Year-End Tax Loss Harvesting with Cryptocurrencies

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In the fast-evolving world of cryptocurrencies, tax loss harvesting is an important strategy that can help taxpayers minimize their tax bill. Tax loss harvesting occurs when a taxpayer sells losing positions to *harvest* losses in order to offset gains realized from other investments during the tax year. This strategy is typically employed to limit the recognition of capital gains from the sale of stocks, thereby reducing the taxpayer’s income tax liability for the year.

For stocks and securities, harvesting is generally allowed if the taxpayer does not retain an interest in the loss asset. Under the wash sale rules, the Internal Revenue Code (IRC) prevents a taxpayer from taking a tax loss deduction for a stock or security if the taxpayer sells or trades a stock or a security at a loss, and within 30 days before or after the sale, the taxpayer buys a substantially similar stock or security, or acquires a contract or option to do so. Thus, loss harvesting is permitted to the extent the taxpayer disposes of the stock or security and does not acquire the same or substantially similar asset within the IRS specified time frame in the wash sale rules.

For income tax purposes, cryptocurrencies are not treated as stock shares of a corporation or as a security. Instead, under current IRS guidance, general tax principles that apply to property transactions apply to cryptocurrencies. What this means is that there is no prohibition to taking a tax loss when a taxpayer sells cryptocurrency at a loss and buys the same or similar cryptocurrency within a short period of time. Unlike the wash sale rules that prevent a taxpayer from taking a tax loss deduction for a disposition of a stock or security when the economic position is substantially preserved, those rules do not apply in the cryptocurrency context.

The current version of the Build Back Better bill, however, which the Senate is still negotiating, includes a provision to expand the scope of the wash sale rules. The applicable version of the bill provides that wash sale rules will apply to “**Specified Assets,**” which includes “**any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.**” As drafted, the statute appears to be broad enough to encompass not only digital coins like Bitcoin and Ethereum, which can be traded or exchanged at equivalency, but also to cover digital assets like Non-Fungible Tokens (NFTs), which are cryptographic assets on the blockchain with unique identification nodes and metadata that distinguish them from each other. The effective date of this amendment is for sales and other dispositions occurring after December 31, 2021. Therefore, absent modifications to the proposed bill and change to the current tax law, tax loss harvesting is a strategy that cryptocurrency holders can utilize in 2021 without the limitation of wash sale rules.

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1 For purposes of dealer in securities rules, the definition of a “security” includes shares of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing. See I.R.C. § 1236.
Cryptocurrency holders should beware nevertheless that the conversion of a cryptocurrency to fiat currency is not the only time a gain or loss can be triggered. The IRS treats exchanges of digital coins as a taxable event. Unlike some countries that do not tax crypto-to-crypto trades, the U.S. does not adopt this view. Accordingly, the swap or trading of Bitcoin for Ethereum triggers a tax gain or loss depending on the cost basis of the Bitcoin and the exchange value of the Ethereum at the time of the swap.

If the cryptocurrency is held for more than a year, the gain or loss is treated as long-term, while if the buy and sell occurs within a year, the gain or loss is taxed as short-term. Depending on the taxpayer’s income, 2021 long-term capital gains are taxed federally at favorable rates of 0% – 20% while short-term capital gains are taxed at higher ordinary rates of 10% – 37%. In both cases, a Medicare surtax of 3.8% applies to investment income for taxpayers with modified adjusted gross income of more than $200,000 for single filers and more than $250,000 for married filing jointly. Therefore, the most advantageous time to use tax loss harvesting is generally when taxpayers have short-term capital gains to offset.

In addition, so long as the cryptocurrency is held as a capital asset, crypto tax losses can be used to offset capital gains generated from other investments like partnership interests and stocks. A cryptocurrency is a capital asset if the asset is held for investment and the taxpayer is not a dealer or creator of the asset. Capital losses that exceed capital gains in a year may be used to offset ordinary income up to $3,000 in one taxable year. Any excess capital losses can be carried forward to future years until fully utilized. Since December 31 is the last day to realize a loss for an individual U.S. taxpayer, taxpayers should review their portfolios in the last quarter of the year to determine whether harvesting is a tactic that makes sense for them. Depending on the taxpayer’s tax bracket, some taxpayers may want to dispose of losing positions to completely offset their year-to-date gains. As always, this strategy should be discussed with your tax advisor in light of the taxpayer’s overall cryptocurrency tax position and other tax attributes.

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