



# IPB Insights

## \*\*\*\* When can an individual deduct a loss from a cryptocurrency transaction?<sup>1</sup>

*The analysis in this memorandum reflects the law in existence as of April 28, 2020.*

### Summary

Suppose an individual bought a cryptocurrency on June 26, 2019 for \$12,000 and sold it on December 17, 2019 for 7,000. Can the individual recognize the \$5,000 economic loss for tax purposes? The ability, timing, and character of any deduction allowable to a taxpayer for a realized loss depends on three variables: (1) the *status* of the taxpayer; (2) the U.S. federal income tax *characterization* of cryptocurrency (e.g., security, commodity, or other property); and (3) whether the taxpayer is engaged in (and holds the crypto as part of) a *trade or business*.

This chart summarizes the different federal income tax treatments that may apply as to the timing and character of any gain or loss in a crypto holding, depending on the taxpayer’s status and on the tax characterization of the crypto:

Taxpayer Status?	Characterization of Cryptocurrency? (Timing and character of gain or loss)		
	Security	Commodity	Other Property
<b>Dealer</b>	Timing: Mark-to-market taxation Character: ordinary	Timing: can elect mark-to-market taxation -if no election, recognize in sale or disposition Character: ordinary	Timing: recognize in sale or disposition Character: ordinary
<b>Trader</b>	Timing: can elect mark-to-market taxation - if no election, recognize in sale or disposition Character: ordinary	Timing: can elect mark-to-market taxation -if no election, recognize in sale or disposition Character: ordinary	Timing: recognize in sale or disposition Character: ordinary
<b>Investor</b>	Timing: recognize in sale or disposition Character: capital	Timing: recognize in sale or disposition Character: capital	Timing: recognize in sale or disposition Character: capital
<b>Not for profit</b>	No deduction	No deduction	No deduction

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## What is the status of the taxpayer?

### *Dealer*

A dealer is a “merchant” who buys and sells property “with a view to the gains and profits that may be derived therefrom.”<sup>2</sup> For example, a stock broker like Charles Schwab would be a dealer in stocks and bonds—an entity that makes money not on the appreciation of securities, but on the transactions that it enters into with its clients. Nevertheless, we note that it is more likely that an individual will be a trader, not a dealer.

### *Trader*

A trader is someone engaged in the trade or business of trading property. This trading must be frequent, regular, and continuous.<sup>3</sup> For example, an individual who makes over 1,100 executed sales of cryptocurrency during the year may be characterized as a trader of cryptocurrency.<sup>4</sup> Unlike a dealer, the trader makes money not on behalf of clients, but for him or herself from activities “directed to short-term trading, not the long-term holding of investments.”<sup>5</sup>

### *Investor*

An investor is a taxpayer who does not fit into the category of either a dealer or trader.<sup>6</sup> For example, a lawyer that practices law for 40 hours a week and spends 1 hour a week managing her cryptocurrency portfolio will be considered an investor. Still, to deduct losses from cryptocurrency, the individual must be engaged in a for profit activity. For example, an investor cannot deduct a loss if she uses the cryptocurrency as a “medium of exchange” (e.g., like the U.S. dollar) but may be able to deduct she uses the cryptocurrency as a “unit of account” or as a “storage of value.”<sup>7</sup>

### *Individuals not engaged in profit activity*

Some taxpayers do not intend to profit from holding cryptocurrency. The so-called “hobby-loss” rules prevent certain taxpayers, including individuals, from deducting a loss recognized on the disposition of property if the taxpayer is “not engaged” in holding the asset as part of a for-profit activity.<sup>8</sup> If a person purchases cryptocurrency not with an intent to make money on the cryptocurrency but instead with an intent to buy because the individual enjoys spending leisure time trading cryptocurrency, that individual likely will be unable to deduct that loss because of the hobby-loss rules.

Whether a taxpayer is engaged in a “for profit” activity or “not engaged in profit activity” is hard to distinguish. Fortunately, there is a statutory presumption for certain taxpayers: if a taxpayer’s cryptocurrency income exceeds his or her deductions for 3 of the past 5 years, it is *presumed* that the taxpayer is engaged in a for-profit activity (unless

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<sup>2</sup> See, e.g., Treas. Reg. § 1.471-5.

