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IRS Could Tax Loans Of Bitcoin, Other Cryptocurrencies

Is a loan income for tax purposes? Of course not, since you have to pay it back. In fact, if you are a borrower, other than tax deductions for interest, you might not even *think* about taxes. Lenders too generally only face taxes on the interest they receive on the loan. Sure, there can be big tax issues when loans are forgiven. If your loan is forgiven, that *is* income in the amount of the debt discharged. Mostly, though, loans can be neutral from a tax viewpoint. How about loans in bitcoin or other digital currency? You might think the tax rules should be the same, but that's not so clear. With loans in dollars, money is fungible. But the IRS says digital currency is property, *not* currency. Most property is not fungible for tax purposes.

The IRS likes finding more opportunities to collect taxes. That can mean gain or loss, even if the deal ends up netting you a different car with the same value. Except for certain special tax provisions such as Section 1031 exchanges (allowing tax-free swaps of property under certain conditions), just about *everything* you trade is taxed. In general, if you want to avoid taxes, a loan of property should require the return of the same property. With loans of cryptocurrency, the parties probably *intend* the cryptocurrency lent to be treated as fungible currency, rather than like property. Whatever the IRS says, people generally view it as money.

A borrower may receive bitcoins and sell them, repaying the lender with other bitcoins. The bitcoins may be intended as fungible currency, a continuation of the bitcoins that were lent (with the same tax basis and the same acquisition date). But will the IRS agree? Consider the fluctuating value of cryptocurrency, and these tax issues could be big. In light of the IRS's conclusion that cryptocurrency is property, there is a risk that the IRS may treat the loan as a sale of the original bitcoins for tax purposes. Even if the IRS agrees that loan treatment is appropriate, it is not clear how interest payments will be treated.

In the current climate of uncertainty, careful documentation might help. Emphasize that the transaction is *intended* to be a loan, not a sale or disposition. Consider stating that both parties will report the loan in this manner for tax and accounting purposes. If the transaction has profit sharing or equity provisions, that could complicate the argument for loan treatment. The loan documentation could emphasize that repayment should be made in digital currency that is *identical in value and denomination* to the digital currency lent.

Perhaps the document could even require that repayment be made with the *exact same* cryptocurrency lent. In practice, this may not be possible. Still, a requirement that the loan repayments be made from the same wallet to which it was lent (and ideally one that is segregated from other funds) might help to strengthen the argument that the very same property has been repaid. The best strategy to avoid IRS problems is not clear. For example, the parties may want to emphasize in the loan documentation that the cryptocurrency is a fungible asset.

Perhaps they want to state that the cryptocurrency received in repayment will be considered identical to the cryptocurrency lent (that will use the same acquisition date and tax basis). Loan documentation could distinguish between transfers made in repayment of the loan principal, and transfers that are payments of interest. Care might also be taken to address possible forks in the cryptocurrency. A loan transaction that began with bitcoin might become even more problematic when the lent funds are now represented by both bitcoin and bitcoin cash. Parties should anticipate what to do, and how to emphasize that repayment is still being made from the same source and property.

Taking steps of this sort may not prevent the IRS from successfully challenging a loan. Even so, it may help put you in a better position in case the loan is examined. The IRS is using tracking software, and is issuing summonses to cryptocurrency exchanges for user personal information and transaction histories. The IRS revealed that nationally, only 802 people reported bitcoin on their tax returns for 2015. Particularly with meteoric rises in value and high demand, perhaps some people are not reporting? The IRS sure thinks so.

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