U.S. Taxes on Bitcoin and Other Crypto Impact Many Transactions

BY ROBERT W. WOOD

As the crypto craze worldwide has exploded, so has IRS' interest in it. The IRS is hunting crypto transactions feverishly, looking for civil as well as criminal violations. As a crypto-investor, you certainly don't want to be caught up in U.S. taxes. Hence, being aware of the U.S.' tax treatment of crypto investments and transactions is a must.

U.S. taxes and the IRS are frequent areas of concern around the world. Businesses all over the world sometimes have to consider the U.S. tax net. Investors into the U.S. do too. You might be willing to pay U.S. taxes on an investment you make *into* the U.S. But you certainly don't want to be caught up in U.S. taxes more generally if you can help it.

Of course, U.S. citizens and green card holders are always subject to U.S. taxes, no matter where in the world they live. Even if they file and pay taxes in other countries, they must report their worldwide income to the IRS. For green card holders who live outside the U.S., that can be a rude awakening.

If you have a green card, you are *conclusively* presumed to be a full-time tax resident of the U.S. for income tax purposes. That is so even if you no longer live in the U.S. You must properly relinquish your green card to be able to stop filing, and you may have to pay an exit tax to the IRS to do it.

For anyone with U.S. connections, there can be many things to worry about, and not just filing with the IRS. For example, in addition to tax returns, there are so-called FBARs, a type of foreign bank account reporting form that must be filed annually with the Financial Crimes Enforcement Network (FinCEN). FinCEN is distinct from the IRS, and another part of the U.S. Treasury Department. Penalties for failing to file the forms can be severe. Fines can be up to 100 percent of the account, and even criminal prosecution is possible in some cases.

All of these issues are more worrisome with FATCA, the Foreign

Account Tax Compliance Act. It is America's global tax law. It was quietly enacted in 2010, and after a multi-year ramp up, is having big effects. Never before has an American tax law attempted such an astounding reach.

FATCA generally requires foreign banks to reveal Americans with accounts over $50,000. Non-compliant institutions can be frozen out of U.S. markets, so everyone is complying. In essence, foreign banks everywhere are pushed to try to ferret out any of their account holders who appear to have American connections.

A U.S passport or green card obviously matters. But even a U.S. address or U.S. cell phone number can be enough. Banks ask questions, and want customers to affirm that they are fully compliant with the IRS. Fail to agree, and the bank can reveal you to the IRS.

Crypto Craze. Against this somewhat frightening background, the U.S. tax treatment of crypto investments and transactions may seem unimportant. But as the crypto craze worldwide has exploded, so has IRS' interest in it. The IRS is hunting crypto transactions feverishly, looking for civil as well as criminal violations.

And there are big tax dollars at stake. The IRS calls crypto property, so every transfer or trade can potentially trigger tax. There is considerable talk today about crypto investments for everyone, for individual retirement accounts, via index funds, and more.

There are also plenty of crypto-related start-ups, some of which have gotten quite big and quite valuable. That means options, crypto bonuses, restricted crypto, etc. All of these raise tax issues, and they can be confusing. Before we address crypto *itself* that is awarded to workers in connection with services, let's start with stock options, and options to acquire crypto.

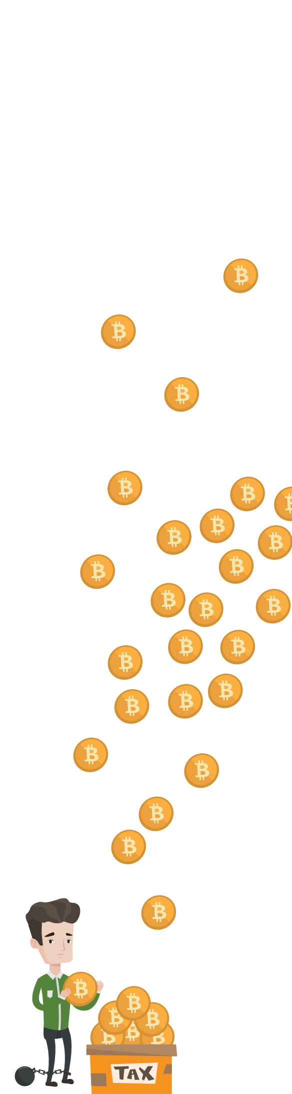
Two Types of Options. There are incentive stock options (or ISOs) and non-qualified stock options (or NSOs). ISOs (only for stock) are taxed the most favorably. There is generally no tax at the time they are granted, and no "regular" tax at the time they are exercised. Thereafter, when you sell your shares, you pay tax, but hopefully as long-term capital gain.

