Covering Crypto Livestream

"Crypto & Your Taxes"

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TRANSCRIPT

SPEAKERS:

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JIM ARMSTRONG: Crypto can be confusing, and tax time does not make life any easier. Essentially here, we're all in the same place, trying to learn enough about crypto to make decisions and kind of in the back of our minds the whole time is that nagging question: Was I supposed to do something with this for my taxes? Thanks for joining us for our *Covering Crypto Livestream*.

I'm Jim Armstrong with Fidelity Crypto. Today's episode is going to start off with our usual market update, but then we'll focus on our top tax season customer questions, including identifying your crypto profits and how to figure out what taxes you might owe. What counts as crypto income—things like staking, learn-and-earn offers, hard forks, airdrops, and yes, we'll take a moment to define all of those terms as well. We'll talk about tracking your crypto losses and how that might help you at tax time, the forms you might need to file, and then, finally, some other tax tips that could help you during tax season.

We're very happy to have Chris Kuiper joining us for today's livestream discussion. Chris is the director of research at Fidelity Digital Assets. That's a separate business here at Fidelity that's dedicated to studying about and innovating in this very fast-changing space. Chris, thanks for doing another one of these livestreams with us.

CHRIS KUIPER: My pleasure, Jim. Thanks for having me.

JIM: Yeah, for sure. Today's show, of course, is all about crypto and taxes, but as always, we do want to start off with a recap on the cryptocurrency markets, the industry as a whole, things making news at the moment. So, Chris, I'll turn it over to you. What's got your attention as we speak?

CHRIS: Well, what's got my attention is this little rally we've been having in the digital asset space. After a brutal year of 2022, we are off to a strong start here. Bitcoin, for example, is up a little over 40% year to date in just the first month here. That's the biggest monthly gain we've seen since October of 2021, when we were up 40%, and it's the biggest January we've seen since, I believe, 2013.

So you have to go back quite a ways to get that kind of performance in January. So a little bit of an outsized month here, and what's interesting is that there was not one big catalyst that I or other people can really point to here. Now, that's not unusual for bitcoin. We've seen this before, and we're not really surprised by it because I think even on this show we've talked about some of the conditions that make it ripe for such a move, and really we're talking about how supply has gotten constrained.

So, for example, we've been noticing before this that the number of illiquid coins, in terms of bitcoin here, were reaching all-time highs. So these are the percentage of coins that haven't moved in over a year. That was getting well above 60%. So this indicates to us that people are holding those coins. They're maybe putting them into cold storage, that sort of thing.

The other thing we watch is balances on exchanges, so the number of coins that are currently on centralized exchanges for trading. That's been slowly draining and going down for quite a few months here, even a couple of years. So that trend continues. That also leads to reduced supply and can create these conditions.

And then also the derivatives market is sometimes interesting to look at. So we saw a lot of people positioning themselves short in the futures market. So they were betting that the price of bitcoin would continue to fall. They got caught off on the wrong side of that trade, and there was a lot of short liquidation that coincided with these moves up, which gives us some clues as to what's behind it.

And then, finally, the last thing I'll say is just on the macro front, we had the Fed decision this last week. Market participants took Jerome Powell's comments as quite dovish, meaning they think that they will pause or ease with their interest rate hikes. That's usually pretty good for digital assets, and this time was no different. We saw bitcoin briefly poking up above $24,000 on that release as well.

JIM: Great to see the green on our screens, as they say. So thanks for that context there, and we'll certainly keep asking questions like that every couple of weeks when we meet. So thank you for that, again. On to the topic at hand, taxes. One note, we will be answering crypto tax questions as best we can, but just remember Fidelity doesn't give tax advice.

So nothing we discuss today should be interpreted as tax advice. The information provided is going to be general in nature, and it might not apply to your specific situation. If you've got tax questions about your specific situation, you should speak with a tax advisor. So, Chris, I'm going to take the first couple of questions, but I'm definitely going to need your help explaining some things along the way.

CHRIS: Certainly, yes.

