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In Satoshi We Trust (Almost): Shifting Crypto Trends In The Investment Landscape

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I apply a multidisciplinary approach to wealth management dovetailed with structured tax planning.

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Frank Sinatra probably wasn't thinking about money and trust when he sang about "Love and Marriage," but the same is true: You can't have one without the other.

Our monetary system is fundamentally based on trust. Over time, I've seen that trust erode with the help of a myriad of institutional players, including certain commercial banks, central banks, regulators and governments. Ironically, many of these institutions are empowered to protect the system from abuses and help to ensure that public trust in the system is warranted.

In 2009, Satoshi Nakamoto (a pseudonym) wrote in a peer-to-peer forum, "The root problem with conventional currency is all the trust that's required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust."

With today's technology, it became possible for someone to create an autonomous currency: one that would make it hard to control, to inflate, to counterfeit, to manipulate – one that doesn't rely on the trust of the government or other central authority. And then, someone did.

Earlier in 2008, it is believed that this same "Satoshi" authored a mysterious paper on the web entitled *Bitcoin: A Peer-to-Peer Electronic Cash System,* which was described as "a system for electronic transactions without relying on trust." It became known as a cryptocurrency, or virtual currency, since the accounting ledger is based on cryptography – complex computer codes used to verify transactions. Normally, the bank verifies our transactions, and we trust that their calculations are correct. With bitcoin, however, transactions are verified by a decentralized consensus vote using a blockchain. While there are over 1,900 cryptocurrencies (as of the time of this writing) using similar technology, bitcoin is currently the most popular.

The advent of bitcoin has created a massive stage for speculation. In 2010, one bitcoin was valued at $0.06. In 2013, an anonymous purchase of about 195,000 bitcoins – valued at approximately $148 million – was made. Bitcoin reached an all-time high of $19,783.06 in 2017. For some, trust has certainly wavered, as bitcoin is currently trading at around $6,500, which is approximately 65% off its all-time high.

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So how does the IRS look at cryptocurrency? The IRS states that virtual currency is treated as property for tax purposes, and generally taxes that apply to property transactions extend to virtual currency transactions. Furthermore, cryptocurrencies can operate like real currency but do not have legal tender status in any jurisdiction.

For transactions that occurred on or before December 31, 2017, some industry experts – including Robert W. Wood – believe that sellers could have deferred the tax liability associated with qualified crypto-to-crypto exchanges by employing a like-kind exchange. According to the IRS, IRC Section 1031 "allows you to postpone paying tax on the gain if you reinvest the proceeds in similar property as part of a qualifying like-kind exchange. Gain deferred in a like-kind exchange under IRC Section 1031 is tax-deferred, but it is not tax-free."

Based on the record high of bitcoin in December 2017, a hypothetical sale of the previously referenced 195,000-bitcoin position would have netted nearly $3.86 billion (195,000 x $19,783.06) and spawned a *cringe-worthy* $771.50 million federal long-term capital gains tax ($3.86 billion x 20%). Had the transaction qualified and had a like-kind exchange been properly employed, that $771 million tax liability could have been deferred and strategically reinvested for the seller's benefit.

Whether you believe there is sufficient legal authority for like-kind exchanges as they relate to cryptocurrency or not, the Tax Cuts and Jobs Act of 2017 (TCJA) made it clear. The tax reform reportedly eliminated the use of like-kind exchanges for anything other than qualified real property. In my experience, however, there are still financial planning strategies that could be employed for the disposition of highly appreciated capital assets such as cryptocurrencies. Some of these planning techniques could provide congruent and possibly even superior tax results compared to like-kind exchanges.

While cryptocurrencies are currently unregulated, the Securities and Exchange Commission has repeatedly warned investors of cryptocurrency risk and the impact on U.S. financial markets. In June, VanEck and SolidX, two firms that unsuccessfully tried to launch bitcoin ETFs, announced that they were teaming up to create an ETF that they hope will alleviate much of the SEC's concerns: the VanEck SolidX bitcoin Trust ETF (XBTC). The New York Stock Exchange's owner, Intercontinental Exchange (ICE), has built a cryptocurrency exchange called BAKKT, while both Fidelity and TD Ameritrade are reportedly entering the space. CoVenture, an alternative asset manager, has reportedly developed strategies and systemic indices, including a cryptocurrency index fund, which could allow institutional investors exposure to a diversified portfolio of cryptocurrencies.

It is clear as more and more industry giants enter the marketplace that cryptocurrency is an emerging asset class – and I believe it's a compelling one to keep your eye on. Whether you plan to use bitcoin to make a small transaction or a large fortune, it's not enough to simply trust computer code like Satoshi's. One should refrain from getting caught up in the hysteria or looking at things in a vacuum. Cryptocurrencies should be viewed, accounted and planned for in the context of one's total balance sheet. For certain accredited investors, having crypto exposure can align with their global financial plans. But for the average investor, it may make sense to sit on the sidelines unless you are going into it with the same mindset that you do when buying a lottery ticket. I believe all investors should deeply consider and understand the inherent risks before entering this new financial realm. As we all know, with investing comes risk, and as Frank sang, you can't have one without the other.

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