DECRYPTING CRYPTO TAXES

The Complete Guide to Cryptocurrency and NFT Taxation

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Introduction

Crypto taxation is one of my absolute favorite parts of my CPA practice. There are few areas in accounting that can be as fascinating or dynamic. It is also one of the areas in which my team and I can provide the most value to our clients and save them the most money.

But at the same time, it can often be one of the most confusing and frustrating areas in the entire world of taxes.

The current state of crypto tax law and regulation is **bad**. There's really no other way to put it. IRS guidance is almost nonexistent on the majority of topics. Regarding the guidance that *does* exist, it can seem outdated, incomplete, and at times even contradictory.

Because of this, most CPAs and tax attorneys do not seem to want to touch crypto, which I suppose is understandable for most tax professionals. You're combining an industry with a lot of its own complexities and technical components (blockchain) with an area of tax law that has minimal precedent. The tax professionals do not understand the topic and do not want to misadvise their clients, so they tell the clients to go elsewhere.

The problem is that the client often can't find anyone else to help them, so they largely end up trying to figure things out on their own. And as they are of course not tax experts, this results in a lot of mistakes being made.

When non-crypto tax practitioners *do* try to dig into crypto, the analysis can feel very (for lack of a better term) academic. What I mean by that is that they are researching the topics based on things other people have written, but it becomes quite evident that they themselves are not actual crypto **users**. They advise their clients based on what they have read, but have never actually done anything with crypto themselves.

And unfortunately, it often shows. That lack of familiarity and first-hand experience will cause them to misunderstand a situation and thereby the appropriate tax treatment. The mechanisms behind these projects and other subtleties around how they operate are vital to **truly** understand, as those nuances can drastically affect the tax treatment.

In this book I am attempting to do what no other CPA has done yet: provide you with a comprehensive guide to your most frequently asked questions on crypto taxation.

As new legislation is passed, the IRS issues additional guidance, and these issues are litigated in court, it is all but inevitable that some of these conclusions will change over time. But we have to start somewhere. People are making (and sometimes losing) money – oftentimes *significant* amounts of money – in crypto **right now**. We can’t just take the “wait and see” approach that many CPAs and taxpayers seem to be taking. The consequences for not doing tax planning around that income can be disastrous.

But if you plan properly, you can not only save on your taxes but also significantly increase your bottom line.

Section 1: Trades & Swaps

Chapter 1: How Are Crypto Trades Taxed?

In crypto circles, one of the most common sentiments is that crypto trading and profits are not taxable until you convert them back into a fiat currency.

"Yeah, but you don't pay taxes until you trade it back for USD. So long as you don't cash out you don't have to pay anything!"

That would be great – if it were true.

Crypto Bros Don't Know What They're Talking About

Unfortunately, it's just not. A taxable event is created each and every time you convert one token for another. Every trade will generate its own capital gain or loss that must be cataloged and reported on your tax return to the IRS. The IRS noted this very plainly in a follow-up FAQ to IRB: 2014-16 (emphasis mine):

"Question: Will I recognize a gain or loss if I exchange my virtual currency for other property?

*Answer: Yes. If you exchange virtual currency held as a capital asset for other property, **including for goods or for another virtual currency**, you will recognize a capital gain or loss. For more information on capital gains and capital losses, see Publication 544, Sales and Other Dispositions of Assets."*

Crypto Trading Presents Unique Difficulties

This can be a bit of a logistical nightmare for two main reasons:

1. The prices and exchange pairs of each cryptocurrency are constantly fluctuating
2. In order to avoid understating your cost basis – and thereby not overpay on your taxes – you need to keep track of gas fees and exchange fees

Let's just run through a basic example to illustrate this. Let's say you have some BTC that you originally bought for $1,000. The market goes up and the value has increased to $2,500 and you decide to swap it for an equivalent amount of ATOM. Then the value of the ATOM goes down to $2,300 and you decide to swap it for KAVA.

Contrary to what people in Discord might tell you, you have taxable income that you must report **even though you did not convert it back into USD**. And it's not just the net of $1,300 that needs to be shown. You have to show the capital gain of $1,500 ($2,500 - $1,000) and the capital loss of $200 ($2,300 - $2,500). You will also need to keep track of any costs associated with the $2,300 purchase of KAVA and also the date purchased to see if you qualify for long-term capital gains treatment when it is sold.

We've[1] noted this before, but we believe the confusion on this stems from the fact that in most other transactions actual cash is received. We generally don't function the barter system. You sell a stock, your house, or pretty much anything of value and cash is received. So – somewhat understandably – people attach the receipt of cash as what generates tax. But it's not. **The disposition of the asset is a taxable event, not the receipt of cash itself**.

How to Stay Compliant and Track Your Crypto Trades

Each crypto trade generates its own reportable transaction and gain or loss. This can cause a bunch of issues, some of which we'll cover in-depth in their own chapters later in this book:

1. Since you didn't convert the crypto back to cash, you may not have the money to pay the tax bill on the crypto profits without liquidating some of your portfolio. And that liquidation will cause more capital gains or losses
2. If you have large gains in one year but then the market goes down the next, you could have a massive tax bill and no means to pay it
3. Unless you have all of your transactions on one exchange, your cost basis is not being tracked properly. The IRS receives much better records of sales than they do for your cost, so if you aren't keeping track of the transactions yourself it's very likely that they're going to think you made more money than you did
4. Some exchanges do not do a great job of including their fees in your cost basis for tax purposes. And if you are using a decentralized wallet like MetaMask, your cost basis is not being tracked at all
5. The holding period resets for long-term capital gains purposes resets after each trade

This would be tedious to track even with a limited portfolio, but as we're sure you can tell this would be nearly impossible at any sort of volume. That's why we recommend using a crypto tracking software, which we'll discuss in Chapter 6.

As always, make sure you're consulting with your CPA throughout the year to make sure you're planning properly and taking advantage of maneuvers to minimize your tax bill on your crypto profits.

Chapter 2: Holding Period: Are Crypto Sales Short-Term or Long-Term Capital Gains?

As we discussed in the last chapter, each time you trade one crypto token for another a capital gain or loss is created. And you need to report that income on your tax return – regardless of whether or not you convert it back into a fiat currency.

Capital Gains Holding Period Resets

Savvy blockchain investors are aware of this and plan accordingly. But one of the things that will often slip by their planning – and even the planning of their less-than-familiar-with-crypto CPA – is that **the holding period also resets with each of these transactions**.

Gains on assets that have been held for more than one year are considered long-term capital gains. Long-term capital gains receive a significantly lower tax rate compared to short-term capital gains, which are taxed at ordinary income rates. Long-term capital gains are taxed at a maximum of 20%[2], which is much lower than the current top tax rate of 37%.

Because many crypto investors so actively trade between different coins, a lot of them do not hold any individual token for more than a year **even if they never cash out and convert back into a fiat currency**.

And depending on the investor, that may still make the most sense. The superior gains they are getting from the market is offsetting the additional tax they are paying.

Strategies to Qualify for Long-Term Capital Gains

Even for active traders, there are strategies that could and should be considered.

For instance, let's say your portfolio mostly consists of different Top 100 projects. The market largely follows the price of Bitcoin (with some variation, of course). Some will perform better than others, but they typically follow the same general trendline.

Given this, you *may* want to choose a specific token to do your day trading with. If you use all of them to actively trade with, it is much less likely that any of them will be held longer than a year.

Just to illustrate, let's say most of your holdings are some of the Top 10 projects – BTC, ETH, ADA, BNB, SOL. But you designate 10% of your portfolio for altcoins and day trading.

If you are using all five of those projects to fund your altcoin trading, you may keep resetting your holding period on them. You trade your BNB for an altcoin, the altcoin surges, and a month later you trade it back for BNB. Then you do the same thing with your ETH the next month.

Each time you're doing this, you're resetting the holding period on your tokens and making it harder to get any age on them to qualify for long-term capital gains.

At least from a **tax perspective** (we do not give investment or trading advice), you are much better off designating a specific token to trade with and leaving the other four projects in your portfolio so they can qualify for long-term capital gains.

There may of course be market considerations that override these tax benefits. But from a pure tax standpoint, this approach is often a no-brainer.

Chapter 3: FIFO, HIFO, or LIFO: What Is the Best Accounting Method for Your Crypto Taxes?

The best crypto accounting method will depend on the type of investor. It will also vary based on overall market conditions. FIFO can be helpful for long-term investors because it is more likely to qualify for the long-term capital gains rate, but it may also show higher capital gains. HIFO is often helpful for active traders who are unlikely to have any assets held for longer than a year. Taxpayers should also investigate the Specific Identification Method. LIFO is rarely the best choice, although there are exceptions.

Different Crypto Accounting Methods Available

Crypto is considered property according to the IRS (at least for now, see Chapter 13). And just like when you sell any other asset, you need to calculate your cost basis when you sell it. This determines your profit and thereby the amount of tax you're going to pay on the sale.

But there are different accounting methods you can choose from. Which one is going to be the most advantageous for your situation? Which one will allow you to pay as little tax as possible?

The answer will largely depend on the particulars of your tax situation:

- How much money are you making from crypto trading?
- What is your income from other sources?
- How long do you typically hold your crypto for before selling it?
- What are overall market conditions? Have prices been going up or going down over the past few years?

There are four basic accounting methods available: FIFO, LIFO, HIFO, and the Specific Identification Method.

FIFO (First In, First Out)

FIFO stands for First In, First Out. As the name suggests, this means that the crypto purchased first is also the crypto that is being sold first. First in (purchased) and first out (sold).

The advantage to this method is that it increases the likelihood that your sales qualify as long-term capital gains. It's always going to pull your earliest purchase, making it more likely that you will have held it for that one year minimum. That's significant because long-term capital gains are taxed at a maximum rate of 20% compared to short-term capital gains being taxed up to 37%.

The disadvantage is that FIFO is more likely to show a higher gain in absolute terms. Asset prices typically go up over time. If you are pulling from the oldest transactions, you will often be pulling the transactions with the lowest cost basis. This is partially (or in some cases, completely) offset by the much more favorable long-term capital gains rates mentioned above.

FIFO can work well for long-term, "buy and hold" investors who are likely to have crypto held for longer than a year.

LIFO (Last In, First Out)

LIFO stands for Last In, First Out and is the opposite of FIFO. It assumes that whatever tokens you most recently purchased are the ones you are selling.

Since you're always pulling the most recent transactions, LIFO gives you the worst odds of qualifying for long-term capital gains. So why would you use it?

In periods of rising prices, your most recently purchased tokens are likely to have the highest cost basis. In those instances, LIFO will show smaller gains than FIFO would.

If you are an active trader and are unlikely to qualify for long-term capital gains, LIFO will often be better than FIFO. However, there are few instances where we would recommend LIFO as HIFO is usually a better option.

HIFO (Highest In, First Out)

HIFO stands for Highest In, First Out. And as you're probably figuring out based on the naming convention of the first two methods, it means that whatever crypto you purchased with the highest cost basis is the crypto you are selling first.

Under normal market conditions where prices are steadily rising, HIFO and LIFO will often show the same cost basis/will pull the same transactions. In many cases, the most recent transactions will be the most expensive.

But instead of leaving that to chance the way LIFO does, HIFO guarantees that you are always pulling the most expensive transactions and will show the lowest gain possible. And while long-term capital gains are not super likely with either method, HIFO does give you a better chance to qualify for them. LIFO is **always** pulling the most recent transaction, giving you the worst possible odds for the one year holding period. HIFO is just pulling the highest cost basis, so there is some chance that it's crypto you held for more than a year.

HIFO is great for active traders with average holding periods of less than a year. It will give you the lowest profit, which is the primary concern when long-term capital gains are off the table.

Specific Identification Method

Possibly the best method of all of them is also the least talked about: the Specific ID method. With this method, **you are manually selecting the crypto you are selling**. That gives you a **tremendous** amount of control – both in terms of holding period and overall gain.

So why does no one talk about it?

Because its strength is also its biggest shortcoming: it is an entirely manual process. None of the existing crypto tracking software programs have Specific ID as an option. This requires you do your crypto tracking entirely on your own or take the reports from one of those programs and manually edit them. Both options are time consuming and with a higher probability of error vs. using software that is specifically designed for crypto trading. This isn't going to be the option that makes the most sense for the majority of people.

But if you have the time, attention to detail, and are not a high-volume trader – the Specific ID method may be worth investigating. It provides you with more control than any other method, which in some cases can save you a tremendous amount of money in taxes.

Crypto Capital Gain Examples

To better illustrate, let's run through some examples. We're going to say that you bought 1 BTC for $20,000. A year later you bought another BTC for $50,000, and then a month after that you bought one last BTC for $40,000. A few months later you sell one of the BTC for $60,000.

How much of a gain would you show under each of the methods?

Method	Sale Price	Cost Basis	Gain
FIFO	$60,000	$20,000	$40,000
LIFO	$60,000	$40,000	$20,000
HIFO	$60,000	$50,000	$10,000

HIFO would only show a $10,000 gain compared to a whopping $40,000 under FIFO. So HIFO is the clear winner here, right?

Maybe. Again, everything depends on the specifics of your personal situation and what other activity you have on your tax return.

Let's say you're a big earner and are in the top tax bracket *(Note: for simplicity in this example, we're just going to use a flat 37% for ordinary income and 20% for long-term capital gains without getting into the more complex calculations that would occur on a real return).* This is what the actual tax paid would look like:

Method	Sale Price	Cost Basis	Gain	Tax Rate	Tax
FIFO	$60,000	$20,000	$40,000	20%	$8,000
LIFO	$60,000	$40,000	$20,000	37%	$7,400
HIFO	$60,000	$50,000	$10,000	37%	$3,700

In this scenario, the tax bill from HIFO is less than half of the one from FIFO – even accounting for the more favorable long-term capital gains rate. That’s a big win.

But what if you had no other income aside from the Bitcoin sale? *(Again, for simplicity we’re going to assume that this taxpayer’s ordinary income tax rate is 12% and aren’t going to factor in things like the standard deduction).*

Method	Sale Price	Cost Basis	Gain	Tax Rate	Tax
FIFO	$60,000	$20,000	$40,000	0%	$0
LIFO	$60,000	$40,000	$20,000	12%	$2,400
HIFO	$60,000	$50,000	$10,000	12%	$1,200

At that income level, long-term capital gains are taxed at 0%. It doesn’t matter that LIFO and FIFO both show lower gains, you still end up paying more because they were short-term.

But What About NFT Sales?

Let’s throw one last change in there.

Like in the last example, you had no income aside from the crypto sale. But this time, let’s say that you were selling PFP (profile picture) NFTs instead of Bitcoin. What does that look like?

Method	Sale Price	Cost Basis	Gain	Tax Rate	Tax
FIFO	$60,000	$20,000	$40,000	12%	$4,800
LIFO	$60,000	$40,000	$20,000	12%	$2,400
HIFO	$60,000	$50,000	$10,000	12%	$1,200

Art NFTs are taxed as collectibles (see Chapter 26), which do not receive the same long-term capital gains treatment as other assets. They are taxed at the lesser of your ordinary income tax rate or 28%.

Conclusion: Plan With Your Crypto CPA

Some of these are admittedly somewhat unusual scenarios, but they do speak to the situation-specific nature of which accounting method is best. There is no one right or wrong answer for every taxpayer.

And the best method could change over time, even for the same taxpayer. As your circumstances change and evolve over time, you need to make sure you are planning with your CPA to you are adjusting your strategies to minimize your tax bill and maximize your cashflow. We’ve worked with clients where simply changing their accounting method has **saved them hundreds of thousands of dollars in taxes**.

A little planning goes a long way, so make sure you’re doing it regularly.

Chapter 4: Does Crypto Qualify for 1031 Exchanges?

No, cryptocurrencies are not considered "like-kind" property and do not qualify for Section 1031 exchanges.

Intangible Assets Ineligible for 1031s Post-TJCA

After reading our guide on how cryptocurrency trades are taxed in Chapter 1, you likely already knew the answer to this. Trading one token for another token is always a taxable event, which would of course not be the case if 1031 exchanges were possible.

