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Crypto Flash Crash Brought Tax Problems Too

Bitcoin and other cryptocurrencies dropped steeply on September 7 despite the feel-good news that El Salvador has made bitcoin legal tender along with U.S. dollars. In fact, the crypto flash crash wiped out $400 billion in market value. Bitcoin itself dipped about 10% to less than $44,000 but recouped some of that by day's end. With volatility there were winners and losers, and the IRS is in the winner's corner because lots of crypto changed hands. This was a big drop, but was it a flash crash? Investopedia defines a flash crash as an event in electronic securities markets where the withdrawal of stock orders rapidly amplifies price declines, and then quickly recovers. The result appears to be a rapid sell-off of securities that can happen over a few minutes, resulting in dramatic declines. However, Investopedia says usually by the end of the trading day, as prices have rebounded, it's as if the flash crash never happened. In securities markets, there have been a number of such events, such as a well-known one on May 6, 2010. That day the market dropped precipitously, a phenomenon that quickly roiled prices, and there were numerous floated explanations thereafter.

In its wake, the SEC voted June 10, 2010 to enact new rules to automatically stop trading on any stock in the S&P 500 whose price changes by more than 10% in any five-minute period. With the market falling off a cliff, there would be big losses, right? Not necessarily. It turns out that many investors sold stock at a *gain* because of stop-loss orders. A stop-loss order directs a broker to sell at the best price available if the stock reaches a specified price. Because of the whopping and sudden decline in stock prices the afternoon of May 6, 2010, many stop-loss orders were triggered.

How does this apply to crypto, which has been especially volatile? The latest crypto flash crash—if that is even a fair description here in the always volatile crypto markets—involved lots of sales and lots of purchases. And yet stock flash crashes of stock are a useful analogy. In 2010, in the wake of a flash crash

of stocks, the IRS had its say about taxes, and in IRS Information Letter 2010-0188, the IRS responded to a request from investors/brokers that:

1. Investors should be allowed to reinvest in the stock they sold;
2. The replacement stock should be given the same basis as the stock they originally held; and
3. Investors should be excused from recognizing gain.

Appealing as this sounds, the IRS said it did not have the authority to grant this relief. Maybe this makes you think of wash sales, where you sell stock to trigger a loss, and then buy it back. But this is the flip side of a wash sale, and it turns out there's nothing in the tax law to allow you to defer any such gains. In the Notice, the IRS agrees that the wash sale rule of Section 1091 of the tax code can prevent you from recognizing a *loss*. Fast forward a decade, and stop loss orders for crypto have become common. Given how volatile the market is, that's no wonder. A stop-loss order works by automatically closing a position when the price hits a pre-determined level. Stop-losses can help manage your risk, and there's plenty of risk to go around. However, there's no rule prohibiting crypto owners from buying and selling as much as they want. There are no wash sale rules like those that apply to stocks. You can sell your crypto and buy it right back without a 30 day waiting period. I'll bet some people did that on September 7, even though each transaction is a disposition.

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