<sup>3</sup> See, e.g., *Commissioner v. Groetzinger*, 480 U.S. 23, 33 (1987); see also Robert Daily, *Deducting Family Office Expenses after Lender*, 45 ACTEC L. JOURNAL (forthcoming 2020) (analyzing case law and distinguishing the activities of traders, investors, and dealers).

<sup>4</sup> Cf. *Moller v. Commissioner*, 721 F.2d 810, 813 (1983) (concluding that a person was a trader after executing 1,100 stock trades during the year).

<sup>5</sup> *Id.*

<sup>6</sup> This analysis only addresses the consequences to an investor who is an individual.

<sup>7</sup> See Rev. Rul. 2019-24. This analysis is similar to that which the IRS has applied in when determining whether gold coins are “currency” or “numismatic coins” under section 1031. Compare Rev. Rul. 76-214 (ruling that two official government coins were “like kind” property under section 1031) with *Calif. Fed. Life Ins. Co. v. Comm’r*, 680 F.2d 85, 87 (9th Cir. 1982) (holding that a numismatic coin was not equivalent to a circulating currency).

<sup>8</sup> I.R.C. § 183(a); Treas. Reg. § 1.183-1(b)(4).

the IRS proves otherwise).<sup>9</sup> If this presumption does not apply, the taxpayer may argue that he “entered into the activity, or continued the activity, with the objective of making a profit,” but it may be difficult to satisfy this test.<sup>10</sup>

## What is cryptocurrency?

The IRS has said that cryptocurrency is treated as property for U.S. federal tax purposes.<sup>11</sup> But that is not the end of the question. The analysis below considers the application of loss rules applicable to different types of property.

### *Security*

In 2019, the Securities and Exchange Commission released informal guidance on when digital assets like cryptocurrency would be considered a “security” under federal securities laws.<sup>12</sup> The IRS has not said whether cryptocurrency can be considered a security under section 475, which governs the accounting method (and character) for dealers and traders in securities (and commodities). However, we note that such an argument seems textually difficult.<sup>13</sup> Regardless, an individual who holds cryptocurrency as a security may face the following federal income tax consequences:

- A dealer in securities should mark to market any losses at the end of the year, meaning that gain or loss would be recognized as if such security was sold for its fair market value on December 31.<sup>14</sup>
- A trader in securities that makes an election under section 475(f)(1) should also receive mark-to-market treatment and recognize an ordinary loss.
- An investor and a trader in securities that does not make a section 475(f)(1) election should recognize gain or loss when upon the sale or other disposition of the cryptocurrency.<sup>15</sup> Additionally, such a taxpayer may be able to claim a “worthless security” deduction if the cryptocurrency loses all of its value in the year.<sup>16</sup> A trader recognizes any such loss as an ordinary loss while an investor recognizes the loss as capital.<sup>17</sup>

### *Commodity*

There may be a stronger position for treating some types of cryptocurrency as a commodity. For example, the Commodity Futures Trading Commission has long taken the position that Bitcoin is a commodity under the Commodity Exchange Act.<sup>18</sup> The IRS has not said whether cryptocurrency is a commodity, but taxpayers may be able to take such a position if the cryptocurrency is personal property that is actively traded.<sup>19</sup> If a taxpayer believes he holds a commodity, the following tax rules may apply to losses:

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<sup>9</sup> I.R.C. § 183(d).

<sup>10</sup> Treas. Reg. § 1.183-2(a).

<sup>11</sup> See IRS Notice 2014-21.

<sup>12</sup> See U.S. Securities and Exchange Commission, Statement on Framework for Investment Contract Analysis of Digital Assets, <https://www.sec.gov/news/public-statement/statement-framework-investment-contract-analysis-digital-assets>. However, the SEC Chairman said that a token could be a security, but Bitcoin would not be one. See Ethan Wolff-Mann, *SEC announces cryptocurrency ether is not a security*, Yahoo Finance <https://finance.yahoo.com/news/sec-announces-ether-not-security-162658147.html>.

<sup>13</sup> Specifically, we note that the term security in I.R.C. § 475(c)(2) is significantly narrower than how the SEC uses the term security.

<sup>14</sup> I.R.C. § 475(a)(2)(A).

