Traded cryptocurrency in 2021? Here's how to approach taxes

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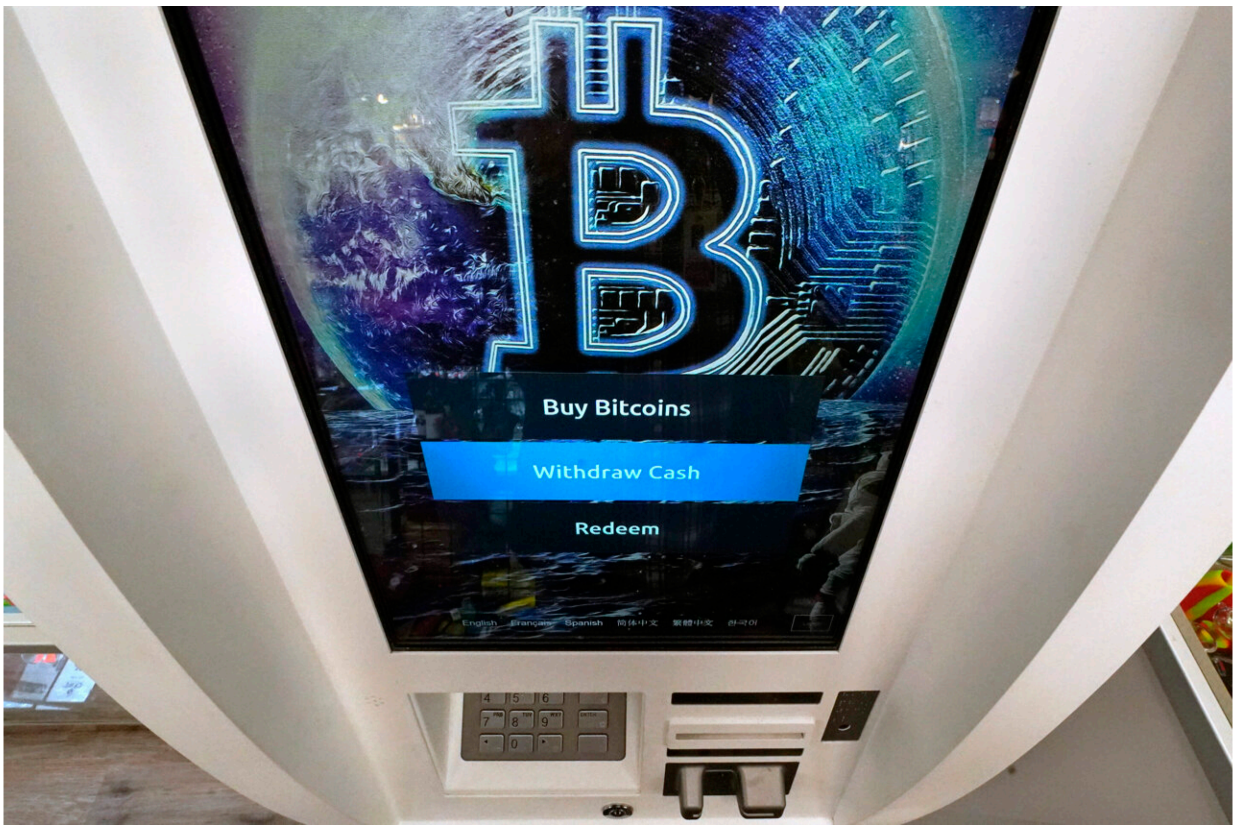

In this Feb. 9, 2021, file photo, the Bitcoin logo appears on the display screen of a cryptocurrency ATM in Salem, N.H. Alternative finance has captured the attention of investors across the U.S. As the 2022 tax season approaches, traders who are new to cryptocurrency taxation will have to contend with the IRS' rules for reporting on taxable events. Credit: AP Photo/Charles Krupa, File

Professionals have a major piece of advice for those who traded cryptocurrency for the first time last year: Take your tax prep seriously.

