

DO YOU OWE TAXES ON YOUR CRYPTOCURRENCY PROFITS?

CULLEN ARMSTRONG*

In 2021, the global cryptocurrency market exceeded \$1.7 billion—a market that was a mere fantasy in the early 2000s.¹ Bitcoin, the world’s most well-known cryptocurrency, was valued at \$0.09 per bitcoin in 2010.² Fast forward to its peak in November 2021 where a single bitcoin was selling for over \$68,000.³ To put this into perspective, if you bought 1,000 bitcoins in 2010 and sold them at their peak in 2021, you would have profited approximately \$68 million.

The ability to make such a profit poses an interesting question: are cryptocurrency profits subject to taxation? In short, yes. The goal of this article is to explain why taxpayers owe taxes on their cryptocurrency profits and outline the recent attempts by both the Internal Revenue Service (“IRS”) and Congress to crack down on tax evasion in the ever-evolving cryptocurrency market.

IRS GUIDANCE

In 2014, after several years of uncertainty regarding the taxation of cryptocurrency, the IRS attempted to clarify this issue through its release of Notice 2014-21.⁴ This Notice provided guidance to U.S. taxpayers on the federal tax consequences of selling and exchanging

*LL.M. in Taxation Candidate, May 2023, University of Florida; Student Materials Editor, *Cumberland Law Review* Volume 52; Juris Doctor, May 2022, Cumberland School of Law; B.S. Accounting, May 2019, Auburn University.

¹See *Cryptocurrency Market: Global Industry Trends, Share, Size, Growth, Opportunity and Forecast 2022-2027*, RSCH. & MKTS. (Feb. 2022), https://www.researchandmarkets.com/reports/5546940/cryptocurrency-market-global-industry-trends?utm_source=GNOM&utm_medium=PressRelease&utm_code=b7t8rj&utm_campaign=1663906+-+Global+Cryptocurrency+Market+Report+2022-2027+-+Industry+to+Cross+a+Staggering+%2432.4+Trillion+by+2027%2c+Exploding+with+a+CAGR+of+58.4%25&utm_exec=joca220prd [https://perma.cc/G8LF-SK35]; see also *Global Cryptocurrency Market Report 2022-2027 - Industry to Cross a Staggering \$32.4 Trillion by 2027, Exploding with a CAGR of 58.4%*, YAHOO! (Feb. 25, 2022), <https://www.yahoo.com/now/global-cryptocurrency-market-report-2022-120800380.html> [https://perma.cc/E832-ASXK].

² John Edwards, *Bitcoin’s Price History*, INVESTOPEDIA, <https://www.investopedia.com/articles/forex/121815/bitcoins-price-history.asp> [https://perma.cc/5AU3-JQJJ] (May 12, 2022).

³ *Id.*

⁴ See generally I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (Apr. 14, 2014).

virtual currency, a category of currency that includes cryptocurrency.⁵ The IRS has since expanded this Notice through a Frequently Asked Questions (“FAQs”) page on its website dedicated to the taxation of virtual currencies.⁶

As an initial premise, the IRS has established that “virtual currency is treated as property” for purposes of federal taxation.⁷ Consequently, the same tax principles that apply to property transactions also apply to virtual currency transactions.⁸ In addition, the IRS has indicated that taxpayers must recognize a capital gain or loss upon the sale or exchange of virtual currency.⁹ Any gain or loss recognized must be reported on the taxpayer’s Form 8949¹⁰ and Form 1040¹¹ as a capital gain or loss, and the taxpayer must pay taxes in accordance with his or her applicable tax rate.¹²

The IRS has further provided guidance to taxpayers on how to calculate their capital gains or losses. A taxpayer’s gain or loss upon the sale or exchange of virtual currency is the difference between the taxpayer’s amount realized for the virtual currency and its adjusted basis in the virtual currency.¹³ To simplify, it is the difference between what the taxpayer received in exchange for the virtual currency and what the taxpayer originally paid to acquire the virtual currency.¹⁴

⁵ *See id.*

⁶ *Frequently Asked Questions on Virtual Currency Transactions*, IRS, <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [<https://perma.cc/U72A-B2F8>] (last visited Apr. 7, 2022).