<sup>15</sup> I.R.C. § 1001(a).

<sup>16</sup> I.R.C. § 165(g). This deduction may be relevant to taxpayers who received a hard fork that became worthless in subsequent year.

<sup>17</sup> Note that individuals can only deduct capital losses to the extent of a taxpayer’s capital gains plus \$3,000. See I.R.C. § 1221.

<sup>18</sup> See *In the Matter of* Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29, available at <http://www.cftc.gov/idc/groups/public/@Irenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>.

<sup>19</sup> I.R.C. § 1092(d)(1).

- A dealer in commodities and a trader in commodities may make an election to receive mark-to-market treatment and recognize an ordinary loss.<sup>20</sup>
- A dealer or trader that does not make an election will recognize a loss when the cryptocurrency is sold or otherwise disposed of. This loss constitutes an ordinary loss.<sup>21</sup>
- An investor in a commodity recognizes a capital loss when a cryptocurrency is sold or otherwise disposed of.

### *Other Property*

If cryptocurrency is neither a security nor a commodity, the following tax consequences may apply:

- A dealer or trader realizes an ordinary loss when the cryptocurrency is sold or otherwise disposed of, or upon theft of the cryptocurrency (e.g., through a replay attack or a Ponzi Scheme).<sup>22</sup>
- An investor can recognize a capital loss when the taxpayers sells or disposes of the cryptocurrency. However, the 2017 Tax Cuts & Jobs Act limited investors ability to deduct losses from theft or Ponzi Schemes until 2026.<sup>23</sup>

Additionally, if cryptocurrency is characterized as a foreign currency, individuals may need to recognize ordinary gain or loss if the taxpayer disposes of that cryptocurrency.<sup>24</sup> Section 988 applies to govern the tax treatment of investors, dealers, and traders, but it is most relevant for investors who may otherwise have a capital (rather than ordinary) loss.

### **Is the individual in a trade or business?**

Section 461(l), enacted in 2017 as part of the TCJA, limits an individual's ability to take a deduction for certain "excess business losses." Individuals can only take "the aggregate deductions of the taxpayer...attributable to trades or business of such taxpayer" when the taxpayer has gross income or gain "attributable to such trades or businesses."<sup>25</sup> A taxpayer who is a "dealer" or a "trader" is likely in a trade or business while an "investor" is not.<sup>26</sup> Taxpayers may also deduct up to an extra \$250,000 (\$500,00 if married couple filing a joint return) of excess business losses that exceed business income.<sup>27</sup> That said, individuals need not worry about this Code section now: Congress recently deferred the applicability of section 461(l) until 2021 for calendar year taxpayers.<sup>28</sup>

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For questions or additional information, please free to contact us.

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<sup>20</sup> See I.R.C §§ 475(e)(1)(A), 475(f)(2).

<sup>21</sup> See I.R.C. § 1221(a)(1).

<sup>22</sup> I.R.C. § 165(c); Rev. Rul. 2009-9.

<sup>23</sup> I.R.C. § 165(h)(5)(A). That said, individuals can deduct "personal casualty losses" if they have "personal casualty gains".

<sup>24</sup> For a more complete discussion of this issue, please see our other paper in the LukkaTax library labeled "Potential for Cryptocurrency to be Treated as Foreign Currency (Giving Rise to Ordinary Gains / Losses)."

<sup>25</sup> I.R.C. § 461(l)(3).

<sup>26</sup> See *supra* note 3.

<sup>27</sup> Additionally, if taxpayers are not limited by section 461(l) but still have a negative amount of total income, the taxpayer may be able to carryforward that loss to another tax year. Individuals will get a "net operating loss" (NOL) if the taxpayer's business deductions exceed business income. See I.R.C. § 172. This NOL may reduce a taxpayer's future income (up to 80% of a taxpayer's future income). That said, Congress removed the 80% limitation for individuals and allowed taxpayers to carryback losses for tax years 2018, 2019, and 2020.

<sup>28</sup> For a summary of the bill, please see Richard Bloom & Ivins, Phillips & Barker, *Cares Act Provides Tax Relief For Individuals And Businesses*, <https://mazarsusa.com/ledger/cares-act-provides-tax-relief-for-individuals-and-businesses/>.



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