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Do Crypto Losses Trigger Tax Losses With IRS?

Crypto markets are notoriously volatile, but even so, the recent activity has been unsettling. Whether you are a buy and hold investor or an active trader with high frequency moves, it is nerve-wracking, and it may not be over yet. For some, it can be downright devastating, particularly if you had put all your nest eggs in Terra USTUST -4.3% or LunaLUNA -4.2%. But even those may bounce back, as luna has shocked some by staging a surprise rally. In the meantime, the turmoil may make plenty of crypto investors, as well as people in various crypto and crypto-related businesses less enthusiastic than they were when prices seemed ever to be climbing. But can some tax losses help? As your dollars shake out in the digital world, is there any lemonade you can make by claiming your losses on your taxes to share the pain with the IRS?

First, ask what happened from a tax viewpoint. If you‘ve been trading and triggering big taxable gains, but then the floor drops out, consider whether you can pay your taxes for the gains you have *already* triggered this year. Taxes are annual, and generally based on a calendar year, unless you have properly elected otherwise. Start with the proposition that each time you sell or exchange a cryptocurrency for cash, another cryptocurrency, or for goods or services, the transaction is considered a taxable event. That is a result of the IRS shot heard round the world in Notice 2014-21, when the IRS announced that crypto is *property* for tax purposes. Not currency, not securities, but property, so most any transaction means IRS wants you to report, Before 2018, many crypto investors claimed that crypto to crypto exchanges were tax free. But that argument was based on section 1031 of the tax code. It was a good argument, depending on the facts and the reporting. But that argument went away starting in 2018. Section 1031 of the tax code now says it applies to swaps of real estate only.

The IRS is auditing some pre 2018 crypto taxpayers, and so far doesn't appear to like the 1031 argument, even before 2018. The IRS even released one piece of guidance saying that tax free crypto exchanges don't work. We may need a court case to resolve it, if the IRS pushes it that far. After all, it only applies to 2017 and prior years so is of diminishing importance. But regardless of whether you use crypto to pay someone, swap crypto, or outright sell it, do you have gain or loss? For most people, gain or loss would be subject to short-term or long-term [capital gain]/losses based on the basis (what you paid for the crypto), holding period, and the price at which the cryptocurrency was sold or exchanged. Yet some people may have ordinary gains or losses, and that topic is worth revisiting. Are you trading in crypto as a business?

Although most investors want long term capital gain rates on *gain* if they buy and hold for more than a year, ordinary treatment could be helpful for some, especially for losses. Securities traders can make a section 475 mark to market election under the tax code, but does that work for crypto? It's not clear. To qualify, one must argue that the crypto constitutes securities or commodities. The SEC has argued that some crypto are securities, and there may be arguments for commodity characterization too. It's at least worth considering in some cases. However, in addition to establishing a position that a virtual currency is a security or commodity, you would need to qualify as a trader in order to make a mark-to-market election. Whether one's activities constitute "trading" as opposed to "investing" is a key issue in determining whether one is eligible to make a mark-to-market election. [The IRS lists details about who is a trader], usually characterized by high volume and short-term holding, although sometimes investing and trading might look rather similar.

If crypto turns out to be eligible for mark to market and if you qualify and elect it, you could mark to market your securities or commodities on the last business day of the year. Any gain or loss would be ordinary income, and gains too. A benefit would be that the cumbersome process of tracking the date and time that each crypto was acquired and identifying the crypto you sold would not be required. For most people, this won't make any sense, but like so much else in the crypto tax world, much is uncertain. In the past, some drops of crypto value have been called 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. In the case of stock, the SEC voted June 10, 2010 to enact 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? We don’t know, but 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*. A stop-loss order works by automatically closing a position when the price hits a pre-determined level. Stop-losses can thus help manage your risk. Notably, 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.

Check out my website.