The IRS has been zooming in on cryptocurrency reporting with increasing interest in recent years. And the last thing you want is to lose money and time reconciling your tax liability, says Douglas Boneparth, a New York City-based certified financial planner.

So as tax season gets into full swing, here's a quick guide to which cryptocurrency activity is reportable, how it's generally taxed and the best ways to prepare.

WHAT YOU NEED TO REPORT TO THE IRS

The IRS treats virtual currencies as property, which means they're taxed similarly to stocks. If all you did was purchase cryptocurrency with U.S. dollars, and those assets have been sitting untouched in an exchange or your cryptocurrency wallet, you shouldn't need to worry about reporting to the IRS this year.

Reporting is required when certain events come into play, most commonly:

— Trading one cryptocurrency for another.

— Selling cryptocurrency for fiat dollars (government-issued currency).

— Using cryptocurrency to buy goods or services (e.g., paying for a cup of coffee with cryptocurrency).

A critical distinction to make is that triggering a taxable event doesn't necessarily mean you'll owe taxes, says Andrew Gordon, an Illinois-based certified public accountant and tax attorney. Just because you have to report a transaction doesn't mean you'll end up owing the IRS for it.

HOW CRYPTOCURRENCY IS TAXED

Anytime you sell an asset for a profit, your resulting gain may be subject to capital gains taxation. To determine your exact gain or loss, you'll need the date you acquired the cryptocurrency; the date you sold, exchanged or otherwise disposed of it; and the cost basis (the amount you paid plus transaction fees).

Gains are then taxed at either the short- or long-term rate, depending on how long you held the asset. Short-term gains for assets held less than a year are taxed as ordinary income, while long-term gains for assets held more than a year are generally taxed at 0%, 15% or 20%, depending on your taxable income and filing status.

For example, say you purchased $2,000 worth of a cryptocurrency in January 2021 and sold it two months later for $5,000. That $3,000 capital gain would be subject to the short-term capital gains rate.

Once you've calculated your gains and losses on Form 8949, you'll need to report them on Schedule D of Form 1040.

HOW TO PREPARE

1. BE HONEST

If you omit information on your taxes, there's a risk of penalties, fees and, in severe cases, even tax evasion charges. And with the revision of Form 1040, which now features a direct yes-or-no question on whether you received, sold, exchanged or disposed of cryptocurrency, the IRS is signaling that those who fail to report won't be able to feign ignorance, Gordon says.

2. GET YOUR RECORDS IN ORDER

Cryptocurrency exchanges won't be required to send taxpayers 1099-B forms, also known as tax-reporting summaries, until the 2023 tax year. So the onus is on traders to keep accurate records of their transactions. Many exchanges, such as Coinbase, allow you to download your trading history, which might make it easier for you, tax software or a tax preparer to calculate gains and losses. If you made trades off-exchange, though, you might need to set aside some additional time for digging.

3. CONSIDER USING TRACKING TOOLS

Reporting a single trade on one exchange likely won't be difficult. But a "typical taxpayer has three to five wallets and exchanges," according to Shehan Chandrasekera, CPA and head of tax strategy for CoinTracker . This makes it harder to reconcile cost basis across varying platforms. If you're an active trader, it might make sense to invest in software that can help track your transactions.

4. HIRE A PROFESSIONAL

If your tax situation is complex, consider working with a cryptocurrency-savvy tax professional. They can guide you through the various accounting strategies the IRS permits for reconciling your gains and losses, and help determine which one makes the most sense for you.

5. MAKE LOSSES WORK IN YOUR FAVOR

If you didn't take advantage of tax-minimization strategies last year—such as tax-loss harvesting, gifting or donating—but you realized losses, you still have a chance to lower your tax bill. Just as with stocks, if you sold a currency at a lower value than what you paid for it, you may be able to deduct up to $3,000 of those losses on your taxes.