The usual capital gain holding period is more than one year. But to get capital gain treatment for shares acquired via ISOs, you must: (a) hold the shares for more than a year after you exercise the options; and (b) sell the shares at least two years after your ISOs were granted. This two-year rule catches many people. Even though exercise of an ISO triggers no *regular* tax, it can trigger alternative minimum tax (AMT).

Nonqualified Options. Non-qualified options are not taxed as favorably as ISOs, but there is no AMT trap. There is no tax when the option is granted. But when you exercise a nonqualified option, you owe ordinary income tax (and, if you are an employee, Medicare and other payroll taxes) on the difference between your price and the market value.

Example: You receive an option to buy stock at $5 per share when the stock is trading at $5. Two years later, you exercise when the stock is trading at $10 per share. You pay $5 when you exercise, but the value at that time is $10, so you have $5 of compensation income. If you hold the stock for more than a year and sell it, any sales price above $10 (your new basis) should be long-term capital gain.

Options to Buy Crypto. Options to buy crypto are treated just like nonqualified options to buy stock. Usually the tax comes when you *exercise* the option, not when you are given the option.



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Restricted stock or crypto means delayed tax. Suppose that you receive stock or any other property – including crypto – from your employer with conditions attached. Say you must stay for two years to get it or to keep it. Special restricted tax rules in Section 83 of the Internal Revenue Code kick in.

THE IRS WON'T WAIT FOREVER. With restrictions that will lapse with time, the IRS waits to see what happens before taxing it. Yet some restrictions will never lapse.

Let's consider pure restricted property. As a carrot to stay with the company, your employer says if you stay for 36 months, you will be awarded $50,000 worth of crypto. You don't have to "pay" anything for them, but it is given to you in connection with performing services. You have no taxable income until you receive the crypto. In effect, the IRS waits 36 months to see what will happen. When you receive the crypto, you have $50,000 of income (or more or less, depending on how the crypto has done in the meantime.) The income is taxed as wages.

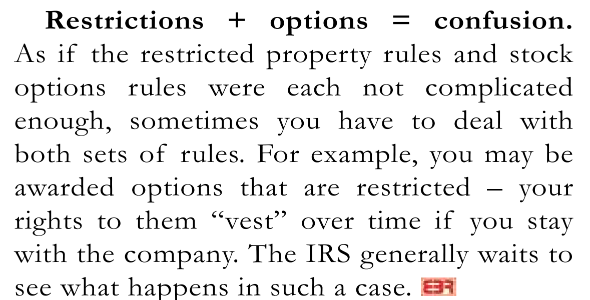
The IRS won't wait forever. With restrictions that will lapse with time, the IRS waits to see what happens before taxing it. Yet some restrictions will never lapse. With such "non-lapse" restrictions, the IRS values the property *subject* to those restrictions.

Example: Your employer promises you crypto if you remain with the company for 18 months. When you receive it, it will be subject to *permanent* restrictions under a company buy/sell agreement to resell it for a fixed price if you ever leave the company's employ. The IRS will wait and see (no tax) for the first 18 months. At that point, you will be taxed on the value, which is likely to be stated fixed price in the resale restriction.

You can elect to be taxed sooner. The restricted property rules generally adopt a wait-and-see approach for restrictions that will eventually lapse. Nevertheless, under what's known as an 83(b) election, you can choose to include the value of the property in your income earlier (in effect disregarding the restrictions).

It might sound counter-intuitive to elect to include something on your tax return before it is required. Yet the game here is to try to include it in income at a low value, locking in capital gain treatment for future appreciation. To elect current taxation, you must file a written 83(b) election with the IRS within 30 days of receiving the property. You must report on the election the value of what you received as compensation (which might be small or even zero).

Example: You are offered crypto by your employer at $5 per coin when it is worth $5. However, you must remain with the company for two years to be able to sell them. You are paying fair market value for the crypto. So filing an 83(b) election could report zero income. Yet by filing it, you convert what would be future ordinary income into capital gain. When you sell the crypto more than a year later, you'll be glad you filed the election.



Restrictions + options = confusion. As if the restricted property rules and stock options rules were each not complicated enough, sometimes you have to deal with both sets of rules. For example, you may be awarded options that are restricted – your rights to them "vest" over time if you stay with the company. The IRS generally waits to see what happens in such a case.

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