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CERTIFIED PUBLIC ACCOUNTANTS

Friday, June 30, 2023

What are the risks when investing in cryptocurrencies?

Cryptocurrencies are not currently regulated in the U.S. and they are not backed by any tangible assets. For this and other reasons they are more risky than typical investments. As with all investments, you should not invest more money than you can afford to lose.

From a taxation perspective, gains and losses in trading cryptocurrencies are the same as for trading stocks and bonds. The IRS expects you to report such gains as short- or long-term capital gains, depending on how long you held the asset. Both gains and losses are reported on Schedule D.

Cryptocurrency Pros & Cons

The first pro is also the first con: volatility. Huge fortunes were made in the early days of crypto trading (2009 – 2016). Bitcoin, the original cryptocurrency for example, traded at $0.09 in 2010 and briefly peaked at almost $69,000 in November of 2021. A savvy investor who purchased $10 of Bitcoin in 2010 and sold at the peak, would have made more than $7 million!

In recent years the number of different cryptocurrencies has increased to almost 23,000 according to Investopedia. Many of these have also created multi-millionaires, as investors sought out new entries into the market that offered unique new capabilities or performance enhancements. A good example is the second most widely traded crypto, Ether, which ushered in the concept of decentralized finance on its Ethereum blockchain network. Its low value in 2015 was $0.42 while it reached a high in 2021 of $4,815.

Unfortunately, many of the tradeable cryptocurrencies have also turned millionaires into paupers. For example, an investor who purchased a highly-touted cryptocurrency named Terra in April 2022 paid about $116 per coin. Just two months later, that price had fallen to $0.0000557 – a loss in value of more than 99.999%!

Other risk factors when investing in cryptocurrencies are changing technologies, scalability and security. The underlying technology of the crypto world is still young and is still undergoing frequent improvements. Some such improvements, particularly with regard to network protocols, may affect existing cryptocurrencies, causing them to have to suspend trading while their designers update the code that represents their coins. This, in turn, can affect the coin's price.

Transaction speeds under the ever-increasing load on the crypto networks have also been an issue, bringing into question the scalability of those networks. While many performance improvements continue to be made, the potential for catastrophic failures due to network overload still remain a possibility.

Finally, there remains the issue of security. Holding and trading cryptocurrencies requires exchanges, just as stocks and bonds require brokerage companies, and traditional currencies require banks and banking systems. It is the cryptocurrency exchanges that pose the greatest opportunity for hackers to break into and steal customer funds. While the more well-established exchanges, such as Coinbase, have had several years to develop security systems to guard against hackers, many more recent exchanges remain vulnerable. According to Forbes, the five largest crypto heists of 2022 accounted for the loss of over $3 billion of investor funds. Perhaps the most well-known recent theft was the $415 million stolen by hackers from FTX exchange, causing its complete collapse and indictment of its co-founder and CEO, Sam Bankman-Fried.

The bottom line is do your homework before investing in cryptocurrencies and never invest more than you can afford to lose.