

**Abstract:** As investing in Bitcoin, Dogecoin and other cryptocurrencies becomes more popular, investors need to understand the potential tax ramifications. Unlike traditional currency, the IRS views cryptocurrency as property. This article explores the impact on capital gains and losses as well as defines key terms such as “hard forks” and “air drops.”

## **Curtailing tax surprises with cryptocurrency**

As investing in Bitcoin, Dogecoin and other cryptocurrencies becomes increasingly popular, investors need to understand the potential tax ramifications. Unlike traditional currency, the IRS views cryptocurrency as *property* for federal income tax purposes and even asks about it on IRS Form 1040.

Many transactions involving cryptocurrency — such as purchases of goods or services — become taxable events where the purchase is also considered a sale. In addition, certain changes to the blockchain (the distributed digital “ledger” on which cryptocurrency transactions are typically recorded) can trigger taxable income.

### **Gains and losses**

Because cryptocurrency is property, investors recognize a capital gain or loss when they sell it in exchange for traditional currency. As with other capital assets, the amount of gain or loss is the difference between the adjusted basis in the cryptocurrency (usually, the amount paid to acquire it) and the amount for which it’s sold. And, as with other capital assets, gain or loss may be short term or long term, depending on whether an investor held the cryptocurrency for more than one year. If cryptocurrency is sold at a loss, there may be limitations on the deductibility of the capital losses.

Cryptocurrency owners often are surprised to discover that using cryptocurrency to pay for goods or services can also trigger a capital gain or loss. Let’s say you purchased 10 units of cryptocurrency 10 years ago for \$1,000 each, or a total of \$10,000. This year, when the cryptocurrency’s price has climbed to \$5,000 per unit, you use it to purchase a \$50,000 car. Assuming your adjusted basis in the cryptocurrency is \$10,000, you’ll recognize a \$40,000 long-term capital gain. Generally, your gain or loss is the difference between your adjusted basis in the cryptocurrency and the fair market value of the goods or services you receive in exchange for it.

### **Forks and drops**

In some cases, a cryptocurrency owner may recognize taxable income because of certain blockchain events. Taxable income may be triggered even if you don’t conduct transactions or take any other actions with the cryptocurrency.

IRS guidance in 2019 addressed the tax implications of two types of blockchain events: “hard forks” and “airdrops.” A hard fork occurs “when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger.” Put much more simply, it’s when a single cryptocurrency is split in two.

A hard fork may or may not be followed by an airdrop, which the IRS describes as “a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers.” According to the guidance, when an airdrop follows a hard fork, it “results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency.” In simpler terms, it’s when “free coins” representing the new cryptocurrency are dropped into the existing cryptocurrency wallets of the owners of the legacy cryptocurrency.

If the new cryptocurrency isn’t airdropped or otherwise transferred to an account of the legacy cryptocurrency’s owner, a hard fork doesn’t trigger taxable income. On the other hand, if a hard fork is followed by an airdrop (which enables owners to immediately dispose of the new cryptocurrency), the owner recognizes ordinary income in the year the new cryptocurrency is received.

### **Stay current**

Buying and selling cryptocurrency involves significant risk, including the possibility you could lose part or all of the money you’ve invested. Tax treatment of cryptocurrency is also subject to change. The IRS will likely continue to provide guidance on the distinctive tax issues presented by cryptocurrency. We can help you stay current on these developments and work with you to avoid unpleasant tax surprises.

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