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Bitcoin Investors Hunt For Transfers That Aren't Taxable

With the stratospheric prices of Bitcoin and other digital currencies, there is understandable worry about diversification. Of course, diversifying without paying a big tax hit would be best if you can. Up until now, depending on how aggressive you were, and how you could orchestrate it, you could try swapping one asset for another. If different kinds of real estate can be swapped for one another tax-free, why not digital currencies? The IRS says that Bitcoin and other digital currencies are property, right? Whatever the arguments for the past, the House tax bill and the Senate tax bill both make it clear that after passage, 1031 exchanges are only for real estate.

Most swaps are taxable as sales, so a 1031 exchange is an exception to the rule that swaps are taxable. When it comes to whether 1031 applies to cryptocurrency, the debates are over the fundamentals. The IRS has been asked about this, but has so far remained mum. The big question is whether exchanges of cryptocurrency should be considered swaps of property of like-kind. A direct Bitcoin for Bitcoin swap might be fine, but that is hardly diversification. A Bitcoin for Ripple or Ethereum trade is much more appealing, but that might not qualify.

If you don't argue for 1031 treatment, or if the IRS rules against 1031 exchanges even for the past, are there any other choices for transfers that might be tax free? Some investors put Bitcoin and other virtual currencies into an investment or trading company, but can it be done tax efficiently? That is, if you form an LLC or a corporation, can you transfer Bitcoin and other digital currencies to your new entity tax free? Generally, yes. Both the partnership tax rules and the corporate tax rules allow for tax free transfers, if you meet certain rules. So, in a simple case, if you transfer $X worth of Bitcoin to a new LLC or corporation you form, swapping your $X worth of Bitcoin for all of the ownership interests in your new entity, it should be tax free.

Of course, then your new entity will be buying and selling, and paying tax on any gains. You may not have changed the ultimate tax due when you sell. But you might alter the reporting playing field materially. For example, suppose that you are worried about IRS Form 1099 reporting rules. The IRS has said that payments for services in Bitcoin are subject to IRS Form 1099 reporting. The payor is supposed to file the form, filing a Form 1099 with the IRS to report the payment. The Form 1099 reports as if the Bitcoin was cash, reporting at its then dollar value.

However, payments to corporations generally do not need to be issued IRS Forms 1099. Corporations--both S corporations that are taxed as flow-throughs and C corporations that are taxed as entities--can be end-runs around the Form 1099 reporting rules. Not having to deal with Forms 1099 could be one advantage. You might also change (and reduce) your tax audit profile with an entity tax return. Sole proprietorship tax returns (Schedule C to IRS Form 1040) are one of the most likely types of tax returns (or portions of tax returns) to be audited. So forming an entity can materially reduce your audit risk.

Finally, there could be some types of transactions that you might more readily facilitate with an investment or business entity of your own. For example, you might end up combining your company with one or more others, in effecting ending up with a smaller percentage interest in a larger entity, rather than owing your small entity all by yourself. There is no magic solution that allows tax-free diversification. But it can be worth trying to be creative.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.