THE COINTELEGRAPH
future of money

FEB 14, 2018

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Paying Tax in Crypto Ironically Triggers More Taxes - Expert Take

EXPERT TAKE

In our Expert Takes, opinion leaders from inside and outside the crypto industry express their views, share their experience and give professional advice. Expert Takes cover everything from Blockchain technology and ICO funding to taxation, regulation and cryptocurrency adoption by different sectors of the economy.

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In the US, the Internal Revenue Service (IRS) is not accepting Bitcoin, Ripple or Ethereum for taxes yet. But it might not be too far off, with Arizona moving to become the first state in the country to accept payments in crypto and other states likely to follow. If passed, Arizona's Senate Bill 1091would allow income taxes to be paid in Bitcoin and other cryptocurrencies that are approved by the Arizona Department of Revenue. The changes would not come into effect until 2020, which seems like light years away.

Tax authorities would be required to convert such payments to dollars at the prevailing rate. That makes sense since tax obligations are in dollars. Taxpayers would get credited with the converted dollar amount. Any swing in price that resulted in the state not getting the full payment would be the responsibility of the taxpayer - so the timing is relatively important.

However, what so far few seem to be noting is the taxable nature of paying in cryptocurrencies. After all, rightly or wrongly, the IRS position is that cryptocurrency is property, not currency. This fact has some big tax implications.

For example, say you owe $5,000 in taxes. You could pay the $5,000 in dollars. Or soon, you could pay with $5,000 worth of say Bitcoin, Ripple, or Ethereum. So far so good. As long as the crypto is worth $5,000 when you pay, you're home free, right?

Not really. After all, you need to consider the sale you just made. Yes, the transfer of the crypto to the tax authority is itself a sale, and that could mean more taxes are payable for the year of the payment. If you bought the crypto for $5,000 the day you pay your taxes, there's no gain. But suppose you bought the crypto a year ago for $1,000, and it's worth $5,000 when you use it to pay taxes?

That's right, and you have a $4,000 gain. Hopefully, it is a long-term capital gain, which would make the taxes lower, but you still have taxes to pay. You could trigger a tax loss too if you had bought the crypto for $7,000 and transfer it for taxes when it is worth $5,000.

Of course, the taxes triggered on paying taxes is just one type of transfer. All sorts of transfers of cryptocurrencies can trigger tax issues. Wages paid to employees using virtual currency are subject to federal income tax withholding and payroll taxes.

But if you pay someone in property, how do you withhold taxes? You can't pay an employee Bitcoin, and send some of the withheld Bitcoin to the IRS (well, not yet anyhow). You have to send the IRS dollars. You either pay the employee some cash and some crypto, and withhold extra on the cash. Or, you can sell some of the cryptocurrency to get dollars to pay the IRS.

Payments using virtual currency made to independent contractors are taxable too. The recipient has their income measured by the market value at the time of receipt. What's more, as with other payments to independent contractors, taxpayers engaged in business must issue IRS Forms 1099.

You can't enter "1,000 Bitcoin" on IRS Forms 1099. You must value the payment in dollars, as of the time of payment. A payment made using virtual currency is subject to Form 1099 reporting just like any other payment made in property.

Many people seem to assume that all gains with cryptocurrencies are capital gains. If you hold it for more than a year, the best deal is long-term capital gain treatment. In reality, the gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in your hands.

Most people can probably say they are investors in cryptocurrencies, not a dealer or someone using it in their trade or business. But it is worth considering how you label yourself as ordinary income vs. long-term capital gain treatment can spell a big difference. You might have to pay only 15 percent on long-term capital gain. But top long-term capital gain rates are 20 percent, plus the possibility of paying the 3.8 percent net investment income tax under Obamacare.

Valuation swings in cryptocurrencies have been astounding, and they matter in many ways. Plainly, this issue is not limited to considering tax payments in cryptocurrencies. With almost any payment you make to anyone, it could matter a lot. Every time you transfer a cryptocurrency, you might trigger a gain or a loss.

Tax basis and holding period are also important considerations, and the record keeping and gain and loss determinations can be dizzying. What is the fair market value of the digital currency? If it is listed on an exchange and the exchange rate is established by market supply and demand, convert it into U.S. dollars at the exchange rate.

Remember, if you receive virtual currency as payment, you must you include its fair market value in income. Report the fair market value in U.S. dollars on the date you receive it. If you later sell it, what is the basis of virtual currency received as payment for goods or services? The fair market value in U.S. dollars on receipt.

If you mine virtual currency, you have income from mining, and the fair market value is income. Is virtual currency mining considered trading or a business that subjects you to self-employment tax? Regardless of the answer, the IRS gets a piece of just about everything.

Soon, though, Arizona could take center stage as the first state to start accepting crypto in payment of tax obligations. This is a positive development and may encourage other states — perhaps even the IRS — to follow suit. Just remember to consider your basis and holding period, and to keep good records.

The views and interpretations in this article are those of the author and do not necessarily represent the views of Cointelegraph.com

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