⁷ I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 (Apr. 14, 2014).

⁸ *Id.*

⁹ *Id.* at 939. Only virtual currency that is characterized as a capital asset is subject to capital gain or loss tax treatment. *Id.* For most individual taxpayers, virtual currency is characterized as a capital asset similar to other investment property, such as stocks and bonds. *See id.* In contrast, virtual currency that is held as inventory rather than investment property is not considered a capital asset and will be taxed at the taxpayer’s ordinary income rates. *See id.* For purposes of this article, it is assumed that virtual currency is held as a capital asset. I.R.S. Notice 2014-21, 2014-16 I.R.B. 939 (Apr. 14, 2014).

¹⁰ Taxpayers use Form 8949 to report their capital gains and losses to the IRS each year. *See About Form 8949, Sales and other Dispositions of Capital Assets*, IRS, <https://www.irs.gov/forms-pubs/about-form-8949#:~:text=Use%20Form%208949%20to%20reconcile,will%20be%20calculated%20in%20aggregate> [<https://perma.cc/4Q33-NMAD>].

¹¹ The subtotals from Form 8949 are carried over to a taxpayer’s Form 1040, which taxpayers use to report their annual income to the IRS. *Id.*; *see About Form 1040, U.S. Individual Income Tax Return*, IRS, <https://www.irs.gov/forms-pubs/about-form-1040> [<https://perma.cc/4LH5-YPVK>].

¹² *See Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 6.

¹³ *Id.*

¹⁴ *Id.*

Taxpayers also must determine whether their gain or loss is a short-term or long-term capital gain or loss.¹⁵ Taxpayers should recognize a *short-term* capital gain or loss if they held the virtual currency for a year or less before they sold or exchanged the virtual currency.¹⁶ A short-term capital gain or loss will be taxed at the taxpayer's ordinary income rate.¹⁷ In contrast, if the virtual currency is held for longer than a year, the taxpayer will recognize a *long-term* capital gain or loss that will be taxed at the taxpayer's capital gains rate.¹⁸ A taxpayer's capital gains rate tends to be lower than his or her ordinary income rate and thus can be more favorable to taxpayers.¹⁹ Hence, it is imperative for taxpayers to keep track of their holding period because virtual currency held for a year or less receives different tax treatment than virtual currency held for longer than a year.

MEASURES TO COMBAT TAX EVASION IN THE CRYPTOCURRENCY MARKET

In an attempt to gather more information on taxpayers' involvement in the virtual currency market, the IRS added a virtual currency question to every taxpayer's Form 1040.²⁰ The question asks: "At any time during [the applicable tax year], did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?"²¹ All taxpayers must answer this question by either checking "Yes" or "No."²² The IRS will likely use this information to ensure taxpayers who affirmatively answer this question properly report any profits from their involvement in the virtual currency market.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *See id.*; DEP'T OF THE TREAS., IRS, CAT. NO. 15074K, PUBLICATION 544: SALES AND OTHER DISPOSITIONS OF ASSETS 1, 19, 34 (2022). The 2021 tax year ordinary income rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37% as determined by income and filing status. Ellen Chang & Kemberley Washington, *2021-2022 Tax Brackets and Federal Income Tax Rates*, FORBES ADVISOR, <https://www.forbes.com/advisor/taxes/taxes-federal-income-tax-bracket/> [<https://perma.cc/RM8U-YCXV>] (Mar. 15, 2022).

¹⁸ *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 6. The 2021 tax year capital gains rates are 0%, 15%, and 20% as determined by income and filing status. Tina Orem & Sabrina Parys, *2021-2022 Capital Gains Tax Rates — and How to Calculate Your Bill*, NERDWALLET (Apr. 12, 2022), <https://www.nerdwallet.com/article/taxes/capital-gains-tax-rates> [<https://perma.cc/N6RG-LFCH>].

¹⁹ Orem & Parys, *supra* note 18.

²⁰ *See generally* I.R.S. News Release IR-2022-61 (Mar. 18, 2022).

