diffusetap
Virtual Event Series

DeFi Taxes

Guest Speakers:

Mackenzie Patel
Sr. Revenue Accountant
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Joe Dillon
Director
Bitwave

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DiffuseTap: DeFi Taxes

Last time on DiffuseTap, Mackenzie Patel, Senior Revenue Accountant at Figment, and Joe Dillon, Director of Customer and Partner Success at Bitwave, talked to us about what are taxable events in crypto and DeFi, the difference between crypto taxes and taxes on more traditional assets, and how to be more tax efficient with your alternative asset investing.

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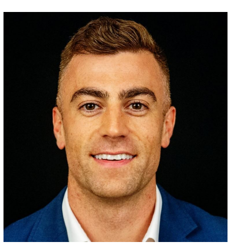
DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)... straight from your armchair like a boss.

Meet the Speakers

MACKENZIE PATEL, CPA, is a senior revenue accountant for Figment, one of the world's largest blockchain infrastructure and services providers. She is also a regular contributor at Decrypt on crypto tax and accounting topics, and hosts the book club for She256, a group for women in crypto.

Linkedin: @mackenziepatel



JOE DILLON, CPA, is the Director of Customer and Partner Success at Bitwave, a platform that provides an all-in-one solution for handling digital assets. Bitwave offers complex tax tracking capabilities, automatic mark-to-market capabilities, crypto invoicing, and crypto bill pay.

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About Diffuse

We are an alternative fund platform offering differentiated investment products. From digital assets, to VC funds, and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information visit www.diffusefunds.com.

KENNY ESTES: Mackenzie, would you mind unmuting yourself and giving the good folks a bit about your background and what you're up to?

MACKENZIE PATEL: Sure. Hi, everyone. I'm Mackenzie. I'm a senior revenue accountant at Figment. I'm also a CPA. I've been at Figment for about over a year, and my specialty and focus is on crypto tax and accounting.

KENNY: By far the most concise introduction, I love it. Thank you very much. Joe, would you mind doing the same?

JOE DILLON: Sure. I'm Joe Dylan. I'm the director of customer and partner success at Bitwave. We are an enterprise digital asset accounting and tax platform. I work with Mackenzie and the Figment team very regularly. I came over to Bitwave about a year ago after spending 12 years in public accounting. I'm also a CPA. So, I look at a lot of what we do at Bitwave through that CPA lens.

AYLA KREMB: Phenomenal. I will start putting everybody on the spot immediately. What is the core difference between regular taxes and crypto taxes? Feel free to toss in some news and updates that might have happened this year from the IRS when it comes to these taxes. Maybe I'll start out with Mackenzie.

MACKENZIE: Sure. I think crypto taxes and DeFi taxes are so different from the ordinary taxes that we're used to because they're so challenging. There are so many different types of activities that are involved in DeFi taxes. You've got wrapping assets, bridging assets, liquidity providing, protocol staking, lending, liquid staking, and all these kinds of things.

I think the variety of the different types of activity is so much more complex than we've seen before. It's much more complex than just getting a W2 from your employer and putting it on your 1040. These are different types of activities that we haven't really seen before, or at least we haven't seen except in the last couple of years. I think that's the first challenge that we have there.

Secondly, I think because these activities are so complex, it's hard getting data to track them all. Being able to get data related to all your liquidity providing positions, for example, is difficult because there's not a lot of block explorers or indexing for a lot of these new protocols. It's really hard to know how your position has changed relative to the pool and its entirety.

I think that getting data to track all your activity is a really big thing within crypto itself, not just within DeFi. That's because we're still in the nascent phase of this industry right now. It's very necessary for taxes, but it might not always be as accessible as you'd like it to be.

JOE: I'll add to that. From an even more basic standpoint, when I think about crypto taxes, I think part of the struggle is that the IRS doesn't care about your crypto denominated amounts you traded. Everything has to be converted back to fiat, to US dollars. They don't care that you sold 2 ETH. They just want to know how much it was worth in US dollars.

