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DIGITAL CURRENCY

FTX Users Can't Count on Help From the IRS

When market investors suffer losses, they're often eligible for a tax write-off to soften the blow. FTX users won't be so lucky.

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By Alexis Leondis, Bloomberg Opinion (TNS)

When market investors suffer losses—or get taken for a ride—they're often eligible for a tax write-off to soften the blow. Users of the bankrupt crypto exchange FTX won't be so lucky.

Here's the difference: Let's say you're a crypto investor on an exchange that's still standing. If you've suffered investment losses amid the market decline, you can simply sell to offset other gains and potentially take a deduction. That's because the IRS allows investors to sell poor-performing crypto, just as with stocks, and use those losses to cancel out capital gains from selling better-performing assets.

If losses exceed gains, investors can deduct up to $3,000 against their taxable income. Losses beyond $3,000 can be carried forward every year until death to offset gains in future years.

But that's not the case for customers at FTX or any other crypto exchange that blows up. The tax code specifies that if you want to take a capital loss, you must sell or exchange that asset. Losing access to it because the exchange shuts down is different and would most likely be insufficient in court, said Matt Metras, an accountant in Rochester, New York, who represents taxpayers before the IRS.

Another provision in the code allows for a deduction if a security is worthless. No luck there, though—the IRS has said digital currency is considered property, not a security, like a stock. Plus, the asset has to be worthless, as in zero—not close to it.

Then there's the theft-loss route, but it's complicated. Before the 2017 Republican tax law, investors who had losses because of theft could deduct them against their ordinary income provided certain criteria were met. Along with a bunch of other miscellaneous itemized deductions, the theft-loss deduction was largely eliminated except for losses tied to a federally declared disaster.

An FTX user's best bet when filing tax returns next April may be to try to take advantage of a special provision to the theft-loss rule (created after the Bernie Madoff scandal) that still allows for a write-off if the loss is due to a Ponzi scheme. But the loss has to meet some stringent requirements to qualify. For example, the investor has to show she expected a profit, and perpetrators must have had specific intent to cheat investors.

FTX's founder, Sam Bankman-Fried, hasn't been charged with a crime. Advisers who are overseeing what remains of FTX are struggling to find the company's cash and crypto, according to a bankruptcy court filing.

Keep in mind, the theft-loss deduction is moot if you plan on taking the standard deduction rather than itemizing. The theft-loss deduction is only for those who itemize because they receive a bigger write-off for deducting items like mortgage interest and charitable gifts separately.

Some crypto investors on bankrupt platform Celsius Network, which offered high yields in exchange for crypto, may consider another tax play, but it seems like a long shot. If they can show that they made a loan to these platforms and that their entire investment has become worthless and can't be recovered, then they may be eligible for what's known as a nonbusiness bad debt deduction.

But that's a high bar. Just because accounts are frozen or withdrawals are limited aren't sufficient. And bankruptcy doesn't automatically mean the total debt is worthless, Phil Gaudiano, a certified public accountant in Great Falls, Virginia, warned in an op-ed for CoinDesk.

Which just goes to say that crypto investors who have been badly burned this year shouldn't expect any relief from the IRS.

ABOUT THE WRITER

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