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

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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 needing to account to the IRS for their newfound cryptocurrency gains (and losses).

This powerful trend reached a new 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 easily buy cryptocurrencies), 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 has 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 staggering 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 burden. And with the historically high federal spending in the face of the COVID-19 pandemic this tax burden seems likely to get even worse: President Biden is threatening to tax both long-term and short-term capital gains at federal rates as high as 43.4% for high-income taxpayers -- plus, of course the state income tax, with Governor Cuomo of New York recently being the first (but not likely the last) state governor to announce an intention to raise state income taxes as a result of COVID-induced budget shortfalls.

But cryptocurrency investors are famously flexible, creative and resilient, and a growing number have addressed the specter of a 50+% combined tax rate by moving beyond despair and to the conversation of how best to avoid, or at least mitigate, the big tax bite.

This conversation quickly turns to the Internal Revenue Code (IRC) and various tax planning strategies. Although the IRC makes for an unlikely hero, it does provide a wonderful tax incentive under IRC Section 1400Z-2 - the highly flexible and impactful Opportunity Zone (OZ) program that can be a perfect match for taxpayers who generated cryptocurrency gains October 5, 2019 or later. Taxpayers who generated 2019 or 2020 gains in a partnership, S Corp or non-grantor trust can also still invest those gains into a QOF until March 31, 2021 or September 30, 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)***:

- 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,
- 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,
- Taxpayers holding the QOF investment for at least 10 years can exclude 100% of the post-re-investment 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 100 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 painful 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, creative and aggressive 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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