So, the taxpayer has this task of taking every single transaction that happens and pricing it accurately into US dollars. And we all know, if you follow the crypto space at all, pricing can be volatile at times. And because of how the IRS considers how they classify digital assets and cryptocurrencies, it's essentially treated as property. So, anytime you dispose of it, you have a taxable event.

That means absolutely anytime you dispose of it, not only when you sell it. If you just use it and there is a transaction fee, they're going to say that's a disposal. You have a gain or loss on that disposal. If you use it, for example, to pay an employee, that's a disposal. You're going to have a realized gain or loss on it.

It's exactly what Mackenzie said about getting your data. The Ethereum network doesn't send you a 1099. You have to get your own transaction data and price it. You've got to track it all super closely, and you will have all of these events that are now taxable events, that for most people in their regular day-to-day life are just not coming across.

MACKENZIE: I think volume is also an important factor here. Just to dig into pricing a little bit, you might have thousands of transactions that you then have to download and price them. That is a big pain point in crypto. What if you're on a new platform or new blockchain where there's not really pricing for the assets that you're trading? In that case, you have to find it through various pricing sources (i.e. Coingecko, exchanges, etc.) or do some sort of labor cost analysis. Pricing is definitely a big issue because as Joe said, the IRS is not going to accept your taxes denominated in Bitcoin. That's definitely a nuance there.

JOE: Yeah, the volume thing is huge. I have thousands of transactions myself, and that accumulates very easily over the course of years or months. I think that frictionless aspect attracts a lot of people to cryptocurrencies, and it's what drives a lot of that volume. But it also makes tracking that much more difficult.

KENNY: Okay, that makes sense. A lot of what you're talking about so far relates to hodling, which includes buying, selling, buying, selling. But there's a whole other area. What about DeFi? That's a whole different thing because of this concept of rewards. Is that interest? Is that capital gains? How is the IRS looking at it? And how is that different than just buying Bitcoin hoping it goes to the moon? Joe, maybe we'll start with you this time.

JOE: I'm actually going to Mackenzie on this because this is more about staking, rewards fee, and income. When I have questions about that, I go to Mackenzie for it. Mackenzie, I hope you don't mind.

MACKENZIE: No, not at all. Thanks Joe. Let's just start with hodling, for instance, buying Bitcoin and holding it for a number of years. If you buy it with fiat, there are actually no tax implications. You're just buying and hodling it. No tax there. But there is a nuance to that. Let's say that you're holding this asset and then a hard fork occurs, like with Ethereum, which just moved from proof of work to proof of stake. That was actually a soft fork, but there was another hard fork that occurred, which is the Ethereum Proof of Work or ETHW.

Even though you were just holding Ethereum, you might be airdropped some of these new assets from a hard fork. In that case, that is taxable because the IRS says the airdrops are taxable as ordinary income. And so, even though you're just holding, you might still have a taxable event just because you're holding an asset and there's a hard fork that occurred. That's a new wrinkle there, if you just wanted to hold your crypto and not pay any taxes on it.

JOE: I want to add that this is true for both individuals and businesses. Part of that difficulty is when you get that data, again, it's not an account statement. You have to look back at your transactions from last year, and find that you received some tokens. The only record you might have of that transaction is on Etherscan, and Etherscan doesn't explicitly say "hey, just a reminder, you got these tokens for this."

It can be really difficult because you really have to go back to the first principles of "What is the thing that I received? Is it income from trading? Is it capital gain and loss? Is it ordinary income? Is it some fee revenue or airdrop revenue," like Mackenzie was talking about? You really have to go back to determining what it was actually for. And remembering that stuff across large volumes, going back in time becomes very difficult.

MACKENZIE: Exactly. Another note on the airdrop, you need to be cognizant of whether it just flew into your wallet or if you actually had to claim it. If you can decide whether to claim it or not, you have some agency there because if you don't claim it, you can delay the taxes. But if it just dropped into your wallet, then too bad. You might be taxed on it.