JIM: Cool, thanks. So we'll take our first customer question. It comes from Horace, who wrote in and said, Do you have to report buying and/or trading cryptocurrency on your taxes? So to do that question justice, we're probably going to have to break it up into a couple of parts. We'll start with the easy stuff.

Let's say you're buying and holding crypto. In that case, no. You don't have to report anything. Let's say you've taken $1,000 of your hard-earned cash, and you bought some bitcoin, maybe bought some ethereum as well. Let's say you're planning to hold them until they've gone up in value, and maybe you'll sell them then, or maybe not. In either event, as long as you're just holding, you don't need to report that on your taxes.

And the same thing is true if you transfer your crypto assets. Let's say you move from one wallet to another wallet or even from one exchange to another exchange. Those are not taxable events. You could think of it kind of like rolling over your retirement account from your old employer to your new one. If it's a straight transfer, no withdrawals, that's not going to trigger a tax bill.

However, when you trade that crypto for another crypto, or if you sell it straight out, then you've triggered what our friends at the IRS do call a taxable event, and you might owe taxes if you sell at a profit. Just a quick reminder, those are called capital gains taxes. You owe long-term capital gains if you've held the crypto for more than one year. Short-term capital gains taxes apply to crypto that you sell or trade after holding for one year or less.

Short-term cap gains rates are higher than long term, which is why some people will try to wait or try to wait to sell or trade until they've held their position for at least a year and one day. OK, so here's a hypothetical example. I'll give you a visual to work with as well. Let's say you've bought $5,000 worth of ethereum, and you hold it for a little while.

It's going to go up in value, perhaps, in this situation, and you decide you'd rather own some bitcoin. So you trade that ether for $7,000 worth of bitcoins. Now, some exchanges might call this a swap, taking one crypto and swapping or trading for another. You can call it a swap or a trade, but in any event, when you buy and sell cryptos, even if you do not move to cash as part of that process, that swap or trade is a taxable event.

So if you stop there, you would owe taxes on the $2,000 in capital gains. So remember, you're going to pay the higher short-term cap gains rate if you held the ether, in this case, for one year or less. And the original $5,000 you spent on the ether is called your cost basis, also known as your purchase price. All right, let's keep going and say your $7,000 bitcoin position goes up in value over time until it's worth, let's say, $15,000, had a good run in this case.

That's when you decide, maybe, that you want to buy a used car with that money. Now, whether you sell that position on an exchange and turn the bitcoin back into US dollars, or let's say you find a car dealership willing to take your bitcoin. The same thing essentially is happening. You're selling your crypto and closing that position. So in this example, your bitcoin cost basis is that $7,000 purchase price, meaning you would owe capital gains on the $8,000 growth of that bitcoin.

Finally, I should mention, too, that whenever and wherever you use crypto to buy something—a car or a cup of coffee, anything—it's technically a taxable event. And it is, therefore, up to you to calculate your original purchase price—that's your cost basis—and the value of the crypto when you bought that coffee or bought that car. And then you have to tell the IRS whether you had a loss or a gain on your crypto position at that time.

So that was a slightly nuanced answer, but one other thing to call out, what you definitely do have to report is when you get paid in crypto. So an obvious case would be if you're a freelancer doing some kind of work like writing, photography, coding, nannying, I mean, you name it, whatever the case, if you allow your clients to pay you in crypto. It all counts essentially as just income, and yeah, you have to pay taxes on it the same way as if you got paid in cash or a check.

It's also worth mentioning as well that you have to consider your state as well as federal taxes. Another tip here, you're definitely going to want to consult a tax advisor to figure out if you need to pay quarterly estimated income taxes, too. One more note before I have a question for Chris. Let's say you do a big project at a company that you're freelancing for, and let's say they pay you $5,000 in bitcoin on September 1 of the year. That's $5,000 in taxable income that you absolutely have to report no matter what happens to the value of bitcoin afterwards.

You might also have to report crypto as income if you get it in other ways, and, Chris, here's where I need your help. People can earn crypto, can get crypto for free through things like play-to-earn or learn-to-earn offers or airdrops where sometimes those are taxable events. Can you explain how those work?

