PERSPECTIVE
Los Angeles | Daily Journal
WEDNESDAY, MAY 25, 2022

# Make Lemonade, Crypto Loss Means IRS Tax Loss

By Robert W. Wood

With the crypto market falling off a cliff, there are big losses to claim on your taxes, right? 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 may not be over. For some, it can be downright devastating, particularly if you had put all your nest eggs in Terra UST or Luna. Yet even those may bounce back, as Luna has shocked some by staging a surprise rally.

As your dollars shake out in the digital world, it is worth asking whether you can make lemonade by claiming losses on your taxes. It depends. If you are just holding crypto you bought worth $10,000 and the price drops to $6,000, you might have "lost" $4,000, but there is no sale so you can't claim the loss. If you have been trading and triggering big taxable gains but the floor drops out, first consider whether you can pay your taxes for the gains you have *already* triggered this year.

Taxes are annual, based on a calendar year, unless you have properly elected otherwise. Each time you sell or exchange a crypto, even for another cryptocurrency or for goods or services, the transaction is a taxable event. That is a result of IRS Notice 2014-21, when the IRS announced that crypto is property for tax purposes. Calling crypto property means it is not currency and not securities, but property. Of course, this is a tax rule, and it may or may not hold true elsewhere.

For example, the SEC is arguing in some cases that some crypto might be securities. Do the IRS and the SEC talk much? The IRS classification of crypto as property means that even trades of one crypto for another (with no cash) are taxable swaps. Before 2018, many crypto investors claimed that crypto to crypto exchanges were tax free 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 in 2018 when section 1031 of the tax code was amended to say it applies only to exchanges of real estate. The IRS is auditing some pre 2018 crypto taxpayers, and so far, doesn't appear to like the 1031 argument, even for years before 2018. The IRS even released a 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, although it only applies to 2017 and prior years.

Regardless of whether you use crypto to pay someone, swap crypto, or outright sell it, you may have gain or loss. For most people, gain or loss is short-term or long-term capital gain or loss based on the basis (what you paid for the crypto), holding period, and sale price. But how about ordinary gains or losses, are you trading in crypto as a business? Plainly, investors want long term capital gain rates on gain if they buy and hold for more than a year.

However, ordinary loss treatment would sure be nice. But to be able to claim ordinary losses, you must be willing to pay ordinary income too. 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 treating crypto as a commodity too.

In addition to claiming that virtual currency is a security or commodity, you will need to qualify as a trader to make a mark-to-market election. Trading rather than investing is a key issue in who is eligible to make a mark-to-market election. The IRS says traders have high volumes and short-term holding periods, but sometimes, investing and trading might look pretty similar. If crypto turns out to be eligible for mark to market and if you qualify, you could mark to market your crypto on the last business day of the year.

That way your gain or loss would be ordinary income. One 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 election if available likely won't make any sense, but as with so much else in the crypto tax world, much is uncertain.

What if you sell but you didn't really want to? Consider stop-loss orders. A stop-loss order directs a broker to sell at the best price available if a stock reaches a specified price. But if you sell, can you claim your tax loss and buy the stock back right away? Let's take stocks first. The wash-sale rules prohibit selling an investment for a loss and replacing it with the same or a substantially identical investment 30 days before or after the sale. If you do have a wash sale, the IRS will not allow you to write off your loss.

But there are no wash sale rules for crypto, so you can sell your crypto and buy it right back without a 30-day waiting period. However you manage your crypto, think about taxes, and not just your gains and losses. Think about reporting with care too. After all, IRS audits of crypto are increasing, and the IRS is inquisitive as it learns more and more about the crypto world. And don't forget your state taxes, as state tax audits, notably California's Franchise Tax Board, are increasing too.

**Robert W. Wood** *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*