But as always, looking into the background and history of the topic is helpful.

When the Tax Cuts and Jobs Act was passed in December of 2017, cryptocurrencies had started to become more mainstream. This was all happening right in the middle of the ICO boom and about a month before the huge crash at the beginning of 2018.

Anticipating taxpayers wanting to defer paying tax on their crypto gains, the TCJA **specifically restricted Section 1031 exchanges to only be exchanges of real property**.[3] Intangible assets such as crypto do not qualify.

That makes things very clear for current and future years. But that TJCA amendment to 1031s was effective 2018. The question that arose was if transactions from previous years could qualify.

On June 18, 2021, the IRS answered this question with ILM (IRS Legal Memo) 202124008.

Different Tokens Are Not "Like-Kind"

The IRS has always defined "like-kind" narrowly. In ILM 202124008, the IRS points to two previous rulings that highlight this perfectly. In Revenue Ruling 82-166, the IRS ruled that gold bullion is not like-kind to silver bullion. It noted that that the investor *"was required to recognize gain in part because silver is primarily used as an industrial commodity while gold is primarily used as an investment."*

Similarly, in Revenue Ruling 79-143 the IRS stated that trading different types of gold coins would also not qualify under 1031. This was *“because one coin’s value was derived from its collectability while the other’s value was derived from its metal content.”*

The IRS has used that same logic when it comes to cryptocurrencies. In the ILM, they only specifically mentioned Bitcoin, Ethereum, and Litecoin (the IRS is usually about five years behind when it comes to cryptocurrency guidance). But in each of those comparisons, they noted the differences in each token. When comparing BTC and ETH, after establishing that the two coins did have some similarities, the IRS noted that: *“However, while both cryptocurrencies share similar qualities and uses, they are also fundamentally different from each other because of the difference in overall design, intended use, and actual use.”*

That same logic could be and would be applied for trades of any other tokens. But again, this would only affect trades from 2017 and earlier. For 2018 and onward, the TJCA removed all intangible assets from consideration for 1031 exchanges.

Chapter 5: Is Crypto Subject to the Wash Sale Rule?

Selling vs. "Selling"

For traditional investments there is something called the "Wash Sale Rule".[4] It states that if you sell a stock at a loss but then buy an identical (or "substantially similar") stock within 30 days, you are not able to deduct the loss.

Essentially, the IRS does not want people "selling" their investments in order to harvest the losses for tax purposes but then immediately go and repurchase those same investments. If an item is sold and immediately bought again, then the taxpayer is not really and truly disposing of the asset. Perhaps on paper it shows as a sale, but in substance of course it isn't.

Because of this, those "losses" are not deductible on your tax return. That makes sense and is fairly well-established tax law.

Crypto Bypasses the Wash Sale Rule – For Now

But <u>CURRENTLY</u>, losses on crypto transactions are not subject to wash sale rules. This is VERY likely to change in the near future. Congress is already proposing legislation to close this loophole, but it is unlikely anything will be passed until later this year at the earliest.

That loophole creates the possibility of those significant tax savings if you have high *realized* capital gains, but also have *unrealized* losses. Under the current rules, you could sell those losing positions, immediately rebuy them, and still use those "losses" to offset against your gains.

In certain situations, this could result in massive savings.

Of course, this is somewhat contingent on scale. It is also dependent on the token itself, the network the token is built on, and where the token is held:

- Some altcoins have very high taxes as part of their tokenomics

- A token on Binance Smart Chain is going to have much lower gas fees than one on Ethereum
- An exchange like KuCoin is naturally going to have lower fees than a larger platform like Coinbase

The losses on those unrealized transactions – and the associated tax savings from them – will need to be substantial to offset against those fees and the fact that executing these trades also resets your holding period for capital gains purposes, as we discussed in Chapter 2.

But it is a potential tool available to you and one you should at least consider when doing tax planning with your CPA.

Chapter 6: How to Track Crypto Activity

The majority of cryptocurrency activity will result in some sort of reportable transaction. This can cause difficulties both if you're trading on a larger centralized exchange and if you're using a smaller decentralized one.

On the larger platforms, your activity is much more likely to be reported directly to the IRS from the exchange. So of course, you need to make sure that your records match what the IRS is receiving to avoid receiving letters from them or trigger an audit because of some discrepancy.

But at least those platforms are doing some of the work for you.

Centralized Exchange vs. Decentralized Exchange Reporting

On a decentralized exchange, you're entirely on your own. Coinbase is going to keep track of your transactions for you because they're required to. Your MetaMask wallet is not, so you have to keep track of every bit of that activity on your own.

And for most of us, we're not just using one platform. We're trading on multiple exchanges and using different wallets.

Worse yet (at least from a tracking standpoint), a lot of us aren't just trading either. We're lending out our crypto, staking it, depositing to liquidity pools, etc.

All of that activity is not only taxable, but it also affects our cost basis for when we do eventually sell. If we aren't properly tracking that basis, we could significantly overpay on our taxes once we eventually do sell the token.

This is why it is almost required that you use a robust crypto tracking software.

At some point we might do more in-depth reviews comparing the different tracking software programs. Most of the top-tier ones operate similarly, although there are pros and cons based on the type and amount of investment activity you have. The key to whichever one you choose being effective is for it to be

AUTOMATIC. They need to pull and categorize these transactions for you.

While it’s theoretically possible for you to do all of this on your own (or with a software that requires more manual entry), the more manual the process is the less likely it is to actually get done. And the much more likely it is to have errors.

Those errors will cost you more than the software ever would – both in terms of overpaying your taxes and from unwanted letters from the IRS. Invest in a tool to help you avoid those unnecessary headaches.

Chapter 7: Can the IRS Even Track My Crypto Activity?

As you've already seen in the first few chapters, dealing with cryptocurrency taxes can be a nightmare. Almost every transaction is reportable in some form or fashion, your cost basis is affected whenever you have a taxable transaction, and the rules are changing so quickly that the understanding you have now will likely be outdated in six months.

Does the IRS Care About My Crypto?

We'll often get some variation of these questions:

1. *"Do I really need to bother with this?"*
2. *"Does the IRS even care?"*
3. *"How could they even find out if I don't report it?"*

The answers are:

1. *"Yes"*
2. *"Yes"*
3. *"Very easily"*

People mistake *"I haven't been caught **yet**"* with *"I **can't** get caught"*.

Remember, blockchain has been relatively fringe up until recent years. Because of that, it represented a fairly small percentage of investment activity and the IRS and SEC paid little attention to it.

This is of course no longer the case. In 2015 the market cap of the entire cryptocurrency market hovered around $5 billion. As of writing this chapter, it sits at just below **$3 trillion**.

If you think the US government doesn't care about that amount of potential income, you're fooling yourself.

The SEC and IRS have both strongly signaled the desire for increased reporting requirements for everyone involved in cryptocurrency transactions. KYC (Know Your Customer) is becoming required for almost every platform operating in the US. If you're trading on a real exchange, your transactions either are already being reported to the IRS or they will be in the near future.

Now, at this point in the discussion, the question often becomes *"well, what if I'm not trading on an exchange? They aren't getting a report for what I'm doing on my MetaMask. They can't see that, right?"*

And while that is perhaps technically true, it ignores a pretty basic question:

"How did you fund your MetaMask to begin with?"

It All Starts Somewhere With KYC

At some point, you had to purchase your first batch of crypto with a fiat currency. And to do that, you more than likely had to use an exchange that had KYC.

All the IRS would have to do is look at your wallet from the KYC platform. They'll see that you're buying crypto on Binance or Coinbase and are then sending the tokens to another wallet.

They're not stupid. They're going to investigate that other wallet and will quickly realize it belongs to you as well.

Blockchain is auditable **by design**. The transactions of each wallet are clearly and easily accessible. Even if you're doing most of your trading "off-exchange", all the IRS has to do is follow the paper trail from your original purchase.

Now, we're not going to claim that there is no possible way to circumvent this. There's probably some way to layer Monero or some other privacy coin with a dozen wallets and Tor to try to obfuscate things. *Some* method likely exists that would hide it from the IRS – at least temporarily.

But we're not going to investigate that nor are any of those methods something we would ever recommend. Crypto income is taxable. Period. We may not like it, but that's the reality. Going through that amount of effort to hide your crypto transactions from the IRS would almost certainly prove fraudulent intent. And that's when we escalate from basic penalties and interest to criminal charges. It is absolutely not worth it to try to hide this income.

But that’s not to say you’re completely stuck. There are a ton of **legitimate** maneuvers you can make to reduce your tax bill. But to do that, you need to make sure you are accurately tracking and understanding your crypto activity – and that you are planning with your CPA throughout the year.

Chapter 8: Do I Qualify for Crypto Trader Tax Status?

It **is very unlikely that crypto investors will qualify for "Trader Tax Status" (TTS) on their tax returns, although it is not impossible.**

Day Trading and Professional Traders

Some investors – in and outside of blockchain – will want to qualify for TTS on their day trading activities. This treats your **trading activities as a business** rather than a regular investment activity. This has some downsides, but also comes with some **major** perks.

Most notably, deductions against investment income are very limited. After the Tax Cuts and Jobs Act (TCJA) eliminated miscellaneous itemized deductions, there are very few investment-related expenses that taxpayers are able to use to offset against investment income.

This is not the case for those with TTS. Like with a regular business, they are able to deduct expenses that are ordinary and necessary to the activity. This can include margin expense, the home office deduction, software programs, newsletters, dues and subscriptions, the cost of equipment used, etc. These costs can add up very quickly and the savings can be substantial.

But because of that, the IRS has very strict requirements for who qualifies.[5] A taxpayer must meet all of these conditions:

- *"You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation;*
- *Your activity must be substantial; and*
- *You must carry on the activity with continuity and regularity."*

Most Taxpayers Will Not Qualify for TTS

That doesn't sound too difficult on the surface, but in practice the IRS definitions of "substantial", "continuous", and "regular" are fairly rigorous. Based on case law, in order to qualify as a trader the taxpayer must:

- Trade full-time – the same as you would with a real business. This means trading the majority of the day, every day that markets are open, with very few gaps/lapses in your activity
- Have an average holding period of 31 days or less (see *Endicott v. Commissioner*)
- Make at least 720 trades per year (see *Poppe v. Commissioner*)
- Have larger brokerage account sizes. It's hard to make a full-time living trading on a $100 brokerage account. In order to qualify as a "pattern day trader", you need a minimum balance of $25,000[6]
- Have operations show that you have significant investment – both in terms of equipment and education – to achieve enough profit for trading to be your primary income source

Obviously, for most of us we do not meet those criteria – for crypto or traditional securities. But if you are a crypto investor, the criteria for TTS is likely going to be the same as it is for other investments. In the unlikely event that you meet all of them, you should be able to treat your crypto income and expenses as a business - absent any future IRS guidance that indicates otherwise.

Chapter 9: Does Crypto Require FBAR or Form 8938 Reporting?

Currently, holding cryptocurrency does not require you file an FBAR filing on a FinCEN 114. Similarly, it also does not require a Form 8938.

But like most things crypto, this is likely to change. For both forms, the IRS has signaled that they are going to propose that the rules be amended to include cryptocurrencies.

What Are FBAR and Form 8938 Used For?

First, let's rewind a little bit to first understand these forms. Understanding the purpose of these forms and what they have traditionally been used for will help us to better understand how they could be applied to cryptocurrencies.

FBAR is short for "Report of Foreign Bank and Financial Accounts". It was first enacted in 1970 as a part of the BSA (Bank Secrecy Act). It requires taxpayers report foreign financial accounts that exceed $10,000 at any time during the calendar year.

Similarly, the Form 8938 is used as a "Statement of Specified Foreign Financial Assets". It has been required since 2011 for taxpayers with substantial overseas investments, although the exact threshold varies based on your marital status and country of residence.

In both cases, the intent is to combat against tax evasion and money laundering. By increasing the reporting requirements for individuals and also putting in significant monetary penalties for failure to comply, the IRS and US government hope to dissuade tax evasion – both people doing it willfully and those doing it out of ignorance.

But how does crypto fall into this? Is a wallet really a "bank" account under FBAR rules? And if it is, is it really "foreign"?

Currently, the answer is no. Taxpayers are not required to report cryptocurrency on either filing.

FBAR Filing Could Be Required in the Future

But again, this will change. The government has made its intent quite clear.

In 2020, FinCEN released FinCEN Notice 2020-2. This notice is extraordinarily short, but very straightforward. It reads, in its entirety:

*"**Currently, the Report of Foreign Bank and Financial Accounts (FBAR) regulations do not define a foreign account holding virtual currency as a type of reportable account.** (See 31 CFR 1010.350(c)). For that reason, at this time, a foreign account holding virtual currency is not reportable on the FBAR (unless it is a reportable account under 31 C.F.R. 1010.350 because it holds reportable assets besides virtual currency). However, **FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act (BSA) regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account** under 31 CFR 1010.350."*

Similarly, in an interview with *Tax Notes* in 2019, an IRS official noted that – while they could not provide a clear answer as to whether or not cryptocurrency holdings were required under Form 8938 – taxpayers may still wish to report them to avoid potential penalties.

Given how closely these two filings relate to each other, it is likely that if one gets amended the other will as well.

At some point in the future, we'll go over the different challenges amending these rules could pose to the IRS. It's a pretty interesting discussion and how they define things could have far reaching ramifications for how blockchain projects choose to structure themselves in the future.

But – for now at least – neither filing is required for crypto assets.

Chapter 10: Tax Write-Offs for Crypto Held on Insolvent and Bankrupt Exchanges

Crypto investors are likely to get tax write-offs from assets held on insolvent exchanges, but they are probably going to have to wait a while. Exchanges simply freezing withdrawals (or even *declaring* bankruptcy) is not enough. The assets must be deemed fully worthless and totally unrecoverable before you can take the deduction.

Exchange Failures Abound

Voyager and Celsius have both declared bankruptcy and other exchanges are likely to follow suit. Based on statements from both companies – along with the basic nature of bankruptcy filings – it is very unlikely that investors who held crypto on either exchange will receive all of their funds back. How much they will receive, if they receive anything at all, is still unclear.

Knowing that they are all but guaranteed to suffer some kind of loss from these exchange insolvencies, crypto investors are wondering if they can get a tax write-off for the assets held on these platforms.

The answer is that they likely will get write-offs, but not as quickly as they might hope.

There are two issues that arise within these situations:

1. The debt must be completely worthless and unrecoverable
2. The exact amount of loss has to be known

When an exchange "temporarily" pauses withdrawals (even if we know how that story is *likely* to end), that action on its own does not have the finality the IRS requires for you to be able to write off the bad debt.

Note: this is the second time we have used the term debt already in this chapter. That is not by mistake. While they present themselves *as custodians of your funds, some exchanges specifically note in their terms that the* funds you deposit are **loans** you are making to the platform*. And your most likely method of writing these losses off on your tax return will be as nonbusiness bad debt.*

Even Bankruptcy Filing Is Not Enough

But what about if an exchange files for bankruptcy? Surely that's enough of a nail in the coffin to be able to take the write-off, right?

Not quite. Most of these exchanges are filing for Chapter 11 bankruptcy, which means they are trying to reorganize and hope to continue operations. Those filings are a very bad sign for the company, as only 10-15% of Chapter 11 filings are ultimately successful, but they are still not **final**. The company could, in theory, recover and you receive some or all of your assets back.

There is also the fact that account holders are likely to receive *something* from these bankruptcies, but it is unclear how much or when they will receive it. In Voyager's bankruptcy filing they said that:

"Each Holder of an Allowed Account Holder Claim will receive in full and final satisfaction, compromise, settlement, release, and discharge of such Allowed Account Holder Claim, its Pro Rata share of:

- **(i)** *the Coin Allocation;*
- **(ii)** *the Claims Equity Allocation;*
- **(iii)** *the Voyager Token Allocation; and*
- **(iv)** *the 3AC Recovery Allocation"*

Three Arrows Capital (3AC) alone owes Voyager over $650 million. Voyager could recover some, all, or none of that loan. That outcome will make a significant difference in the level of recovery account holders will receive.