CHRIS: Yeah, sure. So it reminds me of back in the day, there used to be these things called faucets. And these were just websites where you could go on them, and they even had bitcoin faucets where these websites would distribute free bitcoin or other crypto to anybody who wanted it. They would drip out like a faucet. And, of course, the point was just to get people using it. This is back in the day when bitcoin was worth basically nothing, and they just wanted people to play around with it.

Now, obviously those days are long gone, at least as far as I know. There's no way to get that much free bitcoin anywhere, but there are other ways to get free bitcoin or other crypto that's just starting out. So one of the ways is you can still get free crypto is by playing games. You can visit websites, complete a learning course or a quiz. And so even though these amounts are very small—so for example, playing a game of solitaire on your phone might get you a couple of sats, they still are technically income and must be reported.

Now, you mentioned airdrops. So airdrops are another way, and these are pretty popular, as a way to get free crypto tokens or coins. You can think of these things as a marketing expense or incentive from the developer or the people who are behind, say, a new blockchain ecosystem or a decentralized app. Now, why would they give these out free? Well, they want users to come on board and try it out.

They want them to play with it, give them feedback. They have to get this community and ecosystem jump-started or off the ground, so they're willing to give people free coins through airdrops. Now, how do you actually get them? Well, there's a number of ways, depending on the company or the person behind it. Sometimes if you hold a token, you might just get more added. Sometimes if you register a certain type of wallet, they'll send them to you that way.

Other times you just request them, or you can get them through free drawings or raffles or as prizes or something like that. But again, investors need to consult their tax advisor in regard to whether a particular airdrop is a taxable item to them. And while this doesn't have to do with taxes, I do want to add here, too, that be careful with airdrops, especially any of them that are asking for personal or private wallet information. So you might think you're getting free bitcoin or other crypto, but this has in the past been a popular way to scam people. So just a note of caution there.

JIM: Yeah, be wary for sure for anything that's free. But, Chris, can you also explain how income might be generated by an event called a hard fork? I kind of don't understand hard forks myself.

CHRIS: Yeah, hard forks can get a little complicated, but basically it's when you have a blockchain, and it splits into two versions. It literally forks like a fork in the road, right? So why does this come about, or why does it happen? Well, it comes about when there's a group of people or even just one person who proposes a change to the existing code of the blockchain. And that change of code is big enough that it's not backwards compatible, meaning the new code will not work with the old code.

So ideally, you want everyone to come along and change the code all together at the same time so you don't have this issue. However, if there's even just a few people, a minority, that don't like the change and don't want to change and upgrade their code, they'll keep running the old code. And everyone else that wants to change will start running the new code, and now you have a fork. You have two completely different blockchains, two different ecosystems, two different tokens.

They don't talk to each other anymore. They don't work together anymore. And so when this happens, usually the person holding the original tokens receives an equal amount of the new tokens when the split happens. So if you're a holder when it happens, you'll get new tokens from that hard fork. And this has actually happened many times with many different projects. It's happened many times early in even Bitcoin's original history.

This was commonly known as the blocksize wars when this was all going down. It was a pretty bitter civil war within the community at the time, where some people want to make the bitcoin blockchain faster, more efficient at transactions, and other people said no. We need to stay on this old system because it's more secure. And so you had a number of different splits, some forks, and the people who held—if you held five original bitcoin tokens at the time, you would get five new tokens of the new ones.

For example, a popular one at the time was called Bitcoin Cash. So if you held five tokens, you'd still hold those, but then you'd automatically just magically get these five Bitcoin Cash tokens as well. So that's the basics there. There's a lot more details, but again, investors need to consult their tax advisor in regard to whether a particular hard fork item is a taxable event to them.

JIM: Got it. And one more specific question for you, a terminology question, because it's another activity that could lead to owing income tax, is staking. Please, if you could remind us what staking is all about. We get a lot of questions about this, actually.

