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Assessing the Tax Implications of Bitcoin

The IRS means business.

Dana D'Auria | Jul 12, 2021

Bitcoin and other forms of cryptocurrency are so new, and volatile, that many investors are unsure of how to define them, or how they can be taxed. Adding to the confusion is the fact that many regulatory agencies have not issued definitive guidance on cryptocurrency—but the Internal Revenue Service stands out as one of the few that has done so.

The IRS has clearly communicated that cryptocurrency assets are taxed when they are traded. If you make a gain on a cryptocurrency trade, you will owe a capital gains tax. Similarly, if you use cryptocurrencies to purchase other assets, such as utilizing bitcoin holdings to buy an NFT, that transaction will incur a capital gains tax, since the bitcoin is being cashed in—and some cryptocurrency transactions, if they involve earnings on interest from lending, could also be subject to income taxes.

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This is news to many of the investors who own cryptocurrencies. According to a survey conducted earlier this year by Cardify , 33.5% of cryptocurrency buyers, or approximately one out of three purchasers, either know nothing about the asset class, or possess an "emerging" level of understanding. The Cardify survey found that only 16.9% of investors who own a cryptocurrency "fully understand" the value and potential of what they have purchased.

Making the lack of understanding among investors even worse is that the IRS is cracking down on cryptocurrency tax enforcement. Form 1040 for the 2020 tax year includes a question about cryptocurrency assets on the front page, right after the taxpayer's name and address! The question asks: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

The IRS means business, which adds to the urgency for investors to understand the taxes to which their cryptocurrency holdings are subject. On top of that, the Biden administration's tax proposals signal that capital gains tax rates for high earners may increase.

Investors Can Work With Financial Advisors to Offset Capital Gains on Cryptos

Financial advisors possess the tax management expertise and the tax-loss harvesting tools to help investors figure out what taxes their cryptocurrency holdings are subject to—and then identify opportunities to offset capital gains on cryptocurrencies with losses on portfolio securities, or use crypto losses to potentially offset capital gains on securities.

Advisors can apply tax overlay solutions to ensure clients' managed equity holdings remain in alignment with their individual long-term capital gains tax budgets. These tax overlay tools can help advisors find losses from other parts of their clients' overall portfolios that can offset short-term capital gains in outside assets, such as crypto.

The good news for investors is that cryptocurrencies are considered to be properties instead of securities, which means they are not beholden to wash-sale rules. This presents an opportunity for investors to utilize cryptocurrency losses to potentially offset capital gains on securities and then immediately reenter the market on the cryptocurrency position—harnessing that crypto position to obtain value beyond expected potential growth.

While bitcoin and other cryptocurrencies are volatile, speculative assets, that doesn't mean advisors should ignore their clients' positions in them. Financial advisors have an important role to play in empowering investors to get the most out of their cryptocurrency by mitigating capital gains taxes on their crypto accounts as well as their overall portfolios.

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