Unfortunately, this is likely to drag out for some time. So crypto investors aren't going to be able to take these write-offs nearly as quickly as they would probably like. They may have to wait a good while before they are actually able to take the deduction on their tax return.

How to Claim the Deduction on Your Tax Return

But what about whenever the bankruptcy filings are complete, or it otherwise becomes clear that the loss is final? How do you actually take the deduction?

Assuming there is an actual creditor-debtor relationship (which will be the case for the majority of these exchanges but would need to be examined on a case-by-case basis), then you would write the losses off as nonbusiness bad debts.[7]

Importantly, you are only able to write off your cost basis in the lost tokens, not their FMV when the exchange seized them.

As an example, let's say you bought one Bitcoin when it was $5,000. An exchange freezes withdrawals when BTC is worth $50,000. And when it is determined that the debt is completely worthless and nonrecoverable (which is when you are allowed to take the deduction), the price of BTC was $20,000.

Which amount do you write off? The $5,000, $20,000, or $50,000?

Unfortunately, you are only able to write off your $5,000 cost basis – not the 10x price when withdrawals were frozen or the 4x price when the debt became completely worthless.

The IRS instructs that you take this deduction *"as a short-term capital loss on Form 8949, Sales and Other Dispositions of Capital Assets, Part 1, line 1."* They also note that you will need to *"enter the name of the debtor and "bad debt statement attached" in column (a). Enter your basis in the bad debt in column (e) and enter zero in column (d)."*

Conclusion: Try to Avoid These Losses Entirely

Getting a tax deduction is not the same as getting your money back. Unlike tax credits (which reduce your tax on a dollar-for-dollar basis), you are only getting a percentage of what you lost with a tax *deduction*.

It sounds basic – and to a large extent it is – but the easiest way to preserve your capital is to avoid having your money on platforms that could go insolvent. With the market turbulence we're experiencing right now, the benefit of higher deposit rewards is just not worth the risk of losing your crypto entirely. Only interact with financially robust exchanges and try to keep as much as possible in cold storage.

Keeping your assets in a self-custody wallet has its own risks. If you fall for a phishing scam or someone gets access to your seed phrase, your crypto is lost. There is no support team to reach out to help you recover your funds. That crypto is completely gone. But you also don't have the risks of the platform going completely belly up and you're left holding the bag.

Good and bad, you're entirely on your own with self-storage, so make sure you're following security best practices and are keeping your assets safe.

Section 2: Staking & Farming

Chapter 11: How Is Staking Income Taxed?

In this chapter we are going to be speaking specifically for people who hold proof-of-stake (PoS) tokens as *delegators*, not those who are operating full-blown nodes as *validators*. We discuss validators in Chapter 23 – as there are some interesting factors affecting them specifically – but the majority of crypto investors will only ever function as delegators.

Staking Rewards Taxation

So you've purchased a PoS token, have it staked, and have started receiving staking rewards. There are now two questions that you need to answer:

1. Are these rewards taxable income?
2. And if so, when is it taxable?

We'll give you the short answers first and then we'll get into how and why this might change. Under current guidance (or lack thereof):

1. **Staking rewards are taxable income**
2. **The rewards are taxable income upon receipt**

But again, this is likely to change in the future.

Why?

First, **the IRS has not issued any staking specific guidance yet**. And because of this people are adopting a pretty wide array of stances.

Some are claiming it is not income at all because it does not meet the person's narrow definition of income. This is incorrect and is almost guaranteed to fail (along with massive penalties and potentially criminal sanctions from the IRS). It is income and will need to be claimed as such.

Certain Specifics to Be Determined

What is more up in the air is what *type* of income it is and *when* it should be claimed. Some taxpayers claim that staking rewards should not be taxable until they are sold or otherwise disposed of. There is an ongoing lawsuit in federal court claiming exactly that.

In the next chapter we'll discuss these issues more in depth and how they could affect the FUTURE taxability of staking rewards. But this chapter is more to serve as a notice to the **current tax treatment** of staking income.

And under that CURRENT guidance (scant though it may be), staking rewards are taxable upon receipt. This is highlighted by both Notice 2014-21 (regarding mining rewards) and Revenue Ruling 2019-24 (regarding airdrops and hard forks). Notice 2014-21 said that mining rewards needed to be included as gross income "as of the date of receipt". RR 2019-24 said that airdrops would need to be included as income when the taxpayer had "dominion and control" over the asset. There are some very limited instances where you do not have domain and control over staking rewards immediately, but in the vast majority of instances the IRS guidance is clear that the rewards needed to be claimed upon receipt.

Chapter 12: Jarrett v. U.S Lawsuit: The Future of Crypto Staking Income Taxability

In the last chapter, we discussed how staking rewards are **currently** taxed. We noted that under current IRS guidance we can discern that:

1. Staking rewards are taxable income
2. The rewards are taxable income upon receipt

But we also noted two specific reasons why this was likely to change in the future.

Precedent-Setting Staking Case

The first reason was that, like most other things in crypto, the IRS has not issued any guidance specific to staking. Our current understanding is based on principles from their guidance on hard forks, airdrops, and mining income. We're gleaning from those areas as best we can, but it's reasonable to assume that the explicit guidance the IRS issues (whenever that happens) will have some clarifications.

The second issue is the focus of this chapter.

On May 26, 2021, Joshua and Jessica Jarrett filed a lawsuit against the United States government.[8] The Jarretts staked Tezos and received staking rewards from it. They claimed the rewards as income when they filed their original return, but later filed an amendment requesting a refund. The IRS failed to respond, so the Jarretts filed suit.

The basis of their argument is an interesting one. The IRS effectively treats staking rewards as interest or dividend income – rewards for holding the asset or keeping it on deposit. The IRS has taken a similar stance on airdrops, so this reasoning is generally in line with their philosophy on other sorts of income.

The Jarretts' Argument on Staking Income

The Jarretts are arguing that staking rewards are something entirely different. **They are claiming that the staking rewards are the creation of a new asset and thereby should not be taxable until they are sold**. In a press release issued when they filed the lawsuit, the Jarretts stated that:

"Newly created property, whether it be a piece of art or a baked good, is not considered income under U.S. tax law until it is sold. Innovators and entrepreneurs who participate in blockchain staking are no different from artists and bakers, and if subject to different tax treatment may be forced to seek out other countries with a more fair tax code to operate in. Proof-of-stake blockchain technology is significantly less energy intensive than proof of work systems and has become widely adopted globally as the blockchain consensus technology of choice."

Whether or not this argument will be successful remains to be seen. If someone were going to sue over this issue, this is probably the best argument you could make. Staking *does* facilitate the **creation of new assets** on the blockchain, which is completely true. But in many ways, it does still feel more analogous to interest or dividends than it does actively working in the studio to create a new piece of art or in the kitchen baking a pie from scratch.

We're not sure if this argument will ultimately hold up in court, but the Jarretts' attorneys are doing an excellent job of framing the issue in favor of their clients.

The good news is that, **win or lose**, this lawsuit is going to be beneficial to crypto investors. At the moment, lack of clarity is one of the biggest issues facing blockchain investors. This litigation will force **specific answers** from the IRS. We'll be getting concrete guidance on exactly when and how our staking rewards are taxable, which will allow us to plan appropriately for our taxes.

Chapter 13: IRS Says Not All Crypto Is Property

On December 20, 2021 the IRS offered the Jarretts a full refund of their taxes paid. The cryptoverse exploded with people somehow thinking this meant that staking income was no longer taxable.

It doesn't. Not even close.

This was a **settlement offer** from the IRS. And settlements do not set precedent. Had the Jarretts accepted the offer – which they did not – it would have only meant they did not owe tax on their staking income for that particular year. That's it. As it stands now, the Jarretts rejected the offer and the case is continuing in federal court – with the IRS most recently filing a motion to dismiss on the grounds that the matter is settled since the Jarretts were offered the refund they requested.

What received decidedly less fanfare was the IRS's response to the Jarrett's complaint. This was filed on August 27, 2021, and only a few publications have even mentioned it.

There are two striking things in the IRS's responses. The first one is not surprising but the second one very much is:

1. The IRS denies that the staking of PoS tokens constitutes the creation of a new asset
2. The IRS denies that all cryptocurrency is considered property

Let's separate these so we can discuss them in more detail.

IRS: Staking Does Not Equal Creation

This stance is completely expected on the IRS's part, although looking at their specific responses gives us a little more insight into how they are likely to argue the case.

The IRS admits that Tezos tokens are a virtual currency (Paragraph 16), but denies anything that alleges that the Tezos staking is the creation of a new asset:

- In Paragraph 17, the IRS makes sure to note that Tezos uses a **delegated** proof-of-stake protocol
- In Paragraph 22, the IRS denies that Mr. Jarrett himself created the new Tezos tokens
- In Paragraph 24, the IRS even denies that the Tezos tokens were newly created

This paints a clear picture for how the IRS views (at least this form of) PoS staking: as a passive activity where tokens are being distributed as a reward for holding the asset. This is very similar to dividends being received for holding traditional securities. Paragraph 24 is especially interesting: the IRS even denies the notion that a new asset is being created at all – not simply that delegating is a passive activity.

Cryptocurrency Is Not Always an Asset

This was the real surprise in the IRS's response that should have been all over the news. In Notice 2014-21, the IRS stated that *"for federal tax purposes, virtual currency is treated as property."*

In Paragraph 30 of their complaint, the Jarretts essentially quoted this IRS guidance stating that *"virtual currency is property for purposes of U.S. federal tax law."*

While this was not an area that was expected to be under dispute, the IRS responded that *"the United States denies that virtual currency is in all instances property for the purpose of U.S. tax law."*

This is not the first time that the US government has indicated that cryptocurrency could be something other than property. The SEC's lawsuit against Ripple alleges that the company conducted a $1.3 billion unregistered securities offering. In that lawsuit, the SEC and Ripple's attorneys have gone back and forth over that categorization – especially given that then SEC director William Hinman stated in 2018 that Ethereum was not a security. But the fact remains that the US government is now trying to claim the opposite.

But the IRS contradicting itself – or at the very least opening the door to the fact that *some* cryptocurrencies may not be considered property – is huge. Importantly, in their response the IRS denies that *“virtual currency is in* ***<u>all</u>*** *instances property for the purpose of U.S. tax law.”*

This is something crypto investors are going to need to watch closely. These cases will not only help determine where crypto regulation eventually ends up, but also where the government is going to *try* to take them. Investors need to keep a close watch on these updates and plan accordingly with their CPA to have the most tax-efficient crypto portfolio possible.

Chapter 14: Is Crypto Interest Taxable?

Yes, interest earned on crypto is taxable income.

This is true regardless of where it is held. The most common scenarios we run into:

- Through short-term P2P (peer-to-peer) lending on a platform like KuCoin
- Given as deposit rewards on centralized exchanges such FTX, Coinbase, or Binance
- In vaults, pools, or farms offered on decentralized exchanges such as PancakeSwap

Strictly speaking, liquidity pools are not always paying “interest”, but in practice that is how the rewards are being treated for tax purposes. The rewards from those pools are taxable income. This is true if you are earning in-kind rewards (i.e., CAKE for CAKE) and also true even if you are receiving a different kind of token (i.e., BBQ for BANANAS).

And for anyone not in the crypto space: yes, we fully recognize how absurd that last sentence sounds.

When Is the Interest Taxable?

In all of these scenarios, the interest received is taxable income upon receipt.

The “upon receipt” can cause some confusion in a few unique scenarios.

What about if you use a vault with a lockup period? Apps like Altrucoin allow users to deposit partner altcoins to earn interest – with pretty generous rewards offered in exchange for longer lockup periods.

Let’s say you deposited a token into a Altrucoin vault September 15th and elected a 180-day lockup period. From Sept-Dec Year 1 it earns \$75 and then from January-March Year 2 it earns another \$50.

But you won’t be able to access any of those earnings until March of Year 2. Do you just defer the income until Year 2 and count all $125 at once?

Unfortunately, no. Similar to the taxation of multi-year CDs, the interest that has been accrued during that year is taxable – even if it has not been paid. So the $75 needs to be recognized in Year 1 and the remaining $50 in Year 2.

As always, we recommend using a crypto tracking software to help assist you with this. Manually keeping track of all of these moving parts is of course possible, but can be quite difficult without some assistance.

Chapter 15: How Are Liquidity Pools Taxed?

The IRS has not issued any guidance on the taxation of liquidity pools. That said, there are a few prevailing theories on whether or not the entry into and exit out of the LP are taxable events, which we will discuss in this chapter. The earnings within the pool itself are taxable income.

No IRS Guidance on Liquidity Pools (LPs)

When writing this book, we kept focusing on other chapters instead of this one for a while. Not because there is not an answer to how LPs are taxed, but because that answer is more muddled than the topics we've already written about.

Lack of IRS guidance in crypto is nothing new: the IRS has not issued guidance on staking (Chapters 11-13), nodes (Section 4), or NFTs (Section 5) either. But with all of those other topics, there was something analogous within established case law that we could reference against.

That's still true with liquidity pools, but we're straying further from those precedents. There isn't an obvious non-crypto equivalent to LPs. They function in a way that is much more specific to crypto.

How Liquidity Pools Work

We aren't going to get into an in-depth discussion of the technical aspects of how LPs function. This has already been covered in-depth in existing articles and training programs/communities. In this chapter, we're going to be focusing almost exclusively on how LPs are taxed.

And for the purpose of this discussion on taxation, the **extreme** TL;DR of LP mechanics that you need to understand is that:

- You are depositing crypto assets into a pool and are receiving a share of that pool's earnings in return. In some protocols, you are actually receiving "LP tokens" in return for your contribution. As an example, if you contributed even amounts of ETH and BTC into a liquidity pool you could be rewarded with ETH/BTC LP tokens. In other protocols, LP tokens are not issued but the general process works the same way

- This liquidity (yours and others who contribute to the pool) allows the Automated Market Maker to execute autonomous trades
- The pools are designed to be evenly split between two crypto tokens and are constantly recalibrating to maintain that ratio. This price fluctuation between the value of the two assets can lead to something call “impermanent loss” or “divergent loss”
- As a reward for depositing your crypto into the LP (and taking on the risk of impermanent loss), the protocol will give liquidity providers a percentage of the trading fees the LP charges

Certain components of LP taxation are straightforward. The trading fees you receive are of course taxable income. But the mechanics of how LPs work pose some much more difficult questions. Namely: what happens when you enter or exit an LP? Are those taxable events?

Is Lending Money Into the Liquidity Pool Taxable?

At face value, the answer to this seems very obvious. When is lending money ever a taxable event? Or framed another way: when is purchasing a non-depreciating asset a taxable event?

In most cases, the answer is “never”. Lending money (or borrowing money for that matter) is not a taxable event in most cases. The only taxable income from that transaction is when you receive interest payments.

So why would LPs be any different? All you’re doing is lending funds into the protocol…right?

Sort of.

Again, the mechanics of LPs become important here. Because when you’re contributing to an LP, you are giving up your regular crypto and are receiving an equal value of LP tokens. For most of our examples in this chapter, we're just going to say you're contributing ETH.

Put another way: it is at least reasonable to argue that you are trading your existing ETH for a different cryptocurrency. And as we know, coin for coin trades **are** taxable.

There are two different stances that you can take on the contribution to an LP:

- **Conservative: you disposed of ETH and purchased a new token. Like all other coin for coin trades, this is taxable**
- **Aggressive: you are simply lending ETH into the protocol as collateral. You have no intention of selling any LP tokens received. And like any other lending activity, this is not taxable**

Note: in this chapter we talk about the receipt of LP tokens when entering the pool. But for protocols where LP tokens are not actually received, the taxation is the same. Your entry/exit from the pool can be treated as buying/selling access to it (taxable) or that you are lending funds/recalling a loan from it (not taxable). The issuance of actual LP tokens is not required.

Again, neither one of these stances is inherently right or wrong. And the IRS has issued no guidance. The right approach will largely depend on the particulars of the protocol you are depositing into as well as your personal risk tolerance.

Is Wrapping a Token Taxable?

