In-Kind Contributions – Virtual Currencies

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With the boom of virtual currencies over that past few years, practitioners are seeing an increase in the number of questions relating to the taxation of these investments. One very common question asked by current and potential virtual currency fund managers: Can my investors and I contribute appreciated virtual currency assets into my pooled investment partnership/hedge fund tax deferred?

While virtual currencies are thought of by many as cash or currency, they are in fact viewed by the Internal Revenue Service more similarly to securities (specifically property) and are therefore generally subject to capital gain/loss tax treatment. In 2014, the IRS issued Notice 2014-21, which addressed the tax treatment of Bitcoin and other virtual currency transactions. In the notice, the IRS concluded that Bitcoin and other virtual currencies are to be treated as property for tax purposes, and as such, general tax principles associated with the sale or exchange of property apply to all virtual currencies. It is also specifically noted that virtual currency is not defined as “foreign currency” for tax purposes.

Considering this, the tax effect of an in-kind contribution of virtual currency into a hedge fund would seem to most properly follow the same rules as an in-kind contribution of securities and other similar property. Typically, according to IRC §721(a), there is no gain recognized on the transfer of property in exchange for a partnership interest. However, there is one very specific exception to this code section that pertains to hedge funds and other similar vehicles which, based on its nature, could target a large number of unsuspecting virtual currency funds due to their often undiversified nature.

If a property contribution is made to an “investment company” that results in the “diversification” of the contributor’s assets, then the contribution event is taxable related to unrealized gain positions, not loss positions, upon contribution. For these purposes, an ”investment company” is any entity in which more than 80% of the value of assets are held for investment and are readily marketable stocks or securities (which is often interpreted to include many types of virtual currency). Furthermore, an undiversified portfolio is a portfolio where the securities of one issuer constitute more than 25% of the value of the contributed property, or the securities of five or fewer issuers constitutes more than 50% of the value of the contributed property. In other words, this exception to the tax deferred nature of in-kind contributions commonly occurs when an established hedge fund accepts an undiversified portfolio of non-identical assets, or in the case of a new hedge fund, when two or more partners transfer undiversified portfolios of non-identical assets to the fund in an exchange for an interest in the fund.

As is often the case with tax, there are exceptions to the exceptions, and careful tax planning should take place when considering any transaction, especially those that could cause unsuspecting taxable events. For the application of these rules, please consult your tax advisor or a Richey May specialist.

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- **Understanding Cryptocurrencies: Audit Considerations and Potential Regulations**
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