# Taxation of Digital Assets

**In collaboration with Eaglebrook Advisors**

**Executive Summary**

"Virtual currency," aka digital assets or cryptocurrency, is considered "property" according to the IRS. The tax treatment of virtual currency transactions is typically determined by how the taxpayer intends to use the digital asset. For tax purposes, digital asset transactions held for investment are treated similarly to security (stock) transactions. Currently, the wash sale rule does not apply to digital assets due to their designation as property.

Digital asset regulation is still ambiguous in the U.S., so the taxation may not always be straightforward. We must look to similar scenarios in the tax law and tax court cases to apply them as best we can to digital assets. One common misconception is that all digital asset transactions result in a capital gain or loss; this is not true. The rate at which your income/loss is taxed is determined by the character of the gain or loss and is generally higher if it is not a capital gain or loss.

In this report, we discuss:

- Federal Taxation for Common Digital Asset Transactions
- Tax Loss Harvesting & Wash Sale Applicability
- IRS Reporting Requirements & Form 8949

**Federal Taxation for Common Digital Asset Transactions**

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In general, if a taxpayer sells or exchanges digital assets, a taxable event has occurred, and the character of the transaction could either be capital or ordinary in nature. However, there also are four common nontaxable events related to digital assets that can typically be carried out without reporting income, gain, or loss:

1. Purchasing and holding digital assets;
2. Transferring digital assets from one wallet to another, where both wallets must be owned by the same party;
3. Gifting digital assets if the gift is under the annual exclusion ($17,000 per donee in 2023); and
4. Donating digital assets to a charitable organization (although you may be able to claim this as an itemized deduction on your tax return).

There are five common events that could cause a transaction to be taxable:

1. Converting digital assets to fiat currency, e.g., U.S. dollars;
2. Converting a digital asset to another digital asset;
3. Purchasing goods or services with digital assets;
4. Receiving digital assets as compensation, a fork, or an air drop; and
5. Receiving mining, staking, or other DeFi rewards.





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Once the character of the transaction has been determined, taxpayers can refer to the applicable tax rates for help in determining their tax liability from digital asset transactions.

**2023 Capital Gains Tax Brackets**

| | For Unmarried Individuals, Taxable Income Over | For Married Individuals Filing Joint Returns, Taxable Income Over | For Heads of Households, Taxable Income Over |
|---|---|---|---|
| 0% | $0 | $0 | $0 |
| 15% | $44,625 | $89,250 | $59,750 |
| 20% | $492,300 | $553,850 | $523,750 |

Source: Internal Revenue Service

**Tax Loss Harvesting & Wash Sale Applicability**

A seemingly inescapable topic when discussing buying and selling digital assets is whether the traditional wash sale rules that apply to stocks or securities also apply to digital assets. IRS Publication 550 states that: "A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

1. Buy substantially identical stock or securities,
2. Acquire substantially identical stock or securities in a fully taxable trade,
3. Acquire a contract or option to buy substantially identical stock or securities, or
4. Acquire substantially identical stock for your individual retirement arrangement (IRA) or Roth IRA."

In other words, if you purchase a stock or security, sell the stock or security at a loss, and turn around and purchase a substantially identical stock or security within 30 days, the loss is disallowed. Since digital assets are classified as property for tax purposes, wash sale rules do not apply (as of the writing of this article). In Gantner v. Commissioner[1], the IRS sought to disallow the loss sustained from a taxpayer selling and immediately buying back call options. The court ultimately ruled in favor of the taxpayer because the loss the taxpayer sustained was not from the sale of stock or securities.

With traditional wash sale rules not currently being applicable, taxpayers can take advantage of what is known as "tax-loss harvesting." Tax-loss harvesting, put simply, is a strategy allowing taxpayers to sell their investments at a loss to offset other capital gains while maintaining a similar position in the asset. Importantly, an investor is able to sell and buy back the same digital asset.

*Tax-Loss Harvesting Example*

Taxpayer A purchases one bitcoin for $60,000 in November 2021. As of September 2022, Taxpayer A is still holding their bitcoin. Taxpayer A knows wash sale rules don't apply for digital assets and sells their one bitcoin for $19,000.

Taxpayer A, after selling their one bitcoin, repurchases one bitcoin for $19,000.

Taxpayer A still has approximately one bitcoin and now has $41,000 in tax losses to report on their 2022 tax return. Had the wash sale rules applicable to stocks or securities applied to digital assets, Taxpayer A's $41,000 loss would not be allowed. When capturing this loss on a tax return, taxpayers should keep in mind capital loss limitations and their elected inventory valuation method used in previous years.

1 Gantner v. Comm'r of Internal Revenue, 92 T.C. 192 (U.S.T.C. 1989).

**Digital Assets to Fiat**

In most circumstances, converting digital assets to fiat would result in a capital gain or loss. This is the most common event related to digital assets and a simple formula should be used to determine a taxpayer's gain or loss. The formula is as follows:

*Proceeds – Cost Basis = Gain/Loss*

Proceeds: Fair market value received less any transaction fees

Cost Basis: Purchase price plus any acquisition costs, e.g., transaction fees

The gain or loss may be either short-term or long-term. If the taxpayer has held the digital asset for exactly one year or less, it would be a short-term capital gain or loss. If the digital asset has been held for more than one year, it would be treated as long-term. These gains or losses are then reported on Form 8949 and Schedule D of a taxpayer's individual tax return.

*Converting Digital Assets to Fiat Example*

Taxpayer A purchases one bitcoin in 2017 for $5,000. The fee associated with the purchase was $100. Taxpayer A decides to sell a portion of their bitcoin, 0.4 bitcoin, in 2021 when bitcoin was trading at a fair market value of $50,000, resulting in $20,000 of proceeds. Taxpayer A has a long-term capital gain of $17,960.