Certain protocols require that your tokens be "wrapped" before you can deposit them into an LP. A good example of this is Bitcoin. BTC operates on its own blockchain, so if you're wanting to deposit onto a different protocol like Ethereum, in some cases you'd first need to wrap your BTC into wBTC.

Wrapped tokens stay the same price as their non-wrapped counterparts. But they operate on a different network.

So is this taxable?

Again, there are two basic stances you can take here:

- **Conservative: BTC is a separate and distinct asset from the wBTC with different utility. This should be treated as a regular, taxable coin for coin trade**
- **Aggressive: your wBTC is simply a placeholder for your existing BTC. Wrapping simply adds additional functionality to your existing asset. You can even look at this as just transferring the funds from one bank account to another. You're moving it from your BTC wallet to your ETH wallet, which requires it be wrapped. But this is not a disposition of your BTC and therefore is not taxable**

Once again, until we get some new legislation from Congress or guidance from the IRS, there are no innately right or wrong answers here. It will depend on your risk tolerance and the specifics of the LP itself.

Earning Interest and Governance Tokens

As a reward for providing liquidity, you'll be receiving interest and possibly even governance tokens. Both of these are taxable events and need to be counted as income upon receipt.

Is Exiting a Liquidity Pool Taxable?

Whether or not your exit from an LP constitutes a taxable event will largely depend on which position you took on entry.

Did you treat your receipt of LP tokens as a taxable trade or simply as a swap/depositing collateral?

If you treated it as a trade on entry, it only makes sense to treat your exit the same way. You need to show it as a sale of LP tokens for ETH. In fact, in some cases you'd almost need to from a tax-efficiency standpoint. If you had a capital gain on entry into the LP, there was significant divergent loss, etc. – having a taxable event on your exit from the pool might actually be saving you money.

But if you treated your entry as a loan – and you were counting the receipt of interest/governance tokens as taxable income in real time

– then exiting the pool does not generate any taxable event.

Conclusion: Plan With Your CPA and Stay Tuned for IRS Clarification

There are no easy answers when it comes to liquidity pool taxation. Congress has not introduced any legislation and the IRS has not issued any guidance. And unlike other areas of crypto, there is not a clear parallel to some existing area of business or finance.

Take a careful look at the specifics of the project you are depositing liquidity into to determine which approach is the most appropriate for you. Also make sure you're planning appropriately throughout the year with your CPA – and that you are working with a CPA who is keeping up with these legislative changes.

Chapter 16: Are Airdrops Taxable?

Yes, airdrops are taxable income.

Actual IRS Guidance on Airdrops

Somewhat surprisingly, the IRS has issued specific guidance with respect to airdrops. As we've noted previously, guidance is lacking on the majority of crypto topics. Staking, as ubiquitous as it now is, has still not received any mention. No NFT-specific guidance has been issued yet. And the IRS has been silent on crypto lending.

If we were to venture a guess as to why they've addressed airdrops specifically, it would be because both Bitcoin and Ethereum both have had hard forks – **with resulting airdrops**. Those tokens are of course the two largest cryptocurrencies and the first hard fork goes all the way back to 2014. Even with that, it took the IRS until **2019** to issue any guidance.

But at least they have for this topic.

So, what does that guidance say?

In Revenue Ruling 2019-24, the IRS noted the following:

- *"Cryptocurrency from an airdrop generally is received on the date and at the time it is recorded on the distributed ledger."*
- *"A taxpayer has gross income, ordinary in character, under § 61 as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency."*
- *Section 451 of the Code provides that a taxpayer using the cash method of accounting includes an amount in gross income in the taxable year it is actually or constructively received. See §§ 1.451-1 and 1.451-2. A taxpayer using an accrual method of accounting generally includes an amount in gross income no later than the taxable year in which all the events have occurred which fix the right to receive such amount."*

For the vast majority of airdrops, that is how they would be taxed: upon receipt.

Some Airdrops Are Not Immediately Taxable

But there are a few exceptions to this rule. While you generally have “domain and control” over the tokens on the date they are received, this is not always the case. The current structure of Gala Games nodes is an excellent example of this. RR 2019-24 gives expanded examples of how this could happen, but the basic crux is captured in this paragraph:

“A taxpayer may constructively receive cryptocurrency prior to the airdrop being recorded on the distributed ledger. A taxpayer does not have receipt of cryptocurrency when the airdrop is recorded on the distributed ledger if the taxpayer is not able to exercise dominion and control over the cryptocurrency. For example, a taxpayer does not have dominion and control if the address to which the cryptocurrency is airdropped is contained in a wallet managed through a cryptocurrency exchange and the cryptocurrency exchange does not support the newly-created cryptocurrency such that the airdropped cryptocurrency is not immediately credited to the taxpayer’s account at the cryptocurrency exchange.”

If that example describes your airdrop – the exchange or other factors are prohibiting your ability to actually exercise control over the token – then you would not claim it as taxable income upon receipt.

However, this is not an indefinite deferral. The next sentence states that:

“If the taxpayer later acquires the ability to transfer, sell, exchange, or otherwise dispose of the cryptocurrency, the taxpayer is treated as receiving the cryptocurrency at that time.”

While deferring the tax hit from the airdrop is largely positive, it is not without its downsides. Your holding period does not begin until you gain domain and control over the asset. This can have major repercussions when you ultimately sell your tokens, as we noted in Chapter 2.

Chapter 17: Are Hard Forks Taxable Income?

Tokens received from hard forks are taxable income <u>if a new token is received as a result of the hard fork</u>.

Hard Fork Taxation

We largely covered this topic in the last chapter on the taxability of airdrops. But for anyone searching specifically for hard forks, we wanted to make sure this information was easily accessible.

Hard forks of Bitcoin and Ethereum go back to 2014. At that time, BTC alone represented over 90% of the entire crypto market. This necessitated a response from the IRS, although it did take them nearly five years to issue one.

In 2019, the IRS released Rev. Rul. 2019-24. They noted the principles that we outlined in our airdrops chapter as well as our Gala Games node taxation guide in Chapter 24. Most notably that:

*“Cryptocurrency from an airdrop generally is **received on the date and at the time it is recorded on the distributed ledger.**”*

*“Section 61(a)(3) provides that, except as otherwise provided by law, gross income means all income from whatever source derived, including gains from dealings in property. Under § 61, **all gains or undeniable accessions to wealth, clearly realized, over which a taxpayer has complete dominion, are included in gross income.**”*

In the event that a hard fork results in the creation **<u>and receipt of</u>** a new token, that hard fork generates taxable income. RR 2019-24 illustrates this with an example:

“<u>Situation 1</u>: A holds 50 units of Crypto M, a cryptocurrency. On Date 1, the distributed ledger for Crypto M experiences a hard fork, resulting in the creation of Crypto N. Crypto N is not airdropped or otherwise transferred to an account owned or controlled by A.

<u>Situation 1</u>: A did not receive units of the new cryptocurrency, Crypto N, from the hard fork; therefore, A does not have an accession to

wealth and does not have gross income under § 61 as a result of the hard fork.”

Fewer and Fewer Taxable Events From Hard Forks

We don’t see many hard forks – or at least not “contentious hard forks” that come from internal disputes. They can be disruptive to the token, which of course most projects try to avoid. That’s one of the reasons we wrote about airdrops first. Airdrops occur very frequently and happen independent of hard forks (even though airdrops from hard forks are the reason airdrop-specific guidance exists).

But in the event that a hard fork does occur, and a new cryptocurrency is created because of it, you’ll need to claim it as taxable income.

Chapter 18: What Are Wrapped Crypto Tokens and How Do They Save You on Taxes?

High interest DAOs are horribly tax inefficient. Wrapping the token helps correct this, although it is unclear if this method will hold up to IRS scrutiny in the future.

High Yields, High Tax Bills

Olympus DAO (OHM) and other high-yield DAOs were all the rage in 2021. These projects advertised absolutely insane APYs and people flocked to them because of it. OHM was paying 10,000% interest, KlimaDAO 35,000%, and Wonderland (TIME) was paying 80,000%. And those were some of the more mainstream and “reasonable” APYs. Smaller OHM forks would sometimes have APYs in the **billions**.

It doesn’t take a genius to see that those yields are unsustainable. Most of those projects had their token price collapse or had the project fail completely. TIME peaked at nearly $10,000 and now sits at $50 while KLIMA dropped from $4,000 to $5. Because of this, most projects end up having to reduce their yield. OHM and Klima are both about 400% right now, which is a far cry from their 2021 levels but is still super inflationary.

So the projects themselves have clear issues, which is one of the reasons why they are much less in vogue now compared to 2021.

How Is DAO Income Normally Taxed?

But what rarely gets discussed is how **incredibly tax inefficient they are**. The staking income is taxable in real-time as it is received. And it is taxed as ordinary income, not capital gains.

And when you couple this with the fact that the token is likely to decrease in value, you’re in for a really nasty surprise come tax season.

As an example, let’s say that you staked $100,000 into TIME. You earn 80,000% APY on that token, with payouts occurring every 8 hours. That is all taxable income to you.

If the token price remained stable, that would be fine. Sure, it's a lot of tax, but you'd be earning $80 million on your $100k investment.

But we know that the tokens do not maintain their value. Because of the inflationary nature of those yields, the token price inevitably goes down.

In this example, let's say that you earned $90k worth of staking income but the value of your tokens also went down $90k (from $100k to $10k). And at that point you decide to cash out. You've still just got your original $10k investment. The whole thing was a wash.

There's no tax on that, right?

Wrong. Unfortunately, it's actually **<u>very</u>** wrong. You have $90k worth of staking income and a $90k capital loss. But those two fall into separate buckets and **<u>only $3,000 of the capital loss can be used to offset against the staking income</u>**.

So you made nothing on this transaction, but are still going to end up with $87k worth of phantom income on your tax return. (The only way around this would be if you had $87k worth of capital gains from other activities that could then be offset by your capital loss from the TIME sale).

And if you didn't sell your TIME before the year ended, then you just have $90k of phantom income with no capital loss to even partially offset against it.

As noted at the outset, these things are an absolute nightmare from a tax perspective.

How Are Wrapped DAO Tokens Taxed?

To get around this, many projects offer the option of "wrapping" your tokens. How does this work?

For regular "unwrapped" tokens, rewards are distributed at each rebase period. So multiple times a day, additional tokens are being deposited into your wallet and are taxable upon receipt. This is the scenario we outlined above.

With wrapped tokens, it operates a little differently. You convert your regular tokens into their wrapped counterparts. At each rebase period, **you no longer receive any additional tokens**. Instead, the **value** of your wrapped tokens goes up each period. In their FAQs, Wonderland explains it that:

"wMEMO is a wrapped version of MEMO. Users can wrap their MEMO into wMEMO, and receive their rebase as an increase in the value of wMEMO rather than an increase in the amount of MEMO."

There are huge tax advantages to structuring it this way. Not only does it defer the taxable events until you finally unwrap or sell your tokens, but it may also allow you to receive long-term capital gains treatment instead of being taxed as ordinary income.

Warning/Caution

It should be noted that this structure has not been tested in court. The IRS has not issued any guidance on this type of structure. They could challenge it in the future, perhaps claiming that *in substance* the rewards are still being distributed and need to be taxed upon receipt – essentially that the wrapping is a thin disguise just for tax avoidance and serves no other purpose. This method is unproven.

But there's no particularly clear downside to wrapping. Worst case, you end up with the same tax treatment you would have if you did not wrap them. And if this structure is not challenged, the tax savings are significant.

So if you are going to invest in one of these projects, in most instances wrapping will absolutely be the way to go.

Chapter 19: Are Wrapping and Unwrapping Crypto Tokens Taxable Events?

Wrapping Bitcoin and other tokens allows them to be used on different networks. Is the act of wrapping and unwrapping these tokens taxable? Some experts say yes and some say no. We'll discuss both theories in more detail in this chapter.

What Are Wrapped Tokens?

We've already talked about wrapped tokens in the last chapter, but that was specific to OHM forks and other high-yield DAOs. In that context, wrapping the tokens attempts to defer your tax bill on the staking rewards earned until you unwrap or sell your token.

Wrapping tokens in that context is incredibly important, but it's also very specific to that variety of project – both the mechanism of how you do it and the reason for doing it in the first place.

There are a lot of other wrapped tokens out there that do not earn any interest at all. So why do people wrap them?

Crypto projects run on different networks. Ethereum, Solana, Cardano – they all run on their own networks. This is by design. But one of the current shortfalls is if you have assets on one chain and want to use them another protocol, there isn't mechanism for that. For instance, you can't use Bitcoin on Ethereum's network.

That's where wrapping comes into play. Wrapped tokens are tokens which are pegged to the value of another cryptocurrency but exist on a different blockchain.

Using the same example of Bitcoin and Ethereum, you can't spend your BTC to buy something on the Ethereum network. But what you *can* do is wrap your BTC into wBTC ("Wrapped Bitcoin"). WBTC is an ERC-20 token and exists on the Ethereum network. *(Note: this is a very brief explanation since we're focusing on the tax aspect in this chapter, but there are numerous guides online if you want to take a deeper dive into wrapped tokens).*

Do I Pay Capital Gains When I Wrap and Unwrap My Tokens?

Wrapping tokens can add tremendous amount of utility, as is showcased by their popularity. For instance, wBTC on its own is currently the 16th largest token in the world by market cap.

But how do they affect your taxes? Because wrapped tokens are not the same as their unwrapped counterparts. They are simply **pegged** to them. So if you swap BTC for wBTC or ETH for wETH, does that generate a taxable event?

As is the case with most things crypto, **the IRS has not issued any specific guidance on wrapped tokens**, so this will likely change as we get clarification in the future.

For now, there are two options available on how to treat these transactions on your tax return. We briefly discussed them in our chapter on liquidity pool taxation:

"There are two basic stances you can take here:

- *Conservative: BTC is a separate and distinct asset from the wBTC with different utility. This should be treated as a regular, taxable coin for coin trade*
- *Aggressive: your wBTC is simply a placeholder for your existing BTC. Wrapping simply adds additional functionality to your existing asset. You can even look at this as just transferring the funds from one bank account to another. You're moving it from your BTC wallet to your ETH wallet, which requires it be wrapped. But this is not a disposition of your BTC and therefore is not taxable."*

The particulars of the tokens could also come into play. The utility of wBTC is very different than the utility of wETH, for instance. You're wrapping them for different reasons and are likely using the tokens in dissimilar ways. It is possible that the IRS will look at tokens on a case-by-case basis in determining whether it is appropriate to treat wrapping as a **transfer** or as a **sale**.

Work with a CPA Who Loves Crypto

These nuances are part of the reason why working with CPAs, attorneys, and the like who truly understand crypto is so important.

Without a more tactile feel and first-hand experience, these subtleties are easily missed.

As always, make sure that you are planning throughout the year and stay tuned for updates. Just like crypto itself, the rules and strategies around crypto taxes change quickly.

Section 3: Crypto Cards

Chapter 20: Is Paying With a Crypto Debit Card or Crypto Credit Card Taxable?

Paying for something with a crypto *debit* card generates a taxable event – either a capital gain or a capital loss – no matter how small the transaction is. Crypto *credit* card transactions – at least as they exist now – do not need to be reported, although that may change in the future.

The IRS (at least for now) considers cryptocurrency to be an asset. So if you trade it for another coin or purchase goods/services with it, that creates a taxable event.

Most People Do Not Use Crypto for Ordinary Transactions

Good or bad, most of us do not pay for a huge volume of transactions with crypto.

For all of the amazing things blockchain can do, historically crypto*currency* has not functioned particularly well as an actual currency. The price fluctuations were too volatile and transactions took too long to process. With the introduction of stablecoins and newer blockchains, both issues are getting better all of the time. Still, most of us are not making the majority of our purchases with crypto.

A Potential Solution: Crypto Cards

But these crypto cards could change that very quickly.

You're just swiping the same way you would with a regular Visa or Mastercard. It just so happens that the transaction is being funded by your crypto instead of USD.

As an aside: so far all of these have been through centralized exchanges like Crypto.com or Gemini, but other projects like the Switch Reward Card are coming out with truly defi solutions. Switch is entirely run by a node network, which is pretty cool and also necessary for true decentralization.