CHRIS: Yeah, so staking is when you agree to lock up some of your tokens in a network to help keep it secure. These networks are usually run on consensus mechanisms called proof of stake, right? And so in compensation for locking them up, for providing security to the network, you get a yield. You get a reward or some of the transaction fees as well from the network. And this reward in terms of a yield percentage, kind of like an APR, is—it's usually single digits or can be double digits for some.

And the bottom line here, unfortunately, is there is no specific tax guidance currently on this subject of staking. So it's another case where, unfortunately, I just have to say please consult your tax advisor and how they would approach this conservatively or not. So for any staking activities, consult them to see if the activities are taxable.

JIM: Makes a lot of sense, yeah. No shortage of questions when it comes to crypto and taxation, including this one from Doug, actually. Doug wrote in and said, Is Fidelity Crypto tax deductible? So if you're asking if you can buy and sell crypto and not have to pay taxes on any profits you might make, Doug, that's going to be a solid no. Tax deductions tend to be for things like charitable contributions, student loan interest, contributing to a health savings account. That's a proper deduction that can lower your taxable income potentially as well as the amount of income tax you might need to pay.

But my sense is I wonder if our next question actually gets to the heart of Doug's meaning here. Kathleen asks us, Selling crypto stocks for a tax benefit, is it similar to stock loss tax deductions? Now, Kathleen is asking about, I think, owning stock in a company that's in the cryptocurrency space, like a publicly traded mining company or an exchange or something like that. Because, yes, in some cases, an investor definitely can sell stock that has lost value, take that loss, and then potentially use the loss to lower their overall tax bill.

But that's true of stock in any industry—retail, tech, travel, or whatever it is, you name it, not just crypto. But I think we'll go a step further and answer this question through the lens of cryptocurrencies specifically because there are some similarities. We have another hypothetical situation and a graphic to help with here. So let's say you buy $10,000 worth of bitcoin, and again, your cost basis is that 10 grand. A couple of months later, the value of your bitcoin falls to $6,000.

A reminder, if you're just holding, nothing happens. But if you sell that bitcoin at a loss, you might be able to use that loss to offset your realized gains. And again, here, obviously, if you do the math, you lost $4,000. You're allowed to deduct up to $3,000 from your taxable income for that year if your losses exceed your gains. And in this example, you might also be able to carry forward the other $1,000 of your loss into next year's taxes.

And just to clarify, that $3,000 limit is separate from offsetting other capital gains. The $3,000 is only against ordinary income. And the same thing is true if you take your initial bitcoin that lost its value and trade it for another cryptocurrency or, again, if you use it to make a purchase. At the end of the day in this example, your $10,000 position lost $4,000 in value. So if you sell, you may well be able to deduct that loss just like Kathleen was asking about.

CHRIS: Yeah, and, Jim, if I could jump in here and just remind people about the volatility of all of this, right? So we know volatility is inescapable in the crypto market here. I know Jack talked about it on last week's livestream with you, how volatile it is, how it can be volatile for all kinds of reasons, how much more volatile it is than normal stocks. And the reason I bring this up is because if you're talking about taxes in some of these scenarios here where you're trying to capture a loss or time a few taxable events to your advantage, just be aware of the volatility here and make sure you're closely watching everything. Because it takes a little more timing aspect with these versus some other traditional assets.

JIM: Yeah, definitely. Definitely the case. So time for one more customer question before we wrap up. It's a big one, so it'll take a couple of minutes. What are the tax consequences of investing in crypto, including both gains and losses? How are these reported to the IRS, if at all? That question comes from Chris. Different Chris, not this Chris.

But we will use this question to cover some other scenarios. But first, Chris, it's up to you as the taxpayer to honestly report your losses and gains. Again, you want to consult with your tax advisor about questions specific to your situation, always a smart idea. You want to check out the 1040 tax form if you haven't done so already. The IRS actually updated this form not too long ago.

There's a digital asset section that's literally the first thing on the form right after your personal information. That's where they're looking for you to initially report any digital assets that you got paid or earned or sold right at the top of the 1040. You can report capital gains on Section D of your 1040. You will probably need to complete Form 8949 first in order to complete Schedule D accurately.

