A Bit(coin) of Luck: Cryptocurrency Tax Gains Find Enhanced Value in the Land of OZ

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January 26, 2021

Cryptocurrency continues to gain popularity both as an investment asset and as a means to pay for goods and services. The growing ease with which a person can buy, hold and sell cryptocurrency has resulted in an explosion in crypto transactions – and, in turn, has left taxpayers with the need to account to the IRS for their newfound cryptocurrency gains (and losses).

This powerful trend reached a peak in 2020 when, as a result of COVID-19 disruption, related worldwide economic uncertainty and entry of companies such as PayPal into the consumer market (allowing more than 300 million users to buy cryptocurrencies easily), the crypto-market witnessed a dramatic run-up in the values of bitcoin and many other cryptocurrencies.

The dramatic swings and stunning volatility of cryptocurrencies have led to frenetic trading by investors. This speculative crypto trading (as well as day trading of stocks) has resulted in a substantial amount of short-term capital gains – generally taxed at a current 37% federal rate, plus the 3.8% Net Investment Income Tax (NIIT), or 40.8%. A California taxpayer with more than $1,000,000 of taxable income would pay an additional 13.3% for a 54.1% combined tax rate.

Even if the coin is held long enough (a year and a day) to qualify for long-term capital gains rates, the tax rate will still be up to 23.8% at the federal level (20% LTCG tax rate plus 3.8% NIIT), plus the state capital gains tax. With the historically high federal spending in the face of the COVID-19 pandemic, this tax burden seems likely to increase: President Biden may propose taxing both long-term and short-term capital gains at federal rates as high as 43.4% for high-income taxpayers. Add to that the state income tax, with Governor Cuomo of New York recently being the first (but not likely the last) governor to announce an intention to raise state income taxes as a result of COVID-induced budget shortfalls.

How can investors avoid, or at least mitigate, the possible 50+% combined tax rate? Although the Internal Revenue Code (IRC) makes for an unlikely hero, it does provide an excellent tax incentive under IRC Section 1400Z-2: the flexible

Opportunity Zone (OZ) program can benefit taxpayers who generated cryptocurrency gains on October 5, 2019 or later. Taxpayers who generated 2019 or 2020 gains in a partnership, S corporation or non-grantor trust can also still invest those gains into a Qualified Opportunity Fund (QOF) until March 31, 2021, or September 10, 2021, respectively. See IRS Notice 2021-10 for COVID-19 extensions.

A timely and successful QOF investment provides taxpayers with the following three benefits ***(the third of which provides the unprecedented possibility of unlimited tax-free upside in asset or business investment)***:

1) Capital gains timely invested into a QOF are deferred until the later of: (i) the time that the amounts are withdrawn or otherwise triggered under the "inclusion event" rules or (ii) December 31, 2026.
2) After holding the QOF interest at least five years, the taxpayer's basis in the QOF is increased by 10% of the original amount invested and the reportable gain drops to 90% when recognized.
3) Taxpayers holding the QOF investment for at least ten years can exclude 100% of the post-reinvestment appreciation in the QOF and in the underlying assets held by the QOF – including any eligible Qualified Opportunity Zone Business (QOZB) into which the QOF invests.

To illustrate, assume a crypto investor residing in New York purchased 100 bitcoin on April 1, 2020, for $660,000, and sold all one hundred on December 31, 2020, for $2,880,000, resulting in a short-term capital gain of $2,220,000. Assume the taxpayer is single and had other net taxable income of $600,000 – meaning that the investor is subject to income tax at the highest federal and New York marginal tax rates.

The federal income tax on this gain would be $905,760 (40.8% effective tax rate), and the New York income tax would be $195,804 (8.82% tax rate). This results in a combined tax liability of $1,101,564 (49.62%).

However, if the taxpayer re-invests all or a portion of these short-term gains into a QOF by March 31, 2021 (see IRS Notice 2021-10), that gain and the resulting taxes can be deferred until December 31, 2026. Since the QOF investment will have been held for more than five years on that date, only 90% of the gain will then be reportable. Assuming tax rates hold steady through the end of 2026, this amounts to a tax savings of $110,156 (49.62% x $222,000), and allows the taxpayer the interest-free use of the remaining deferred tax liability of $981,408 ($1,101,564 – $110,156) for a period of almost six years.

For taxpayers with patience, the OZ tax program allows for diversification of asset investment classes, a powerful tax deferral and ultimately the avoidance of tax on all post-reinvestment appreciation from the investment date until the date of sale, which can be anywhere from ten to almost thirty years in the future (the investment incentive ends on December 31, 2047).

Although a small number of states (California, Mississippi, North Carolina and Massachusetts) have declined to adopt the OZ tax benefits, the vast majority of states do follow the federal OZ provisions, and some states even provide additional incentives for OZ investors.

Cryptocurrency has gained favor because it offers impressive flexibility and an alternative investment strategy to bold investors. The "Land of OZ" may well be the next frontier for crypto investors and others generating short-term gains in the market, and the ultimate tax tool for maximizing the after-tax economic return on those 2020 cryptocurrency gains.

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The authors would like to thank Gerald J. Reihsen III, Esq., for his contributions to the article.