Crypto Debit Cards

Debit cards are really straightforward on this. You are disposing of crypto in exchange for something else. So ***every single transaction***

– no matter how small – generates an event that you have to account for and report to the IRS.

That creates an absolute logistical nightmare in addition to possibly creating a surprise tax bill at the end of the year. You'd need to keep up with your cost basis and holding period for every time you swipe your card for $5 at a Starbucks.

There is some proposed legislation to help address this. In early 2022, the Virtual Currency Tax Fairness Act was introduced, which would exempt personal transactions $200 or under from these reporting requirements.

This would be immensely helpful, although it seems like there will need to be some provisions to ensure it is not abused. It's easy to envision people selling $1 million worth of low-cost basis Bitcoin in 5,000 individual transactions in an attempt to avoid the capital gains.

In the meantime, the best way to avoid the tracking nightmare would be to fund your debit card with a stablecoin or fiat. If you fund it with a stablecoin, you will still need to report the "sale" of your crypto on your tax return, but assuming there were no fees when you purchased the stablecoin, the transaction will be a net zero. And since there is no gain or loss, in practice your holding period also does not really matter. That is ***much*** easier than the alternative.

Crypto Credit Cards

Credit cards function differently – at least for now. As of writing, there are only a few crypto credit cards on the market, and they are all fairly new. As more launch, it is plausible that there will be more variations in how each project functions.

With credit cards, you aren't immediately disposing of an asset/drafting the funds from your account the way you are with a debit card. Instead, you're creating a ***liability***. If these crypto credit cards function the same way that normal credit cards do, then swiping the card would not create a taxable event.

As an example, let's say you use your crypto credit card for shopping and at the end of the month pay off the balance with a fiat currency from your bank account – the same as you would with a regular credit card.

Well, you aren't really disposing of crypto at any point in that transaction, are you? In fact, crypto is not involved in the core transaction at all. The only time it even comes into play is that you are receiving crypto as a reward instead of cashback or points, which in and of itself is not taxable.

On the other hand, it's feasible that some cards will function more like debit cards where each transaction is more closely tied to the crypto in your account, in which case each transaction might be reportable.

As always, crypto is a rapidly evolving area with very little concrete guidance from the IRS. This topic is no exception. The IRS has not specifically addressed crypto cards and as we've mentioned above there is currently legislation in place to address some of these issues. Make sure you are planning with your CPA throughout the year to ensure you are staying up to date with any changes.

Chapter 21: Are Crypto Credit and Debit Card Rewards Taxable?

In general, rewards received from crypto credit and debit cards are <u>not</u> taxable. They are considered a reduction in purchase price, not income. However, promotional amounts that are not tied to an actual purchase (such as some sign-up bonuses), are typically considered taxable income. When those crypto rewards are ultimately disposed of, this will also trigger a capital gain or loss.

Crypto Card Rewards Aren't Usually Income

The vast majority of crypto transactions generate some kind of taxable event. Mining, staking, coin for coin trades – basically any activity seems to generate a transaction that you have to report to the IRS. As we noted in the last chapter, even just paying for something with your crypto debit card creates a capital gain or loss.

Because of this, many people are surprised to find out that the rewards received from crypto cards are not taxable. Why is that – especially since seemingly similar "free" crypto from airdrops and hard forks are both taxable?

It is treated this way because the IRS does not even consider these credit and debit card rewards income at all.

How?

The IRS classifies these rewards as rebates and **<u>reductions in the original purchase price</u>**, not income received.

In a somewhat related Private Letter Ruling (PLR-141607-09), the IRS noted that:

*"Section 61 provides that gross income means all income from whatever source derived. A rebate received by a buyer from the party to whom the buyer directly or indirectly paid the purchase price for an item is **an adjustment in purchase price, not an accession to wealth, and is not includible in the buyer's gross income**. See*

Rev. Rul. 76-96, 1976-1 C.B. 23, as modified by Rev. Rul. 2005-28, 2005-1 C.B. 997."

But There Are Taxable Events Associated With Crypto Card Rewards

The exception to this would be rewards received that are not tied to a purchase at all. If you are given crypto just for opening an account and are not required to spend any money to receive it, it is likely that those rewards will be taxable income. In those cases, it is much more analogous to receiving an interest bonus for opening and *funding* a new bank account – not actually *spending* the money on a purchase. In those cases, the income is taxable and the bank is required to issue you a 1099-INT or 1099-MISC.

As always, it is worth noting that the IRS has not issued any guidance on crypto rewards cards specifically. But absent that, we use the existing precedent from regular credit cards and rebate programs.

One area where these crypto rewards **will** differ is when you actually use them. When you redeem your cashback or points, that doesn't trigger a taxable event. You're just buying something with cash or a cash equivalent. But if you use your crypto rewards to purchase something, that is the disposition of an asset.

This will create a capital **gain** in the vast majority of cases since your cost basis on the rewards is zero. You had no cost to acquire it and the IRS never considered it taxable income. Because the sale will be almost entirely profit, monitoring your holding period is important so that you can hopefully qualify for long-term capital gains.

If you fall into one of the rare cases where a promotional reward was classified as taxable income, then your cost basis will be whatever amount of income you were assessed (i.e., if you received a $200 taxable promo, when you sell the crypto your cost basis will be that same $200). The cryptocurrency could have gone down in value from the time received to when you sell it. In that case, you will have a capital loss when you sell the crypto, although those cases will be few and far between because most of the rewards will not be taxable to begin with.

Section 4: Mining & Nodes

Chapter 22: How Are Crypto Mining Profits Taxed?

Not all crypto is taxed the same way. Each category of cryptocurrency income has its own rules that must be followed. These different types of blockchain income are all taxed differently.

And crypto mining is probably one of the “most different” of the bunch.

Mining Compared to Other Crypto Income

Most other types of cryptocurrency profits are (effectively at least) treated as investment income: crypto trading, staking income, loan interest on deposits, etc.

And like regular investments, some of the expenses you are allowed to use to offset against your investment income can be limited.

With mining, you are allowed to deduct a wider array of expenses than with the other categories of crypto income. But this doesn’t always mean you’ll be paying less in taxes.

Why?

Because crypto mining is considered **business income**. While this allows for a broader range of expenses to offset against revenues, there are two major downsides:

1. **Any profits are subject to self-employment tax**[9]
2. **The profits are taxed as ordinary income**

Self-employment tax (the employer and employee halves of Social Security and Medicare) is 15.3%. That’s the surcharge you’ll pay on **every** dollar of profits.

In addition, business income is considered ordinary income. This means that it is taxed at your regular income tax rates and is not eligible for long-term capital gains or qualified dividends treatment the way some other investments would be.

More Flexibility With Mining Income

These factors (and their associated costs) make it all the more important to ensure you are planning properly throughout the year. And that planning includes **making sure you are not missing out on any potential expenses**.

Just as with a regular business, there are strategies on capturing and allocating your expenses that can significantly reduce your profits and thereby reduce your tax hit. In some instances, it may be advantageous to set up an entity to run your mining operations through and make a corporate election on it.

All of this is dependent on your unique circumstances, so make sure you are planning throughout the year with a “crypto-literate” CPA.

Your mining income can be effectively tax free. Or it can be the most expensive income you earn all year. It largely comes down to planning.

Chapter 23: How Is Node Operator and Node Validator Income Taxed?

Node operators will most often be taxed the same way as crypto miners. But there are situations where their rewards could be taxed as regular staking income.

Node Income ≠ Staking Income

In Section 2, we discussed how staking rewards are taxed – both currently and how they may be taxed in the future.

But both of those discussions focused on rewards you receive as a *delegator*. What about if you are a node *operator* (also referred to as node *validators*)? Are those rewards taxed the same way? (As always, we'll preface this by saying that the IRS has not issued any staking-specific guidance yet. These are simply our best guesses based on other rulings).

At first blush, one might think that rewards received as a node operator or staking validator would be taxed the same as rewards received as a delegator, **but we're not so sure that's the case**. Staking delegator rewards are very similar to airdrops. They:

1. Are passive activities with minimal (if any) work required aside from owning the token
2. Are rewards distributed for holding a token
3. Require little to no investment outside of the token itself

However, that's generally not the case for node validators/node operators:

1. Setting up the node can be time consuming and require ongoing maintenance
2. The rewards received are for the operation of the node and support of the blockchain
3. There can be substantial investment in terms of equipment, server space, internet service, and other costs

associated with running the node

Those circumstances make node operation much more analogous to crypto mining, which is taxed as business income.

Fake Nodes May Be the Exception

As a quick aside: crypto is an ever-changing market, so in the future the usage of the term node may change. That's one of the reasons we're hedging during this discussion. It's possible that in the near or distant future there will be "nodes" sold that are so passive that they barely meet the current definition and the parameters that we outlined above.

For instance, let's say a project sells you a "node" and every day you are rewarded with a set number of tokens. But receiving those rewards does not require a computer or VPS, any ongoing maintenance, and in fact does not even require your node be online at all. You will receive your tokens regardless.

Well, that's not really a node, is it? That's an NFT or software license of some kind masquerading as one. In that case, your "node" income would be much closer to income received as a staking delegator and likely should be taxed as such.

How Are Nodes Taxed?

But back to **REAL** nodes: they are much more similar to crypto mining. And as we covered in the last chapter on crypto mining, mining income is taxed as business income. That treatment has some advantages and disadvantages.

The disadvantages:

1. By default, any profits are subject to self-employment tax of 15.3% (or 2.9% if you're already maxed out on your Social Security contributions for the year)
2. Those profits are taxed as ordinary income. This is also true of staking rewards and the majority of other crypto income, but pure crypto trading may be eligible for long-term capital gains treatment for trades extending beyond a one-year holding period

The advantages:

1. The profits **may** qualify for the 20% Qualified Business Income Deduction (QBI)
    1. QBI is a complex calculation with phaseouts based on a number of different factors. Total personal income, total business income, wages paid from the company, type of entity, depreciable assets held by the company, the nature of the business activity, and a number of other factors all come into play. Maximizing this deduction will require careful planning with your CPA throughout the year, especially if you are a high earner
2. You may elect to have the income taxed through an S-Corp or C-Corp
3. You are allowed to deduct a much wider array of expenses than you are with regular investment income

Again: **this is all subject to change**. None of this is based on concrete IRS guidance, simply our analyzing the situation and applying tax and accounting principles from other, similar situations.

That said, the tax strategies for node income are more complicated than for other types of crypto income – the same way that actually operating the node is more complicated. You have a lot more flexibility with how you can structure and mitigate that income, but you also have a lot more exposure. Make sure you are planning carefully with your CPA throughout the year to minimize your tax hit.

Chapter 24: How are Gala Node Earnings Taxed?

This is the only chapter in this book that discusses a specific crypto project. While Gala Games is close to my heart (it was the first project that made me "get" crypto), that is not why it is included. We're including it because it is one of the best examples of some niche tax situations can affect crypto projects, along with a great illustration of the concepts of "dominion and control".

If you've recently purchased a Gala Games node, you may be wondering how these earnings will be taxed. And if you aren't, you should be. Not fully understanding how crypto is taxed – especially given the volatility in the market and corresponding potential for big gains and big losses – can cost you **<u>a lot</u>** of money in taxes.

Current Gala Node Taxation

We'll provide some background below, but the short answer is that under current IRS guidance:

1. **<u>Gala node earnings would not be taxable until they are minted</u>**
2. Your holding period for capital gains purposes does not begin until the tokens are minted
3. Your taxable income upon minting the tokens becomes your starting cost basis for when the tokens are sold

For clarification, the term "minting" means transferring your tokens from your treasure chest to your inventory. This adds them to the actual blockchain.

This being the current guidance cannot be emphasized enough. Congress recently passed legislation that forces additional reporting from blockchain companies to the IRS, SEC Chair Gary Gensler is frequently criticizing cryptocurrencies and asking for more authority to control them, and there is frustratingly little guidance in many areas of the market. A map the Library of Congress published last year shows just how limited the current rules are. The majority of countries have very limited guidance on crypto, if they have any guidance at all. And if guidance exists, it is usually only for one or two areas (i.e., they have guidance on mining income but not staking).

All of this is to say that as the US government continues to grapple with these issues and issues new rules and regulations, this guidance may change.

IRS Factors to Consider

Under that current guidance, the tokens actually being minted appears to be the controlling factor. This has to do with a concept known as "domain and control", which we discussed in Chapter 16. That means the full and actual possession of the asset and ability to use it.

As it relates to crypto, that would be when you mint it. With gas fees as high as they are, it's not unreasonable to argue that those costs are prohibitive to you being able to gain domain and control over your unminted tokens. It's the reason many node owners are not minting their tokens and are instead accruing them in their treasure chests.

In Rev. Rul. 2019-24, the IRS was asked if taxpayers needed to claim income from hard forks and airdrops. It noted:

*"**A taxpayer does not have receipt of cryptocurrency when the airdrop is recorded on the distributed ledger if the taxpayer is not able to exercise dominion and control over the cryptocurrency**. For example, a taxpayer does not have dominion and control if the address to which the cryptocurrency is airdropped is contained in a wallet managed through a cryptocurrency exchange and the cryptocurrency exchange does not support the newly-created cryptocurrency such that the airdropped cryptocurrency is not immediately credited to the taxpayer's account at the cryptocurrency exchange. **If the taxpayer later acquires the ability to transfer, sell, exchange, or otherwise dispose of the cryptocurrency, the taxpayer is treated as receiving the cryptocurrency at that time.**"*

Note: this will change when Gala Chain is released. Currently, Gala lives on their Ethereum network and because of gas fees, you do not receive your Gala tokens as an ERC-20 token. You almost receive a voucher that you can then redeem for actual Gala tokens on the blockchain. That will change when Gala Chain is fully functional. Whenever that happens, you will have "dominion and control" when the tokens are received.

Tax Planning Is Still Required

That's great because it defers the taxable income until you actually mint the tokens. But it's not without its downsides.

The taxable income you report is the FMV (Fair Market Value) of the tokens you are minting – basically the market price of the tokens multiplied by the number of tokens being minted. The higher the token's value, the higher the amount of taxable income. Importantly, **this also becomes your cost basis**.

Let's run through a few examples. "John" and "Steve" both have 100,000 Gala tokens. John mints his when the token was worth 1 cent while Steve waits until it's worth 10 cents. They both sell when the token is 12 cents.

Upon minting the coins, John is hit with $1,000 of taxable income ($0.01 x 100k) and Steve is hit with $10,000 ($0.1 x 100k).

That's a **big** difference in the initial tax hit. But it is partially offset once the tokens are sold because of the differences in cost basis.

When John sells his Gala, he is going to have capital gains income of $11,000 ($12,000 sale price minus his cost basis of $1,000). When Steve sells his Gala, his capital gains are $2,000 ($12,000 minus $10,000 cost basis).

Ultimately both end up with $12,000 in taxable income, it's just a difference of timing and what type of income the earnings are classified as.

That's not to say that the type of income does not matter. Assets that are held for more than one year before being sold are taxed as long-term capital gains, which receive a much lower tax rate than ordinary income.

And that holding period does not begin until you acquire possession and control of the asset – which again means when you mint it. So even if you are planning to buy and hold, there are times where it may make sense to mint the tokens to get the clock ticking on your holding period.

As with anything tax related, these things are complicated and can vary greatly based on your individual situation. Plan for this carefully with your CPA throughout the year, otherwise you may end up with a nasty surprise come tax time.

Section 5: NFTs & P2E Gaming

Chapter 25: How Are NFTs Taxed?

At this point there has not been any NFT-specific guidance issued by the IRS. Their taxation will vary based on future guidance and likely the use case for each specific NFT.

No NFT Guidance or Case Law

When first writing this book, after the first roughly dozen or so chapters we had – astoundingly –already run out of established case law.

Which is why, at least until some lawsuits establish precedent and the IRS issues additional rulings, we so often talk in terms of "possibly", "maybe", and "what if".

And one of those "what ifs" that we need to address are NFTs.