KENNY: That's hilarious. You can just buy and hold and do nothing, but you still have a tax implication. And it's even better because a lot of these airdrops are scams, so you have to go figure out what it is and what the value is. And you also might get hacked along the way. It's kind of a double whammy. But I'll go back to you, Mackenzie. DeFi. How is that different? Staking is a term that's thrown around a lot. Are there different types of staking? How are they treated differently?

MACKENZIE: There are different types of staking. The one that I'm most familiar with is protocol staking. That's what the Figment does. You stake your assets on a blockchain and then you earn staking rewards for locking up your assets. And even just within protocol staking, which is just one subset of DeFi, there's controversy around whether the rewards are taxed or non-taxable. I've seen arguments both ways. Some people say yes, they're taxable as ordinary income. But when you actually receive them, some people say no, it's not taxable because it's more akin to a stock split. They're not taxed until you actually dispose of them, sell them, trade them, or otherwise do something with them. Even just within that one category, people have different opinions on it.

There's also DeFi or liquidity providing staking. You put your assets into a pool, you get an LP token back, and you stake that LP token and continually earn rewards on the LP token. Those are definitely taxable. I've read a lot of articles about that, and it's taxable as ordinary income when you actually receive the asset. That's a little bit more clear than the protocol staking that I just talked about, so I call it liquidity providing staking, and it's taxable.

You also have liquid staking, which is a little bit different. Think of Lido, for example. You put in ETH and you earn rewards in stETH. And again, it could be taxable or not taxable. There's not really a lot of clear guidance on this. It depends on what position you want to take, and at what point you think you've had a realization event of revenue.

JOE: To add to that, like you just said, to me the most important thing is that there is still no regulatory clarity here. This is still very much a gray area. In the accounting space, what we're seeing is all accounting issues. We see folks taking very aggressive tax positions, and some folks taking a more conservative approach.

Like with that issue of staking income. When do I have to recognize the revenue? Is it literally when it hits my wallet? There was this really public case last year with the IRS and taxpayers. It's the Jarrett case, if you want to look it up, where the IRS essentially settled. Jarrett's argument was that he locked up assets in this protocol, and he just got back some tokens. The IRS was saying that it was ordinary income so when he received them, he needed to recognize that income then.

The Jarretts made the case that it's more akin to taxpayer created property, in the same way that if you were to bake a loaf of bread, you don't record income when the bread is done in the oven. You wait to record the income when you actually sell the loaf of bread. That was the case that Jarrett was making. He was saying "Hey, this is taxpayer created property., I shouldn't have to recognize any income on it until I sell it."

The IRS actually settled that case. I think at first, when that news came out, everyone was like, "Oh my gosh, this means that staking rewards are taxpayer created property." That is not true. They did not actually opine on that. They have not given guidance. They just settled a case out of court. That's what they did.

People are reading between the lines of what that might mean for the future. I think distinctions like that, of things like how to handle staking and DeFi income that you receive, will be addressed in the coming legislation. I think that has to be pretty high up on the list.

AYLA: I'm going to toss another question your way. When it comes to being more tax efficient with your investing, are there any suggestions that you guys might make for folks that are just thinking about how you should plan out their portfolio? What are the things that one could do to be more tax efficient?

JOE: There are definitely some things to do here. One, these are taxed like capital property. We do have this distinction between long term gains, which is property that's been held for more than 12 months, versus short term gains. Just to make it easy on the listeners, your long term tax rate is typically lower than your short term tax rate because your short term gains are going to be taxed at whatever your ordinary income rate is, where there's more of a preferential lower rate for long-term.

One, you can think about your holdings and know that holding them for a longer period of time before you dispose of them or sell them will often result in a smaller tax liability. Now, to do that, you have to track your stuff. You actually have to track your holdings. That includes how long you've been holding, whether you bought it, and so on. We could go really deep into the mechanics of that. It's really difficult to do as an individual. We see a lot of folks trying to do it in Excel, and it gets really hard. There's a few different strategies here. I'll let Mackenzie talk about a couple of them.

