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How Financial Instruments Help to Avoid Big Crypto Tax Bills?: Expert Take

EXPERT TAKE

In our Expert Takes, opinion leaders from inside and outside the crypto industry express their views, share their experience and give professional advice. Expert Takes cover everything from Blockchain technology and ICO funding to taxation, regulation, and cryptocurrency adoption by different sectors of the economy.

With the cryptocurrency economy now worth more than $500 bln, the IRS is waking up to massive tax revenues at stake. The IRS's summons to Coinbase for their customer data is an early warning shot. A wide-scale and coordinated IRS/ DOJ enforcement campaign is surely coming.

Nobody likes paying taxes, but simply hoping the IRS won't find out who owes what is a dangerous game. Is there any hope for those that want to legally plan around cryptocurrency taxes, while hedging their substantial gains? There might be, but the wild card is how the IRS will approach these transactions.

With the recent emergence of futures and options trading, it should become more commonplace for parties to design tailored cryptocurrency loans, swaps, forward contracts and more. An explosion in cryptocurrency financial product innovation is coming. Whether this innovation is a blessing or a curse may depend on your perspective. What you **can** count on, though, is that the IRS will be lurking.

Lend me a Bitcoin

What if I lend out my Bitcoin, either as a hedge, or to raise cash for other investments? Do I need to pay tax on the cash I receive? It's a good question, and **a lot of** tax dollars are now at stake in some Bitcoin loans. The catch is that the IRS must agree that what took place is actually a loan. Simply calling it a loan is unfortunately not enough.

Indeed, proper documentation and execution are essential. And even so, there can still be complications. For example, the IRS might say that the Bitcoin borrowed needs to be the same Bitcoin returned at the end of the loan term. Indeed, if I lend someone a painting, and they give me back a different painting, the IRS would probably say this was no loan at all. Rather the IRS could tax me as though I sold the first painting.

It might sound silly for the IRS to take such a technical position on Bitcoin loans. Most everyone treats one Bitcoin as fungible with any other Bitcoin. And what would returning "the same Bitcoin" even mean?

But with so much tax dollars at stake, some amount of posturing is to be expected from the IRS, and no argument is too technical for the taxman. The IRS has a variety of legal tools to attack a loan and claim it's actually a sale.

Prepaid forward contracts too?

Another approach might involve a prepaid forward contract. The IRS has said that these transactions can work for publicly traded stocks if designed properly. In other words, they can allow parties to receive cash without triggering the tax.

How do prepaid forwards work? Someone holding appreciated stock receives a fixed amount of cash up front (often 70-90 percent of the value of the shares). In exchange, the stockholder might agree to deliver a variable number of shares at a forward date (or an equivalent amount in cash), such as five years in the future. The idea is that title will transfer years later, so there's no current tax now.

So why not prepaid forward contracts for Bitcoin? Again, expect some pushback from the IRS. How much pushback may depend on how the forward contract is documented. The more similar a Bitcoin forward is to a stock transaction the IRS has approved in the past, the better the chance it has to survive IRS scrutiny.

But past performance doesn't guarantee future results, especially in an IRS audit. Indeed, the IRS has attacked prepaid forwards that it considers abusive, such as where the shares were lent out over the course of the deal.

As with loans, much may depend on how closely a Bitcoin forward contract tracks deals the IRS has already blessed. While the IRS is used to seeing prepaid forwards on IBM stock, they may be quick to poke holes in the cryptocurrency versions. So again, plan carefully.

The future of futures

The emergence of futures and options trading in Bitcoin is a potential game-changer for these transactions. While they may not change the IRS's mind about how to tax any particular financial instruments, they do offer market participants many more options.

Only a year ago, finding a counterparty to take the opposite side in a Bitcoin loan or prepaid forward contract was no easy feat. Now, institutional investors should be stepping in, not to mention cryptocurrency hedge funds. A futures market offers bigger players a foothold and can allow them to reduce risk when taking the long or short side in a particular trade.

Whether the IRS likes it or not, cryptocurrency financial instruments are here to stay. But, as with ICO's, buyer beware is on order. Some innovations will create tremendous value, and allow parties to hedge effectively. Financial instruments can also help investors obtain targeted exposure to certain assets, which can't be reached any other way.

But with financial innovation comes risks, and it goes without saying that leverage can magnify those risks. If designed properly, financial instruments might offer a way for early adopters to lock in profits now and defer tax until later. Yet thoughtful planning is crucial, and the IRS is going to initially approach these transactions with skepticism (and, likely, some serious confusion). We should expect some interesting conversations.

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