²¹ The IRS released an online news release providing guidance to taxpayers on how to properly answer this question. *See id.*

²² *Id.*

Additionally, in March 2021, the IRS launched “Operation Hidden Treasure” to combat tax evasion in the cryptocurrency market.²³ Through its fraud enforcement and criminal investigation units, the IRS will actively seek taxpayers who fail to report cryptocurrency profits on their tax returns.²⁴ With much more to learn about the cryptocurrency market, trained agents are making it a priority to uncover taxpayers that are using specialized techniques to avoid paying taxes on their cryptocurrency transactions.²⁵

Not only has the IRS taken a tough position on the taxation of virtual currency, but Congress has done the same. The bipartisan infrastructure bill passed by Congress in 2021 included a requirement that virtual currency brokers file a Form 1099-B with the IRS.²⁶ Traditionally, stockbrokers have been required to file this form with the IRS each year reporting the taxable gains and losses of their customers.²⁷ Starting January 1, 2024, virtual currency brokers also must file a Form 1099-B with the IRS each year reporting the taxable gains and losses of their customers.²⁸ The IRS has a computerized system that compares a Form 1099-B attributable to a particular taxpayer with that taxpayer’s reported income.²⁹ Thus, if a taxpayer fails to report virtual currency profits and his or her broker properly files a Form 1099-B, the IRS will flag this deficiency.³⁰

EXAMPLE

Let’s assume Taxpayer A buys a single bitcoin for \$45,000. Taxpayer A holds this bitcoin until he sells it for \$60,000 fifteen months later. Taxpayer A held the bitcoin for longer than a year, so he has a

²³ Guinevere Moore, *Operation Hidden Treasure Is Here. If You Have Unreported Crypto, Get Legal Advice*, FORBES (Mar. 6, 2021, 4:07 PM), <https://www.forbes.com/sites/irswatch/2021/03/06/operation-hidden-treasure-is-here-if-you-have-unreported-crypto-its-time-to-get-legal-advice/?sh=2b57e50839c9> [https://perma.cc/VT48-HY6Y].

²⁴ *Id.*

²⁵ *See id.*

²⁶ *See* Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, § 80603, 135 Stat. 429, 1339–41 (2021); Shehan Chandrasekera, *How The Infrastructure Bill Is Brewing A Crypto Tax Compliance Nightmare*, FORBES (Nov. 30, 2021, 12:53 PM), <https://www.forbes.com/sites/shehanchandrasekera/2021/11/30/how-the-infrastructure-bill-is-brewing-a-crypto-tax-compliance-nightmare/?sh=5323d39169a9> [https://perma.cc/63SP-MQNV].

²⁷ Chandrasekera, *supra* note 26.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *See id.*

long-term capital gain of \$15,000³¹ and is taxed at his capital gains rate.³² At the end of the year, Taxpayer A is required to report this gain on his Form 8949 and Form 1040 as a \$15,000 long-term capital gain.³³ In addition, Taxpayer A's broker is required to report this \$15,000 long-term capital gain on a Form 1099-B that is filed with the IRS.³⁴

If, on the other hand, Taxpayer A sold the bitcoin for \$60,000 *six* months after the purchase, he would recognize a *short-term* capital gain of \$15,000 since he held the bitcoin for a year or less.³⁵ Consequently, Taxpayer A is taxed at his ordinary income rate.³⁶

CONCLUSION

The bottom line is that taxpayers owe taxes on their cryptocurrency profits, and the IRS is actively seeking taxpayers that fail to report those profits. Thus, it is important for taxpayers to keep track of certain attributes of their cryptocurrency to properly calculate their tax liability. Through different reporting requirements, a once-believed untraceable market is becoming much more transparent, and it will be interesting to see how the taxation of cryptocurrency evolves as its market has the potential to play a larger role in our everyday lives.

³¹ \$60,000 amount realized minus \$45,000 adjusted basis.

³² See *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 6.

³³ See *id.*

³⁴ See Infrastructure Investment and Jobs Act, § 80603; Chandrasekera, *supra* note 26.

³⁵ See *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 6.

³⁶ See *id.*