NFTs (non-fungible tokens) have absolutely blown up in the past few years. They're being used for digital art, items in blockchain video games, collectibles such as NBA TopShot cards, and an ever-expanding list of other uses.

In general:

1. NFTs are going to be considered intangible assets, although it is unclear if they will be able to be amortized under Section 197
2. The creation and sale of NFTs (by the original artist or company) will be considered ordinary income
3. The sale of a purchased NFT will often, but not always, be treated as the sale of capital assets or collectibles

NFT Utility and Use Case Come Into Play

<u>But the variation in NFT use case is going to make their taxation an absolute nightmare</u>. Other topics are much more cut and dry – once the topic has been decided for one crypto, that principle will follow for similar projects. For instance, the Jarrett case related to Tezos staking will likely settle the matter for all other staking tokens. Similarly, the IRS ruling on BTC and ETH being too different from each other to qualify for 1031 exchanges gives strong guidance for all other cryptocurrencies.

But we're not nearly as optimistic when it comes to NFTs because of the huge variation in how they will be utilized. There will be some principles that will carry through across the board, but they're not going to be applicable for all projects.

We were originally going to cover all of this in one chapter, but given the variation in utility, it's not practical. Instead, we're going to break this discussion up into separate chapters on each of the more common use cases:

- Art
- Gaming
- Virtual Worlds/Metaverses

In these chapters, we'll discuss the unique issues that will affect these different uses. And again, we still have to emphasize that there has been **zero NFT-specific guidance issued by the IRS,** so some of our assumptions will almost certainly end up being proven wrong. But given the prevalence of NFTs, the lack of current lawsuits regarding them (to help establish case law), and the IRS's tendency to issue guidance very late on crypto-related issues, we simply aren't going to be able to ignore NFTs on our tax returns until guidance comes to us.

Like anything in this market, we will consider the existing principles and case law, will plan accordingly, and will adjust as clearer guidance becomes available.

Chapter 26: How Are Art NFTs Taxed?

In our last chapter on NFTs we noted how the different use cases for various NFTs may affect how they are taxed. NFTs that have a hard utility (such as usable items in gaming) are possibly going to receive different tax treatment than those that do not.

What Are Digital Art NFTs?

Again, we stress that **the IRS has not issued any NFT-specific guidance yet**. These are simply our best guesses based on other IRS rulings and general accounting principles.

For this first chapter we're going to start with art NFTs, since those are a bit more straightforward.

When we say "art NFT", this isn't exclusive to digital paintings. This would include:

- Art
- Memes
- Movies/Films
- Music
- Trading Cards

Essentially, these NFTs are functioning as **collectibles**. The NFT shows your ownership of the item, but in practice does not provide you utility beyond that.

In many cases, you could download the same song, look up the meme, "save as" the image, etc. without purchasing the NFT. And you would, in general practice at least, have the same utility as you would actually purchasing the NFT itself on the blockchain.

Again, you are purchasing these NFTs essentially as collector's items – for bragging rights, rarity, and also hoping that the item goes up in value.

The Taxation of Collectibles

So how are collectibles taxed?

First, we need to look at if you are the original creator of the NFT or if you purchased it. If you created it and sold it, then this is taxed as business income. No further discussion needed. But if you purchased the NFT and then resold it, we need to look more closely at your circumstances.

To do this, we first need to look at your purpose and operations. If you have substantial activity, it is possible that you could be considered a "dealer" for tax purposes.[10] A dealer is someone whose **business** is the buying and selling of an asset. As an example, think about someone selling *tangible* collectibles like the owner of an antique shop. They aren't acting as investors; they're acquiring inventory to sell at a high volume for profit. Dealer status also exists for securities and real estate.

The IRS has not addressed this status for crypto or NFTs specifically, but it's not unreasonable to believe that the status *could* apply to blockchain assets. Depending on your operations, you may be considered a dealer.

But most of us probably aren't trading with that frequency. So, assuming we have determined that you do not qualify as a dealer, let's discuss how that would be taxed.

For this step, the first thing we have to look at is how long you've owned the collectible for. It may seem like semantics, but in order for the "collectible" designation to even matter **for tax purposes**, the item must have been owned for greater than a year. If the item is held for less than a year before being sold, the collectible status does not affect the rate you pay on your tax return. It is simply treated like other short-term capital gains and is taxed at ordinary income rates.

If the item has been held for greater than a year, the gains are taxed at the lesser of your ordinary income tax rate or 28%. This is much higher than the 0-20% that is available for regular long-term capital gains. This goes back to the Taxpayer Relief Act of 1997 when they dropped the tax rate on most capital gains but left it the same for collectibles. The logic behind this was that collectibles did not stimulate innovation and were also generally owned by the wealthy.

If the collectible is being held as an investment but is sold as a loss, you are able to claim it as a capital loss. But if it was purchased for personal use, you are not able to deduct the loss.

As always, when the IRS does finally provide some guidance, it is almost guaranteed it will vary somewhat from what we are outlining here today. But for now, art NFTs are more analogous with collectibles than anything else and this seems to be a reasonable tax treatment for them.

Chapter 27: How Are Gaming NFTs Taxed?

Gaming NFTs vs. Art NFTs

In the last chapter we discussed how digital art NFTs are taxed. Some of those principles will be true for gaming NFTs as well:

- If you are the original creator of the NFT and sell it, this will be considered business income
- If you buy an NFT simply to hold and later resell it, this will be taxable either as a collectible or short-term capital gain depending on your holding period
- If you are in the business of buying/reselling NFTs, you may be classified as a dealer and have that income classified as business income
- If NFTs are purchased for investment purposes and are sold at a loss, you should be able to claim that as a capital loss. If the NFT was purchased for personal use, you cannot deduct the loss

In essence, if your gaming NFTs are functioning as collectibles the way that art NFTs are, there is not likely going to be any difference in tax treatment.

But let's talk about if you're actually using the items in-game. This gets into a really interesting discussion that we think is **going to take years (if not DECADES) to litigate**.

As always, we'll stress: **there is no NFT-specific guidance available from the IRS**. All of this is conjecture and our "best guess" given the existing case law and revenue rulings.

For most intangible assets, we end up with two options for tax treatment:

1. The intangible asset is not eligible to be amortized at all. It will sit on the books as an asset with no deduction for the purchase

2. Amortizing the asset under Section 197. By default, this is done over 15 years, **<u>although it can be done over a shorter period if it can be proven that the useful life of the asset is less than 15 years</u>**

This is going to be absolutely fascinating as blockchain continues to evolve. Because by default, the IRS is likely to say that the intangible assets (in this case NFTs) should not be amortized at all or will perhaps concede that they should be amortized over 15 years.

And for a lot of NFTs, that is likely going to be appropriate guidance.

A lot of them…not all.

The Importance of NFT Function

Let's give some examples. Imagine you're playing an MMORPG like Mirandus (note: we have no idea if this is how Mirandus itself will actually work, this is just to illustrate) and that in-game you have:

- A hatchet or pickaxe that degrades over time/has a finite amount of use available to it before it needs to be replaced
- A sword or other piece of equipment that does not degrade, but becomes increasingly obsolete over time as superior versions become available
- A plot of land that you rent out/allow other users to build on
- A tavern or other piece of in-game real estate that you operate a business out of
- A limited-edition piece of art that you hang on the walls of your home in-game

All of those are NFTs **<u>within the same game</u>**, but clearly have very different use cases. Treating them all the same way would seem to miss the point and the core functionality of the asset itself.

If these were *tangible* assets, they would all be taxed and depreciated very differently (or not be depreciated at all). The pickaxe is not going to last more than a few months and the sword will be obsolete within a year. On the flip side, the land, tavern, and painting will last indefinitely and – if they mirror their real-world equivalents – will likely appreciate in value.

We don't think we're going to see virtual buildings being depreciated over 40 years like tangible non-residential real estate, but we do think these differences in utility are going to have to be taken into consideration.

And this does not even begin to consider the purpose, scope, and operations of these in-game activities and how those could affect the tax treatment. We'll discuss those in more detail in the next two chapters on the taxation of metaverse NFTs and also on P2E (play-to-earn) gaming.

With the insane prices of some gaming NFTs (and the corresponding tax ramifications of different tax treatments for them), it's all but guaranteed there will be substantial litigation surrounding this in the future years.

For now, and absent the clarification that will come from future court cases and IRS guidance, we do believe that examining the nature of each NFT itself is going to be important.

Chapter 28: Are Crypto P2E (Play-To-Earn) Gaming Rewards Taxable?

Rewards from blockchain games are likely taxable – either as hobby income or as business income.

Making Money Just by Gaming

We're going to take a break from talking about NFT taxes to discuss P2E (play-to-earn) gaming, since some of the ideas we discuss here will help set a foundation for our discussion on taxation in the metaverse.

Play-to-earn gaming is the concept that *really* got us into cryptocurrency. As a kid we probably played thousands of hours of video games over the years. We were especially hooked on games that had some sort of character progression – either by leveling up or by accumulating money/assets – even though those assets had no real-world value.

If there had been an option to play a game that allowed you to earn real-world money – even fairly *de minimis* amounts – it would have been game over. That would have been the only game we ever played.

Twenty years ago that was not an option, but it is today. And it is going to be an absolute game changer.

But with that, there are going to come some tax issues that people are not anticipating. We're going to have gamer kids with six and seven figure incomes because of dungeon raids or their successful blacksmithing shops. Which is some mix of hilarious, inspiring, and terrifying all at once.

And unfortunately, all of that income is taxable. But *how* is it taxed?

Gaming as a Hobby or a Business?

The first question we have to answer is if the activity is a hobby or a business. The IRS provides nine initial parameters[11] for taxpayers to consider when determining what an activity is:

- *“Whether the activity is carried out in a businesslike manner and the taxpayer maintains complete and accurate books and records.*
- *Whether the time and effort the taxpayer puts into the activity show they intend to make it profitable.*
- *Whether they depend on income from the activity for their livelihood.*
- *Whether any losses are due to circumstances beyond the taxpayer's control or are normal for the startup phase of their type of business.*
- *Whether they change methods of operation to improve profitability.*
- *Whether the taxpayer and their advisors have the knowledge needed to carry out the activity as a successful business.*
- *Whether the taxpayer was successful in making a profit in similar activities in the past.*
- *Whether the activity makes a profit in some years and how much profit it makes.*
- *Whether the taxpayers can expect to make a future profit from the appreciation of the assets used in the activity.”*

Especially since it is a *game* being played, the first instinct is to call the video game a hobby. But just because the activity revolves around a game does not mean it is not a business. Think about traditional sports leagues, esports athletes, Twitch streamers/creators whose content is centered around video games, and even gold farmers performing mundane tasks in MMORPGs.

Are we really going to claim that any of those activities are **<u>not</u>** businesses?

Hobby Income Benefits and Drawbacks

For many P2E gamers, their income will be hobby income. They earn a little bit of money in the game, stick it on their tax return (if they're even required to file a tax return), and that's the end of it.

And there's good and bad to something being hobby income.

The good is that it's simple and is not subject to self-employment tax.

The bad is that after the TJCA passed in 2018 **you can no longer deduct ANY hobby expenses**. Previously you had been able to deduct your hobby expenses (up to the amount of hobby income) as an itemized deduction subject to a threshold of 2% of your AGI.

So now, every bit of hobby income you generate is taxable, regardless of whether or not you have expenses. That's fine if you earned a couple hundred dollars, but is much more painful if your in-game activities become more involved. And as it becomes more involved, the more likely the activity is to be a business and the more beneficial it is to the taxpayer to classify it as a business.

To illustrate, let's use the two examples above as a starting point.

A kid raids dungeons for a few hours every weekend in his spare time. He ends up getting a pretty rare (and valuable) drop that he then sells.

That's pretty clearly hobby income. He does this purely for his own enjoyment (and the drop is an unexpected bonus), spends very little time doing this, does not rely on that income to survive, is unlikely to maintain any records surrounding the activity, etc.

That kid has to claim the dungeon drop as taxable income on his tax return (assuming he has enough income to require him to file one) and is not able to write off any in-game expenses to offset against it.

Business Income Benefits and Drawbacks

On the flip side, let's say there's a 50-year-old single father of five who has a blacksmithing shop in an MMORPG. He spends at least 40 hours a week grinding out weapons and armor to sell to other players.

Even though that activity is happening in-game, it is much more likely to be business income. The time commitment is much more substantial, he relies on the income to support his family, creating the weapons requires substantial investment in terms of raw materials and equipment, he is tracking all of his activity very closely to improve profitability, and this is a fairly mundane activity that he is only doing because it generates income.

The income is subject to self-employment tax, which is on the surface a negative. But since it is business income, **the 50-year-old is able to write off his corresponding in-game expenses to offset against his revenue**. Especially as the activity scales, that can be a **huge** benefit and possibly have the activity taxed more favorably than if it were counted as hobby income. It also may benefit him to have the activity run through an entity and taxed as an S-Corp.

Like with any hobby vs. business discussion, the scope, scale, intent, and other factors related to the activity will come into play. Make sure you are planning carefully with your CPA throughout the year. The bucket your gaming falls into – along with other factors related to how you operate your in-game hobby/business – can **drastically** affect your tax bill at the end of the year.

Chapter 29: Are P2E Games Good Investments?

Is it a good idea to invest in play-to-earn (P2E) games?

In Chapter 32, we'll talk about the need to cash out a percentage of your profits in real time. And we'll gave some examples of the catastrophic consequences that can arise if you fail to do that.

Play-to-earn (P2E) games might be one of the most consistent examples of this danger.

P2E Token Prices Consistently Fall

To be clear, we're big fans of P2E games. The concept (in conjunction with NFTs and nodes) from Gala Games was the first time we truly understood the use case for a specific blockchain project.

But P2E games aren't without their own issues, at least in their current form. Because – so far at least – the in-game economies of these projects inevitably seem to crash. We'll discuss why this is the case in a moment, but just to give a few examples:

Game	Token	High	High Date	Current	Drop
Town Star	TOWN	$2.32	11/29/2021	$0.02	99.14%
STEPN	GMT	$4.11	4/28/2022	$0.83	79.81%
STEPN	GST	$8.51	4/28/2022	$0.12	98.59%
Axie Infinity	AXS	$164.90	11/6/2021	$14.51	91.20%
Axie Infinity	SLP	$0.40	7/13/2021	$0.003	99.25%
Thetan Arena	THG	$21.13	10/25/2021	$0.08	99.62%
Splinterlands	SPS	$1.07	7/28/2021	$0.05	95.33%
Crypto Raiders	RAIDER	$13.54	1/5/2022	$0.20	98.52%
EtherOrcs	ZUG	$3.60	2/22/2022	$0.03	99.17%

Admittedly, some of that is because of the current bear market, but that's not the main issue. So far, even successful P2E games follow this unfortunate trendline of a big spike and then a precipitous fall.

Are P2E Games Just Ponzi Schemes?

P2E games are economies in and of themselves, so whether the economies succeed or fail will depend on the particulars of each game.

But if that's the case, why is this trend we see above so consistent? Those projects are all in different spaces and have very different in-game economies. Is this collapse just completely unavoidable?

You could argue that these games are just unintentional Ponzi schemes:

- You're fabricating money out of thin air
- Early players are able to purchase NFTs for low prices
- As the game increases in popularity, demand for the token also goes up
- Players are incentivized to keep purchasing tokens/NFTs and reinvesting their earnings back into the game
- This further increases demand for the tokens and in-game NFTs, increasing the value of both
- As the token price keeps going up, so do the real-world earnings from playing the game. This attracts more and more players and investors who are hoping to make what current players are earning
- Eventually there aren't enough "money sucks" for players to reinvest in and the token becomes more inflationary. Or people just start cashing their earnings out instead of reinvesting in the game
- The token price starts to slip, decreasing the real-world earnings. This attracts fewer and fewer new players and existing players increasingly cash out their earnings. It's one thing to HODL when token/NFT prices are going up 100%, it's entirely different when it's dropping daily – especially if you have not recovered your initial investment yet
- This trend continues until there is a price drop like the examples we see above. In many cases the economies

will stabilize at this point, albeit at a 99% drop from the peak and with a bunch of players having lost money

Again, an unintentional Ponzi. The people who got in early did great, the people who got in later got hosed.

