax code says taxable gain results from the "sale or other disposition of property." The sale of *any* type of property for cash or other property can create taxable gain. The IRS says crypto is property, so trading crypto for other crypto is a *sale* of crypto for the value of the new crypto.

Before the Section 1031 amendment in 2018, a crypto-for-crypto swap might have been ok as a like-kind exchange under Section 1031. But the IRS is pushing back on this position in tax audits, and has issued guidance that denies tax-free treatment for certain cryptocurrency swaps. It is not precedential, but it tells you what the IRS is thinking. In any case, now that Section 1031 has limited like-kind exchange treatment to real property, crypto-to-crypto swaps are taxable unless they qualify for another exception.

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