Now, gains classified as income are reported on Schedule 1 if you receive them as an employee. And if you received income as a self-employed entity, like let's say you run a mining business or something, then you would use Schedules C and SE to report that. I should also note that tax reporting is actually potentially different if the mining you did was a hobby rather than a business. And, Chris, I want to pause here again, too. We get a lot of questions about mining, what it is, how it works. What can you tell us?

CHRIS: Yeah, like you alluded to there, it's very complicated. So let's just step back a second and remind people what mining is all about, right? So this is any time when you have a proof-of-work blockchain that uses a proof-of-work consensus mechanism—like Bitcoin, it's the most popular that uses this. And it uses this mining process to verify transactions, to add transactions to the blockchain, the ledger. And by doing so, they're helping to secure the network. So it uses a lot of computing power, a lot of electricity.

So there's a lot of costs involved. Why would they do this? Well, these miners are rewarded newly minted bitcoin. So they also get a gain. So back to taxes, again, it's important to remember, if you're doing mining even as a hobby, it is doing work. So you are getting an income, and that does probably need to be reported then. But again, consult your tax advisor.

JIM: Yeah, I was going to say, that's sort of just getting on the edges of what the scope of this particular discussion is. So we should have said an over-under on the number of times we would tell folks to talk to an expert, but can't say it enough. But back to the viewer's question, the other Chris's question. Tax consequences, which Chris was asking about, do vary, as we discussed, but there are a handful of things to keep in mind.

First, there's generally not a tax deduction available if your crypto got lost or stolen. If you paid fees when you bought or traded your crypto, you might be able to add those fees to your purchase price, and that's going to help you figure out your cost basis. That has the potential to change any tax you might owe, so keep that in mind. You might be able to take a tax deduction if you donated crypto to a charitable institution. That deduction would be based on the fair market value of your crypto at the time you donated.

One quick reminder, long-term capital gains tax—long-term capital gains are taxed at lower rates than short-term capital gains. So you'll want to hold your crypto for at least one year and one day before selling or trading in order to be considered long term. And, finally, consider tax-loss harvesting like we've talked about before. You might know this term, actually, from other investments and other assets, but essentially what this means is offsetting your crypto losses against crypto gains or other capital gains to possibly help reduce your tax bill.

How does Fidelity Crypto fit into all of this? Well, first, Fidelity does not provide tax forms related to any activity in your Fidelity Crypto account. We're not going to do that until crypto tax reporting requirements are legally defined and in effect. However, you can still view all of your account activity within the Activity tab on the Fidelity Investments app. As we said earlier, you are ultimately responsible for reporting any taxable events within your Fidelity Crypto account.

If you had any taxable events during the tax year, you will receive a gain-loss summary in the first quarter of the new tax year, and you can always find your gain-loss summary in the app as well. Finally, just a reminder that Fidelity doesn't provide a copy of your gain-loss summary directly to the IRS. We provide it only for you, for your own recordkeeping and your own tax-prep purposes.

CHRIS: Yeah, Jim, I just want to say you've covered a lot here. We've gone pretty in depth on some of these things, but unfortunately, it's still pretty high level in the grand scheme of things. So just a reminder to everyone to consult your licensed tax professionals to help you prepare your tax return accurately or help manage your tax bill as well.

JIM: Yeah, for sure. Chris, thanks for taking the time to answer all of those questions. We got a ton of great ones. We used as many as we could in this particular show. So thank you to all of our livestream viewers who sent them in, and, Chris, thank you again for your time.

CHRIS: Yeah, my pleasure.

JIM: There's always so much to learn, and Fidelity Crypto is constantly adding to our library of videos, articles, FAQs, infographics, and more. So check out Fidelity.com/LearnCrypto. You can see all of those great things there as well as watch our older livestreams and register for upcoming livestreams. We've also built a help desk, continuing to update that as well, which you can find at Fidelity.com/CryptoHelp. Trying to make it as easy as possible for you to get your questions answered online, so check out those resources if you can. Thank you for watching, and we hope to see you back here very soon.

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