Tokenomics Are Not to Blame

Those are all legitimate issues – and are things that any P2E game is going to need to contend with. But we don't think that's the primary issue.

All you have to do is look at existing MMORPGs like World of Warcraft or RuneScape. Those games have been around for decades with complex in-game economies.

And most importantly for our discussion here today: **despite not being on the blockchain, their in-game currencies have real world value**. As of writing this chapter, you can buy 1,000 gold pieces for WoW Classic for $10 or 10 million gold for Old School RuneScape for $5. "Gold farming" on these games is an entire industry.

Investment Opportunity First, Video Game Second

The primary issue with the current model is that the tokenomics are set up to give you the same – or better – returns than you get from other blockchain projects just for playing.

In essence, these games are being viewed as investment opportunities rather than video games. And as we're seeing, that's just not sustainable long-term.

The fact that WoW, RuneScape, and other multiplayer games have gold farmers speaks to the fact that in-game currencies have intrinsic value **if the game itself is fun**.

But earning real-world money has to be secondary. It needs to be a great game that has its own in-game earnings, but just happens to be on the blockchain. The game itself being good gives some intrinsic value to the token. And it should stop the incentive to make the game's economy so inflationary.

This model can work, but it feels like developers (and players) have to change their entire mindset first.

For Now: Cash Out Regularly

Hopefully GameFi developers change their approach and fix all of the issues we noted above. In the meantime, you don't really have much of a choice. If you want to avoid potential tax (and financial) catastrophes, you need to ensure you are taking profits as you go. Take a percentage of your in-game earnings, convert them to fiat, and set them aside for taxes.

If you don't, you could be absolutely clobbered. Chapter 32 which discusses regularly cashing out profits gives an unfortunate example of this:

"A few months ago we picked up a client who had over $1 million in crypto profits the prior year. We won't include too many details for privacy reasons (and we'll also change a few details just for good measure), but they made most of this income from play-to-earn (P2E) games, nodes, and capital gains from token trading. This income generated a tax bill of about $500k.

*The problem is that they reinvested **all** of it back into the market, especially into the NFTs for the P2E game that was the source of a lot of their income.*

Unfortunately, as is all too common in P2E games, the in-game economy collapsed. The token's value went down nearly 99% from its peak. And with that token drop, the value of the NFTs they purchased went down as well."

Until things change with the underlying thought process behind P2E games, that trendline is likely to continue to be followed. Things will spike and then they will crash.

If you cash out your earnings as you go, you'll be fine. You might lose out on some profits, but at the very least you'll be covered from a tax standpoint. But if you don't, you might end up in the same situation as the P2E investor above:

- *"A half a million dollar tax bill and no money to pay it*

- *No income to pay the taxes*
- *A bunch of devalued, illiquid NFTs*
- *The remainder of their portfolio also underwater*

*If they are able to pay the bill – which is uncertain given the illiquidity of NFTs – doing it might **wipe out their entire crypto portfolio**."*

Don't let FOMO get the best of you. Be smart and take that percentage of profits as you go. The risks are just too high if you don't.

Chapter 30: How Will Metaverse NFTs Be Taxed?

If you're searching for specific topics and thereby end up reading this book out of order, we suggest first reading the previous chapters here in Section 5 on NFTs and P2E gaming. While they're of course different topics, several of the concepts in those chapters are foundational to what we are discussing here with respect to metaverse NFTs.

- How Are NFTs Taxed?
- How Are Art NFTs Taxed?
- How Are Gaming NFTs Taxed?
- Are Crypto P2E (Play-To-Earn) Gaming Rewards Taxable?

The Metaverse and Its NFTs Are Coming

Whether we like it or not, the metaverse is upon us. Facebook changing their name to Meta caused the price of Decentraland (META) to more than quadruple – even though the two projects are unrelated. It simply lent more credibility to the concept of the metaverse, which is MANA's entire proposition. Now Apple and other major corporations are now getting involved as well.

Who will control the metaverse and exactly what form it will take is still very much in the air. But it's increasingly transitioning from theory to reality all the time and with that new "reality" are going to come metaverse NFTs.

So how are those NFTs going to be taxed?

As always, we stress that **there is not currently any NFT-specific guidance from the IRS**. **Especially when it comes to more complex and nuanced topics such as utility NFTs and gaming/metaverse income, we believe it will take years if not decades to litigate.** As such, these are simply our opinions and conjecture until more authoritative guidance becomes available.

But as we discussed in the previous chapters in this section, the use case of each NFT is very likely to come into play.

Metaverse NFTs vs. Gaming NFTs

The metaverse is not going to be a "game" per se. It is going to be some form of augmented reality – perhaps looking like a more robust and sophisticated version of Second Life. (As a side note, if you'd like a preview of the bizarre and depressing world we could be living in once the metaverse gets rolling, take a look at the documentary Life 2.0 that covers people playing Second Life). But the concepts we covered in our play-to-earn gaming chapter as well as our gaming NFT chapter are very relevant to the metaverse.

In those chapters, we discussed how the 1) function of each NFT and 2) nature/activity in which the NFT is used will both significantly affect how they are taxed. First, we asked you to imagine you had a number of different items in a game:

- *"A hatchet or pickaxe that degrades over time/has a finite amount of use available to it before it needs to be replaced*
- *A sword or other piece of equipment that does not degrade, but becomes increasingly obsolete over time as superior versions become available*
- *A plot of land that you rent out/allow other users to build on*
- *A tavern or other piece of in-game real estate that you operate a business out of*
- *A limited-edition piece of art that you hang on the walls of your home in-game*

*All of those are NFTs **within the same game**, but clearly have very different use cases. Treating them all the same way would seem to miss the point and the core functionality of the asset itself.*

If these were tangible assets, they would all be taxed and depreciated very differently (or not be depreciated at all). The pickaxe is not going to last more than a few months and the sword will be obsolete within a year. But on the flip side, the land, tavern, *and painting will last indefinitely and – if they mirror their real-world equivalents – will likely appreciate in value."*

NFT Functionality Comes Into Play

So first, we have to look at the NFT itself and its functionality. From there, you next have to look at the surrounding activity in which the NFT is being used. Chapter 28 gave the examples of a child playing a video game a few hours a day vs. an adult who was spending the majority of his time working within the game:

"To illustrate, let's use the two examples above as a starting point.

A kid raids dungeons for a few hours every weekend in his spare time. He ends up getting a pretty rare (and valuable) drop that he then sells.

That's pretty clearly hobby income. He does this purely for his own enjoyment and the drop is an unexpected bonus, spends very little time doing this, does not rely on that income to survive, is unlikely to maintain any records surrounding the activity, etc.

That kid has to claim the dungeon drop as taxable income on his tax return (assuming he has enough income to require him to file one) and is not able to write off any in-game expenses to offset against it.

On the flip side, let's say there's a 50-year-old single father of five who has a blacksmithing shop in an MMORPG. He spends at least 40 hours a week grinding out weapons and armor to sell to other players.

Even though that activity is happening in-game, it is much more likely to be business income. The time commitment is much more substantial, he relies on the income to support his family, creating the weapons requires substantial investment in terms of raw materials and equipment, he is tracking all of his activity very closely to improve profitability, and this is a fairly mundane activity that he is only doing because it generates income."

That type of situation is going to be **very** analogous to what people are going to be experiencing in the metaverse. You are going to have people using it for recreational activities with the same tax treatment as hobby income and personal use NFTs. But you're also going to have people who are operating entire businesses out of it, in which case any income generated within the metaverse will be counted as business income and the NFTs taxed as business assets.

In essence, the metaverse is going to be an extension of our regular day-to-day lives. How those NFTs are being used within the metaverse will very much inform their tax treatment.

Chapter 31: How Do I Write Off Worthless NFTs and Cryptocurrency Tokens?

You are able to write off worthless crypto and NFTs if you can show you have permanently discarded them. The simplest way to do this is usually to send them to a null address.

The Volatility of Crypto Assets

If you're only buying assets associated with major crypto projects, you'll probably never run into this issue. The crypto market is of course extremely volatile, but Bitcoin isn't going down to zero and neither are any of the CryptoPunks. You might sell them for a loss, but they'll still have value and you'll be able to sell them for *something*.

If you're investing in brand new projects/are hoping for moonshots, this is probably something you've experienced. What do you do if the project you invested in went completely belly up? The NFTs or tokens associated with the project that you purchased are now worthless, so no one is going to buy them from you.

In the case of NFTs specifically, there could be circumstances where the project is still *technically* alive, but you have no ability to dispose of the asset via a sale. As an example, let's say a project has taken a 99% hit since you invested. If you purchased tokens, you *may* still be able to sell them on an exchange – albeit for a massive loss. It's much less likely you'll have that ability with an NFT given how illiquid they are.

Writing Off Worthless Tokens and NFTs

So how can you write off these losses?

Like most things crypto-related, the IRS hasn't issued any blockchain-specific guidance on these situations. Thankfully, we have some very clear-cut principles we can apply from stocks and other traditional investments.

Pub 550 gives guidance on writing off worthless securities. It notes that:

*“**Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became completely worthless during the tax year are treated as though they were sold on the last day of the tax year.** This affects whether your capital loss is long term or short term.*

***Worthless securities also include securities that you abandon** after March 12, 2008. **To abandon a security, you must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for it.** All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.”*

Section 1.165-2 gives similar guidance on the “allowance of deduction” for obsolete non-depreciable property. It notes that:

*“A loss incurred **in a business or in a transaction entered into for profit** and arising from the **sudden** termination of the usefulness in such business or transaction of any nondepreciable property, in a case where **such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained**. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.”*

For most NFT and crypto investors, they meet the initial criteria. They were investing with the intent to make a profit, the project suddenly lost its value, and of course blockchain assets are non-depreciable.

Final Step: Abandoning the Property

The final step that you need to take in order to write off the loss is the one that many crypto investors miss: the actual abandonment of the property. The tokens/NFTs may be worthless, but until you relinquish all rights to the property, you are unable to write off the loss.

Abandoning the property is pretty simple – you just need to send the tokens or NFTs to a dead address. This shows you have permanently abandoned them and have no ability to recover the assets. The only downside to this is the gas fees – especially if the assets are on ETH. If you have a several thousand-dollar loss, the benefits from the tax deduction more than offset the gas fees. But if you have a $100 position that went to zero, spending $50 on gas fees doesn't really make much sense. In those cases, you're probably better off just leaving the tokens in your wallet and hoping that the project gets resurrected – however unlikely that may be.

Section 6: Tax Planning

Chapter 32: Cashing Out on Your Crypto Profits to Avoid Tax Catastrophes

Taking profits and setting aside a percentage of that income is one of the most important things you can do as part of your crypto tax planning. It's simple (and often ignored), but it is one of the most important wealth preservation strategies available – especially during periods of market volatility.

The Importance for Cash Flow Planning for Taxes

With the bear market (perhaps even another crypto winter) in full swing, the idea of large crypto profits might feel like a distant memory. But the volatility of crypto works both ways, so at some point people will start making money again.

When that happens, it is crucial that you ensure you're doing proper tax planning throughout the year – including cashing out part of your profits and setting that money aside for taxes.

Failing to do this can have absolutely catastrophic consequences.

A bull market year followed by a bear market the next – like what we're seeing now and what we saw in 2017 during the ICO craze – provide some pretty perfect examples of these consequences.

Crypto PROFITS Can Cause Financial Ruin

A few months ago we picked up a client who had over $1 million in crypto profits the prior year. We won't include too many details for privacy reasons (and we'll also change a few details just for good measure), but they made most of this income from play-to-earn (P2E) games, nodes, and capital gains from token trading. This income generated a tax bill of about $500k.

The problem is that they reinvested **<u>all</u>** of it back into the market, especially into the NFTs for the P2E game that was the source of a lot of their income.

Unfortunately, as is all too common in P2E games, the in-game economy collapsed. The token's value went down nearly 99% from its peak. And with that token drop, the value of the NFTs they purchased went down as well. The value of this type of NFTs is largely tied to the amount of income they can generate. As that earning potential goes down, so does the value of the NFTs themselves.

The rest of the market then crashed as well, which reduced the earnings on the rest of their portfolio. Their income plunged from thousands of dollars a day to less than $100 a day.

Unless things turn around – either in the greater market or the game – they're going to need to start liquidating assets in their portfolio to pay the taxes. And again – unless things turn around – that liquidation will be happening at one of the worst times imaginable.

To recap, this person has:

- A $500k tax bill and no money to pay it
- No income to pay the taxes
- A bunch of devalued, illiquid NFTs
- The remainder of their portfolio also underwater

If they are able to pay the bill – which is uncertain given the illiquidity of NFTs – doing it might **wipe out their entire crypto portfolio**.

How to Avoid This Tax Trap

Unfortunately, this is not an unusual example at all. A lot of the new clients we are seeing right now are in similar situations.

With all of them, we're working to reduce their tax bills – and with some pretty great success in a number of cases. But with this level of income and no planning/maneuvering having been done throughout the year, the taxes due are still massive.

So how could this have been avoided?

There are all sorts of strategies we can implement to reduce the amount of tax you're paying – entity structure, loss harvesting, strategizing on the timing of transactions, figuring out what we can expense, etc. – but in this case what would have preserved their wealth more than anything else is really simple:

Take profits as you go.

These people were convinced that:

1. Their project's tokens and NFTs were going to keep appreciating in value
2. The greater crypto market was going to continue to go up

Unfortunately, neither of those things happened.

If they had just done tax planning throughout the year and every time they had a transaction had taken 40-50% of the profits and converted it into USDC* or fiat, they would be fine right now.

Sure, they'd still have to pay the taxes. And they'd still have some devalued NFTs and tokens. But they'd at least have the money to pay the tax bill **and would be under no pressure to touch the rest of their portfolio**.

Instead, they have twice as many underwater NFTs/tokens, a $500k tax bill, and no way to pay it. That sad reality might wipe out the entirety of their portfolio.

This entire situation could have been avoided with tax planning, especially making sure they took profits as they went and set the funds aside for April 15th.

We mentioned USDC because it **appears to be the most stable of the stablecoins, but it is always worth noting that **stablecoins are not currency and are not FDIC insured**. They can and do fail. We most notably saw this with the crash of Terra Luna's UST, but it's far from the only example. We also saw it with the 2021 crash of IRON/Titanium. And even as we're writing this, Tron's USDD has been depegged for nearly a week – although this is a new project and it's unclear how that situation will resolve.*

There are different types of stablecoins and each one is backed by different protocols/companies. They are not created equal, so DYOR. But also understand the inherent risk associated with stablecoins in general – especially compared to having actual cash *in the bank. For a more in-depth explanation, look at the next chapter for a discussion on the risks of stablecoins.*

Chapter 33: Stablecoins Are Not “Risk Free”

Stablecoins are not currency. While they are an important part of blockchain’s development and can be a component of your crypto investing strategy, they are anything but “risk free”. Like any other crypto asset, do not invest anything in them that you cannot afford to lose. Given the importance of paying your tax obligations, putting the money intended for your tax bill into a stablecoin may not be the best idea. Even if it does end up working out, understand that the maneuver is not without risk.

At the end of the last chapter advising that you set aside money for taxes as the transactions occur, we had a short footnote on this risk of stablecoins and how they are not currency. But the topic deserves to be expanded on.

Stablecoins Are Not the Same as Cash

Stablecoins are one of the most important developments in crypto. Their price stability – especially compared to the significant volatility in the crypto markets – gave a place of relative safe harbor. Without them, token holders would be forced to either immediately cash out for fiat or hold their tokens and ride the price fluctuations. For all of the amazing things blockchain technology can do, the actual *currency* aspect of cryptocurrency has often been lacking. Stablecoins have helped to address that.

On top of that price stability, stablecoins also offer yields well beyond what you could get on fiat in a traditional bank account. With market conditions shifting these rates are being reduced, but it has not been at all unusual to see 8-12% APY paid on USDC/USDT. Before Luna failed, the Anchor protocol was paying nearly 20% APY on UST. And all of this during a period where money market accounts at banks are offering 0-1% interest.

