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The return of stolen crypto can be a taxing event

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Digital assets have been subject to some of the largest thefts in history. In fact, the largest crypto theft — in connection with the February 2025 $1.5 billion Bybit hack — dwarfs the Guinness Book of World Records' entry for the largest bank robbery of $282 million. *See* "Crypto's biggest hacks and heists after $1.5 billion theft from Bybit," Reuters, Feb. 24, 2025. Sometimes, however, all is not lost and at least some portion may be recovered and available for restitution or return to victims.

While any recovery may be cause for celebration, unforeseen or unintended tax consequences can put a damper on the festivities. The tax due on the recovery of stolen crypto can depend upon several factors, including any deductions taken in connection with the initial theft, the type of property returned and intervening changes to its value, and other taxpayer circumstances.

Yesterday's hacks; tomorrow's recoveries (and taxes)

In the past five years, an estimated $189 billion in total cryptocurrency value was reportedly transferred to illicit addresses, and there are undoubtedly more thefts to come. *See* "2025 Crypto Crime Trends: Illicit Volumes Portend Record Year as On-Chain Crime Becomes Increasingly Diverse and Professionalized," Chainalysis.com, Jan. 15, 2025.

Over 300 hacking incidents were reported in 2024 alone. *See id.*, "$2.2 Billion Stolen from Crypto Platforms in 2024, but Hacked Volumes Stagnate Toward Year-End as DPRK Slows Activity Post-July," Dec. 19, 2024. And during the first quarter of 2025, over $1.63 billion in crypto was lost to hacks. *See* "Crypto crooks targeted $244M in May, hack losses down 40% — PeckShield," CoinTelegraph, June 1, 2025.

When cryptocurrency is stolen, recovery rates vary significantly on a case-by-case basis, but the silver lining is an industry average recovery rate of approximately 70%. *See* "Most Legitimate Crypto Recovery Service in 2025," TheChain, June 6, 2025.

Crypto investors may have several paths to recover their stolen crypto. For example, where the government has recovered stolen crypto, investors have been provided the opportunity to seek restitution as a victim under the Crime Victims' Rights Act or recover their stolen assets through proceedings ancillary to the criminal forfeiture proceedings.

Whether an investor receives the actual assets that were taken, substitute property, or their cash liquidation value (or anything at all), may depend upon such factors as whether the assets were laundered, ownership of the assets, and the crimes for which the hackers are charged.

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Although such factors are mostly outside the control of the investor, the form of distribution has a significant impact on the taxes owed. As discussed below, understanding the potential form of recovery should inform an investor's tax position at the time of the loss (and whether they should take a deduction at all in the year that the assets are stolen).

You may or may not want to claim a crypto theft tax loss

In most cases, when investment property such as cryptocurrency is stolen, the owner of that cryptocurrency can claim an ordinary (as opposed to capital) deduction for the loss. This deduction is equal to the taxpayer's adjusted basis in the property. For cryptocurrency, the adjusted basis is generally the amount paid for it, or if the cryptocurrency was directly mined or won by the taxpayer, the value included in the taxpayer's income tax return when the taxpayer received the cryptocurrency.

For example, say an individual bought five Bitcoin in 2020 for $10,000 each, the taxpayer would have a total basis in those five Bitcoin of $50,000. If the Bitcoin were stolen in 2022, when the value of a single Bitcoin equaled $40,000, the taxpayer would only be entitled to deduct the basis in the stolen Bitcoin,

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or $50,000 (even though the total value is $200,000). This $50,000 deduction would be available to offset income taxes the taxpayer would otherwise owe.

However, the value of the theft deduction can potentially be very small in comparison to the potential value the investor may eventually recover, which is especially the case for early-stage crypto investors. Take the previous example: assume the taxpayer claimed a $50,000 taxable deduction in 2022. If the Bitcoin were returned to the taxpayer in 2025 (when Bitcoin is valued at around $100,000), the taxpayer would owe taxes on $500,000 of ordinary income (regardless of whether the taxpayer sells the Bitcoin in 2025).

This is because once a loss for theft is claimed on property for tax purposes, any subsequent recovery of that property is treated as a taxable gain. And, the amount of such gain is added to the basis of that property to offset future gains upon disposition. On the other hand, if the taxpayer did not claim a loss in 2022, he or she could have potentially avoided any tax in 2025 when the cryptocurrency was returned.

The form of recovery matters (even if a deduction was not taken at the time of theft)

If cryptocurrency is returned to its rightful owner in its original form, and the owner didn't previously take a theft deduction for that cryptocurrency, then the return is a non-taxable event. If, however, the cryptocurrency is returned to the owner in the form of its cash value (and the owner did not take a previous theft deduction), this recovery still may result in taxable income to the owner.

Using our previous example, assume the investor bought five Bitcoin in 2020 at a price of $10,000 each, the Bitcoin were stolen in 2022, and the government sends the taxpayer $500,000 in 2025 as recovery for the five stolen Bitcoin. Here, the investor would have taxable income on the cash received ($500,000) minus the taxpayer's basis in the cryptocurrency ($50,000), meaning the investor would have to pay taxes on $450,000 of capital gains in 2025.

This sudden tax bill from recovered cash can be disadvantageous for multiple reasons. First, most obviously, the tax could easily eat away a substantial portion of the cash recovery received.

Second, even if the investor wanted to realize cash from their cryptocurrency, doing so all at once may result in a higher tax bill than if the investor sold the cryptocurrency over a matter of years. In other words, the investor could have potentially reduced his or her total tax bill by spreading out their taxable income from recovered cryptocurrency by selling it in different years.

Third, individuals generally pay state income taxes on realized gains from cryptocurrency based on their state of residence when the gain is realized. If an individual lives in a high-tax state at the time they recover previously stolen cryptocurrency, the taxpayer may have an opportunity to move to a lower-tax state before ultimately selling the cryptocurrency and realizing gain from it. If the recovery is in the form of cash, however, the owner will recognize all the gain in their current state of residence.

Conclusion

Crypto thefts are bound to increase in the future with the expansion of Decentralized Finance (DeFi) and the increasing sophistication and technology of hackers, especially if Bitcoin and other digital assets continue their growth trajectory. Before taking any tax position at the time of loss, investors should consider their potential right to participate in distributions if assets are recovered in the future and the tax implications under possible scenarios.

Though much of the process for recovery and participation in recovered assets is beyond investors' control, tax liability resulting from the recovery of assets may be anticipated and possibly deferred or reduced with advanced planning and analysis.

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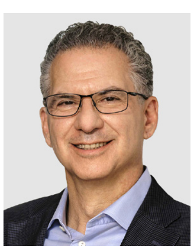

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