I'll say one more thing. Wash-sale rules don't apply to cryptocurrencies right now, which is a huge thing, especially this year where prices are down. If you're trading regular securities like equities, for example, if you buy it for 1,000 bucks and now the price is 200, you could, in theory, sell your asset for 200 and lock in that $800 loss, and then just rebuy it for $200. Now, they have rules to prevent people from doing that. Those are called wash-sale rules. But those rules do not apply to cryptocurrencies, so you can do that.

If you're holding Bitcoin, ETH, or any token that you purchased when it was much more expensive, you can literally sell those assets, lock in a loss, and rebuy them one minute later. And now, you've captured a really large loss. Again, you want to be a little strategic if you want to do that. You might want to do that in a year, for example, when you have some gains to offset. That's a big strategy that we see people doing.

MACKENZIE: I think it's really interesting that crypto is excluded from the wash-sale rules because it's so easy to actually carry out a wash-sale within crypto. Going back to the capital gains and losses that you mentioned, I agree with you on the capital losses. I definitely recommend looking at your portfolio near the end of the year and see whether there are any positions that you have at an unrealized loss that you're willing to realize. Because then, you can use those capital losses to offset capital gains.

If you have short term capital losses, you have the option to offset the short term gains first, and then it goes to long term gains. You can take up to 3,000 capital losses and deduct that, and then you can just carry that forward indefinitely. There are some really good rules around that. And as Joe mentioned, it's better to have long term positions because you can have lower tax rates with that. But it's October now and it's getting close to the end of the year, so I really recommend looking at your portfolio and checking whether there are any loss positions you can realize, and then take that loss and carry that forward.

JOE: I just want to add one more thing. There is one caveat on that wash-sale rule which is that it's eventually going to go away. That's because it's kind of like this loophole. It has to do with how cryptocurrencies are classified as property. If they were classified as securities, you wouldn't be able to do it. I think we're going to get some new rules that say some of these are securities and commodities, which means you're not going to be able to do it.

The other thing is that I think it was in the original draft of the Build Back Better bill that didn't pass. I think they had a piece in there to close this loophole, but it didn't pass. So to me, it's almost like this waiting game of when we are going to get legislation to close that loophole.

KENNY: That's hilarious. Alright, one last question. We talked a little bit about all these different choices, and crypto and DeFi are clearly the wild west. I would assume the IRS doesn't like some of these things, and I can see why. We have a fund. Should we drop everything and put this down right now because it's an index fund? And is the IRS going to come back?

I also want to pick up some of the themes from the questions here in the chat. Is that uncertainty driving people off shore? Because obviously, they don't want to deal with that risk of the IRS coming in and completely smacking everybody's hands who did it for five years and charge them a big bill. Maybe Mackenzie you have thoughts on it?

MACKENZIE: Yeah. We're hearing a lot about Cayman foundation entities. I think people are being driven offshore because they don't want to have risky investments where it's super uncertain, especially when you can't even get the reporting to back up your position. So yes, I think that is driving people offshore.

But at the same time, I think that technology will develop, and companies like Bitwave and other crypto accounting softwares are making it easier to track your DeFi activity. I think once those get better, and people actually have that visibility into their activity, then I think they will be less likely to go offshore because there's more certainty in their actual activity. And then once the regulation catches up, then I think, again, people will get more comfortable with it. I think it'll take some time.

KENNY: I'm sure. Joe, anything to add?

JOE: A quick note. If you're an individual taxpayer filing your taxes, if you have unreported stuff, the statute of limitations for the IRS is three years. They have three years to go back and see what you have that you didn't report. But the thing people forget is, if you don't file, they can go back forever. So, if you just literally haven't filed, there is no statute of limitations to how far back they can go. There is also no statute of limitations if they determine you committed fraud.. A lot of people think that maybe the IRS isn't competent enough to find all this stuff, but they can actually hire outside professionals to assist them. Just keep that in mind.

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Corporate Director, CME Group

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