So people flocked (and continue to flock) to stablecoins. You have a “risk free” asset that stays $1 in price, all while earning stock market ROI. What’s not to love?

As we’ve said before, we’re not against stablecoins. We invest in them ourselves, but this point cannot be overstated:

Stablecoins are not currency. They are not FDIC insured. And they can and do go to zero.

Examples of Stablecoin Failures

We most notably saw this with the collapse of Terra Luna/UST. UST’s market cap went from nearly $20 billion to less than $100 million in about a month. And Luna (now Luna Classic) went from over $40 billion to $0 in that same period – although they did rebrand as Luna 2.0, which has a market cap of about $300 million as we write this chapter.

But that is far from the only example, it’s just the biggest and the most recent. Iron Finance’s TITAN and IRON tokens went from $2 billion to effectively $0 when they had a similar bank run on their stablecoin protocol. MakerDAO’s DAI has struggled to hold its peg in the past, although it has typically traded above $1 in those instances, not below it. Tron’s USDD project has already depegged just a few months after launch.

And those are just the bigger projects. Ever heard of any of the following?

- Basis Cash
- SafeCoin
- OUSD
- BitUSD
- NuBits
- CK USD
- BitUSD
- DigitalDollar
- Empty Set Dollar

We only remembered one or two of those, but those are just some of the stablecoins that have failed in the past few years. And we’re sure there are smaller ones that have not had articles written about them.

Different Types of Stablecoins

Now, admittedly, most if not all of those are what they call "algorithmic stablecoins". At least in their current form, we are not fans of these projects at all – which given their track record should be no surprise.

There have been countless in-depth articles written on how each of these types of stablecoins work that do a better job than we could, so we won't rehash them. For the purposes of our discussion here, it's fair to say that the other three categories are reasonably simple: the stablecoin is backed/collateralized by some kind of other asset – cash or cash equivalents, other crypto tokens, or commodities like gold.

Fiat-backed stablecoins would seem to be the least risky, since they do not have the same risk from market volatility that the other three categories do. But again, and this cannot be overstated:

They are not cash.

Security of Bank Deposits vs. Stablecoin Deposits

In the unlikely event that your bank fails (there were only four bank failures in the US in 2020), up to $250k is insured by the FDIC. That's pretty low-risk – especially since that $250k limit is *"per depositor, per insured bank, for each ownership category"*, so you can spread out your funds to have quite a bit more than $250k insured. And the entire US government/USD itself is unlikely to crash. If it does, we all have much bigger issues than the loss of our bank deposits.

But stablecoins are still only as good as:

1. The company or protocol that backs them
2. The exchange or wallet where you hold the funds

Even though they are fiat-backed, if the company behind a stablecoin gets into trouble then the stablecoin itself will be at risk. Tether is the world's largest stablecoin, but has faced numerous lawsuits and government probes. Most recently it came to light that it is backed with “non-U.S.” government bonds. If anything happens with the company, then USDT could easily crash.

But people especially seem to forget that second point: even if the coin itself does not fail, where you hold the funds also has some risk. The exchange could be hacked, your keys could be stolen, or the exchange itself fails.

We’re seeing that last point right now with Celsius and Voyager going bankrupt and freezing withdrawals. You may have your money in USDC (which we’ve noted before seems to be the most transparent and stable of the stablecoins, although of course not without its own risk), but if it’s deposited on an exchange that fails, your money is lost the same as if the token itself had failed.

Are Stablecoin Deposit Rewards Worth the Risk?

That’s especially important, because **the main reason people want to hold stablecoins is for the yields**. There’s no real reason to keep them on a cold wallet since there is no earning potential. If they aren’t going to be held somewhere earning interest, you’d be better off having actual fiat in your bank account. The vast majority of stablecoins are on deposit with some protocol or centralized exchange.

If that money is **needed** to pay your taxes and something happens to the exchange, you are absolutely hosed.

Again, we are not entirely against this strategy. If you have a $100,000 tax bill and set it aside as stablecoins on a centralized exchange, you could earn $10,000 of interest income. That’s not inconsequential money.

But it is far from *risk free* money. Understand the inherent risk of this maneuver before investing money you cannot afford to lose in stablecoins.

Chapter 34: Bear Market and Crypto Winter Opportunities: Tax-Loss Harvesting

Most people aren't making a ton of money in crypto right now. The market is down substantially and a lot of people – especially those who got involved in crypto more recently – are underwater. As we've mentioned in previous chapters, we have people coming to us who made millions of dollars last year who are now making a fraction of that. Crypto exchanges are freezing withdrawals and some are even going bankrupt.

In that environment, it's easy to put tax planning on the backburner. And to an extent, that's understandable. If you're not making any *income*, then you aren't generating *income* tax.

But bear markets provide unique opportunities for tax planning, especially for cryptocurrency. We're just shifting our mindset. Instead of maneuvering to save taxes on the money you're making right now, we're maneuvering to save taxes on the money you'll be making in the future. In this chapter we'll be discussing one of those strategies: tax-loss harvesting.

Tax-Loss Harvesting

If your portfolio is underwater, one of the easiest ways to save money is loss harvesting. Tax-loss harvesting occurs when you sell assets for a loss to offset against capital gains.

As an example, let's say you bought 10 Bitcoin when the price was $60,000/BTC and now the price has dropped to $20,000/BTC. That's $400,000 of *unrealized* capital losses in your portfolio, which is a **substantial** write-off sitting there unused. Selling the Bitcoin to realize that loss is an excellent strategy and one we'd often recommend.

But you might be asking, *"What's the point? I don't have any gains this year to offset against. And you're only allowed to use $3,000 of losses per year against ordinary income. $3,000 isn't worth my time. Why even bother?"*

But we aren't doing the loss harvesting for the $3,000. We aren't even necessarily doing it for this year. We're doing it for the future.

There is no expiration to capital loss carryovers. The losses carry forward until they are exhausted – either $3,000 at a time or when you have capital gains.

So when the crypto market does turn around and you start having gains again, you now have $400,000 of capital losses ready to be absorbed. Your next $400,000 of capital gains will all be tax free.

The Wash Sale Rule

This strategy is especially beneficial for crypto, because currently cryptocurrency is not subject to what is called the "Wash Sale Rule". In Chapter 5 where we discussed this exception to the Wash Sale Rule we noted that:

"For traditional investments there is something called the "Wash Sale Rule". It states that if you sell a stock at a loss but then buy an identical (or "substantially similar") stock within 30 days, you are not able to deduct the loss.

Essentially, the IRS does not want people "selling" their investments in order to harvest the losses for tax purposes but then immediately go and repurchase those same investments. If an item is sold and immediately bought again, then the taxpayer is not really and truly disposing of the asset. Perhaps on paper it shows as a sale, but in substance of course it isn't.

Because of this, those "losses" are not deductible on your tax return. That makes sense and is fairly well-established tax law."

Because of those limitations, tax-loss harvesting with traditional securities can be somewhat complicated. A lot can happen in the 30 days where you are not allowed to repurchase the stock. If the market goes up, you don't have that exposure to it and lose out on those gains. Investment firms and financial advisors have to work very carefully to balance these risks and will sometimes use complex strategies to get around the wash sale penalty.

But that’s not the case with crypto – at least for now. Crypto is considered property for tax purposes, not a security (although that may change in the future, as discussed in Chapter 13). And since it is not a security, it is not subject to the Wash Sale Rule.

Again, this is likely to change in the future. Multiple members of Congress have proposed legislation that would close this loophole and subject crypto to the rule just like traditional securities.

But for now, at least, this makes loss harvesting even easier. You can sell your crypto and immediately buy it back. The loss will still be generated and available for use on your tax return.

Transaction Fees Limit Tax-Loss Harvesting Benefits

The only real limitations to this strategy are the transaction fees. In Chapter 5, we noted that:

“Of course, this is somewhat contingent on scale. It is also dependent on the token itself, the network the token is built on, and where the token is held:

- *Some altcoins have very high taxes as part of their tokenomics*
- *A token on Binance Smart Chain is going to have much lower gas fees than one on Ethereum*
- *An exchange like KuCoin is naturally going to have lower fees than a larger platform like Coinbase*

The losses on those unrealized transactions – and the associated tax savings from them – will need to be substantial to offset against those fees and the fact that executing these trades also resets your holding period for capital gains purposes.”

Smaller losses – or losses on tokens with large “taxes” built into their tokenomics – are unlikely to be worth your while. Those fees will eat up some or all of the tax benefit generated from loss harvesting.

But for larger holdings – especially in a severe bear market – it can be an important tool and can save you a tremendous amount on your taxes.

Chapter 35: Bear Market and Crypto Winter Opportunities: Accelerate Income

Accelerating and increasing your income can be a good strategy during a bear market. You will pay the taxes sooner, but it may save you significantly in the long run.

Pay Tax Now, Save Later

This next strategy is counterintuitive: actively working to **increase** your income and generate taxable events **sooner** rather than later.

That's the opposite of what you're often trying to do – especially in a bull market. During bull runs, you're more likely to be making a lot of money and be in a higher tax bracket. In those high income years, you're typically trying to do whatever you can to defer the tax hit.

So how and why would you accelerate your income?

As an example, let's look at income from Gala Games nodes again. As we discussed in Chapter 24, income from these nodes is not taxable until the tokens are actually minted. This will change in the future when Gala moves to its own blockchain (at which point it will become taxable upon receipt, just like mining income and airdrops). But until then, minting is what finalizes your having "dominion and control" over the asset and is what triggers the taxable event.

So in the majority of cases, you'd want to hold off on minting the tokens to delay the tax hit. But a bear market can be the perfect time to mint them.

Why?

Because it can drastically decrease your taxable income in the future.

There are a few main benefits to minting your tokens now instead of later:

1. It will decrease the initial amount of taxable income, since you are minting the tokens at a lower price

2. You are generating a taxable event in a year when your income is already down and will possibly be paying a lower tax rate on that income
3. When you sell your tokens, more of your income will be taxed as capital gains. And if you hold the tokens for at least a year, you will receive the much more favorable long-term capital gains treatment

How Bear Market Income Saves You Long-Term

This is best illustrated with examples.

"John" and "Steve" both have 1 million Gala tokens that they have mined from their nodes.

John mints his when the token was worth 5 cents. One year later he sells all of his tokens when Gala reaches 60 cents.

Steve waits until Gala is worth 50 cents to mint his tokens. One month later, he also sells all of his tokens at 60 cents.

Both of them have $600,000 of proceeds from the sale of their tokens. But how is it taxed?

On the initial minting, John gets hit with taxable income of $50,000 (1 million tokens x $0.05 mint price). This becomes his cost basis for when he sells his tokens a year later ($600,000 - $50,000) for a $550,000 capital gain.

Steve on the other hand gets hit with $500,000 of income when he mints his tokens (1 million tokens x $0.50 mint price) and when he sells is hit with another $100,000 in capital gains ($600,000 - $500,000).

So both of them generate $600,000 of taxable income ($50,000 + $550,000 and $500,000 + $100,000). No big difference, right?

If only.

Node income is not only considered ordinary income and is taxed at regular income tax rates, but also business income. Business income is subject to self-employment tax unless you are structured as an S-Corp. (*Reference Chapter 23 on the taxation of nodes for additional guidance)*

With node income you're getting hit with:

1. Ordinary income tax rates. There is no option for it to be taxed as capital gains
2. 15.3% self-employment tax up to the Social Security cap and 2.9% after that cap is hit, unless you've got your node income run through a corporation

So Steve has $500,000 of self-employment income. He also didn't hold his crypto for a year before selling it, so his sale of the tokens is a short-term capital gain and is taxed as ordinary income as well.

John is in a much better situation. He only has $50,000 of node income from his minting. And his $550k from the sale of his tokens all qualify for long-term capital gains treatment.

The Savings of Long-Term Capital Gains

Like every tax situation, exactly how much tax this generates will depend on the taxpayer's situation: the amount of income and deductions they have from other sources, their filing status, if they have dependents, etc.

But for the ease of this example, we're going to show this all as income for a single year, even though John's income would hit in two separate years. We'll also assume that John and Steve both have no other income or deductions, are single filers, have no children, and did not run their node income through an S-Corp. How much federal tax are they each going to pay?

John is going to pay about $115,000. That's a lot of money, but on an income of $600,000 that's a pretty good tax **rate**.

Steve is going to pay closer to $215,000. Nearly **double** what John paid the exact same amount of income.

That's not to say that John's approach is not without risk. If the project had gone belly-up and the token had instead gone to zero – which can and does happen – then he would have $50,000 of phantom income he'd have to pay tax on while Steve wouldn't have to pay anything.

When Can You Control the Timing of Taxable Events?

Unfortunately, you don't always have this level of control. Oftentimes, taxable events will occur and you have no control over their timing. In most cases, income is taxable upon receipt. Mining income, staking rewards, interest on crypto deposits – all of those are taxable in real time. You don't really have the ability to defer or accelerate them.

But sometimes you do. You can choose when you execute trades to buy and sell your crypto. In a bear market we're often doing this for tax-loss harvesting, but you may also have capital gains. Realizing those gains in a down year is often a viable strategy.

You have a similar level of control on when you enter/exit liquidity pools and wrap/unwrap tokens. If you are taking the stance those are taxable events, you may look at triggering them during a down year.

While the example we gave above is specific to Gala, it is far from the only project out there that has those dominion and control issues. You need to make sure you understand the mechanics of these projects and are working with a CPA who understands these nuances – otherwise these opportunities will be completely missed.

Make sure you are planning regularly with your CPA during this bear market. While it's less exciting (and we use the term "exciting" very loosely here) than the immediate benefits you'd see during a bull run, the tax savings can be just as significant.

Conclusion

As we mentioned at the outset, the rules around crypto taxes change about as quickly as crypto itself. We're really proud of the information we've set out in this book and are confident in its merits, but that near constant evolution of crypto rules and regulations cannot be overstated.

Make sure you are planning with your CPA throughout the year. And make sure you are doing it with a CPA who actually understands AND uses crypto. At present, there aren't very many of us, although that may well change in the coming years. As blockchain becomes more ubiquitous, there will be more users. And with that, it is probable that more CPAs will become crypto enthusiasts and then perhaps even become experts on the tax side. Hopefully by the time you are reading this book, that has already become the case.

We don't want to sound self-aggrandizing here, but it is hard to overemphasize how important it is going to be to keep yourself to date on these changes and plan around them. Taxes are not the most important thing in the world, nor are CPAs the only important professionals in your financial life, but failing to fully understand the tax consequences of your crypto activity can drive you into bankruptcy – literally.

We anticipate blockchain being heavily litigated over the next few decades, in addition to a significant amount of regulation coming through the pipeline. Things are going to continue to change and they are going to change fast. That's why we love the crypto taxation specialty – it is constantly shifting and evolving, which allows (and forces) us to adapt in a way that is not common in most areas of tax. It never gets boring – and we normally get bored very easily.

But those same things that can make us wax poetic about crypto taxation are the same issues that can make them a nightmare for average taxpayer. So stay vigilant, stay up to date, DYOR, and as always (and where appropriate):

HODL.

Notes

[←1]

For the rest of the book, “we’ll” be using plural pronouns, despite my being the sole author. It’s force of habit and just sounds less egotistical than hearing “me/my/I” over and over again.

[←2]
IRS Tax Topic No. 409 Capital Gains and Losses

[←3]

26 U.S. Code Section 1031 - Exchange Of Real Property Held For Productive Use Or Investment

[←4]

IRS Publication 550

[←5]

IRS Tax Topic No. 429 Traders in Securities (Information for Form 1040 or 1040-SR Filers)

[←6]

SEC Investor Bulletin: Margin Rules for Day Trading

[←7]

IRS Tax Topic No. 453 Bad Debt Deduction

[←8]
Jarrett et al v. United States of America, Case Number 3:21-cv-00419

[←9]

Internal Revenue Bulletin: 2014-16

[←10]

26 CFR Section 1.475(c)-1 - Definitions - Dealer in Securities.

[←11]

IRS Tax Tips: Earning side income: Is it a hobby or a business?