Proceeds: $20,000 ($50,000 x 0.4).

Cost Basis: $2,040 (($5,000 + $100) x 0.4).

Gain: $17,960 ($20,000 - $2,040).

Tax Action Item: The $17,960 gain should be reported on the taxpayer's Form 8949 and Schedule D in tax year 2021.

Remaining bitcoin = 0.6

Value in USD = $30,000 (50,000 x 0.6)

Remaining basis in bitcoin: $3,060 ($5,100 x 0.6)

**Determining Cost Basis**

It's important to note that in the above example, specific identification was used to determine cost basis. IRS Virtual Currency FAQ guide suggests that specific identification or first-in-first-out (FIFO) are the only two methods available for determining cost basis; however, this is a non-authoritative guide. This leaves the door open for other cost basis methods such as last-in-first-out (LIFO) and highest-in-first-out. Take a look at the next example for an illustration of how this can change your overall tax strategy.

*Cost Basis Example*

Taxpayer D purchases one bitcoin in 2017 for $5,000. The fee associated with the purchase was $100. Taxpayer D purchases one more bitcoin for $30,000 in July 2021. The fee associated with the purchase was $200. Taxpayer D decides to sell a portion of their bitcoin, 0.4 bitcoin, in January 2022 when bitcoin was trading at a fair market value of $50,000, resulting in $20,000 of proceeds.

| | FIFO | LIFO |
|---|---|---|
| Proceeds | $20,000 ($50,000 x 0.4) | $20,000 ($50,000 x 0.4) |
| Cost Basis | $2,040 (($5,000 + $100) x 0.4) | $12,080 (($30,000 + $200) x 0.4) |
| Gain | $17,960 ($20,000 - $2,040) | $7,920 ($20,000 - $12,080) |
| Nature of Gain | Long Term | Short Term |

**IRS Reporting Requirements & Form 8949**

Taxpayers may be familiar with receiving Form 1099, which summarizes their annual brokerage account tax information. These Forms 1099 report gains, losses, interest income, and dividend income, among other items. Digital asset activity is generally not required to be reported on a 1099 until the IRS publishes final regulations at some point in the future. As of the writing of this article, the IRS is working on the proposed regulations. Until then, the burden for calculating and summarizing a taxpayer's activity is left to the taxpayer. Receiving a Form 1099 is not the only triggering event requiring taxpayers to report digital asset activity. In fact, the act of performing the transactions triggers the reporting requirement regardless of receipt of a 1099.

Taxpayers that use centralized exchange products may be fortunate enough to receive a summarized report for their tax reporting. Other centralized exchanges may still only allow taxpayers the option to download a spreadsheet that lists all of the taxpayer's transactions. These spreadsheets are typically difficult to interpret and can be time-consuming to digest. On-chain transactions are recorded on a public blockchain; however, there is no spreadsheet or summarized report that can be provided because public blockchains are decentralized.

Taxpayers are left with a couple of options to procure a summarized report of their tax gain, loss, and income items if they are not already provided one by an exchange. The first option: track all of their transactions in a spreadsheet. This is time-consuming, requires expertise in how to read the data, and is subject to human error. The second option: use crypto-tax software products like Ledgible, TaxBit, or CoinTracker. These software products allow taxpayers to connect their wallets and centralized exchange accounts and can automatically pull in transactions, analyze the transactions, and provide reporting. However, these software products often come with a cost.

**The Benefits of the SMA Structure**

Separately managed accounts (SMAs) offer financial advisors the opportunity to work with their clients to own digital assets directly in the client's name. With SMAs, clients can fully customize their overall digital asset portfolio based on risk tolerance and investment objectives with a minimal to no tracking error rate and limited administrative costs. While some investment vehicles are tailored to benefit a targeted group, an SMA's strategy is tailored specifically to its owner. Eaglebrook's proprietary trading system identifies tax-loss harvesting opportunities creating tax efficiencies. Finally, SMAs offer transparency into each individual trade so clients can see their account details.

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**Eaglebrook Advisors**

Founded in 2019, Eaglebrook Advisors is a turnkey asset management platform (TAMP) that provides institutional access to digital asset solutions for wealth management firms and their clients. Eaglebrook is an SEC-registered investment advisor that works with over 50 RIAs and has over 650 financial advisors allocating to digital assets through the company's TAMP. The Platform offers custom allocation modules and access to third-party asset manager models in separately managed account (SAM) format. This solution allows for seamless client onboarding, investment, reporting, and holistic portfolio management of a client's bitcoin and digital asset investments within a secure, compliant, unified ecosystem.

**Disclosures**

This is presented for informational purposes only and has not been verified by a qualified tax or legal professional and should not be relied upon as legal or tax advice. Eaglebrook is an investment advisor and is not licensed or permitted to provide legal or tax advice. Please consult your CPA or tax attorney for advice on taxability of digital assets. Or, for more information on the tax treatment of property transactions, please see www.irs.gov, where the Internal Revenue Service provides several publications, including Notice 2014-21 and Publication 544, Sales, and Other 7 48022522.8 Dispositions of Assets. Where some digital assets are treated for tax purposes as property, the wash-sale rule presently does not apply, but that is subject to change. Some digital assets such as bitcoin and ether are treated by the Internal Revenue Code as property and as such general tax principles applicable to property transactions apply to digital asset transactions.

For important information about Eaglebrook Advisors and the services we offer, please see our Form ADV and Form CRS at www.eaglebrookadvisors.com. Please review our Privacy Policy for information on the use and protection of your personal information.

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