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Using Bitcoin For Taxes...Triggers More Taxes

First, it was Arizona, and now Georgia is moving to accept payments in Bitcoin and other cryptocurrencies. Both proposed laws are not yet final, but Arizona's Senate Bill 1091 has passed the State Senate. It seems likely that some other states will follow, and perhaps the IRS eventually will too. In Arizona, the tax man would convert it to dollars at the prevailing rate. You would get credited with the converted dollar amount, so timing could be important. IRS position said cryptocurrency is property in Notice 2014-21. That classification as property has some big tax consequences, accentuated by wild price swings.

If 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. 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. The transfer of the crypto to the tax man is a sale, and that could mean more taxes 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, 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—because of your tax payment. 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.

All sorts of transfers can trigger taxes. For example, payments using virtual currency made to independent contractors are taxable transactions to both parties. The recipient has income measured by the market value at the time of receipt. What's more, as with other payments to independent contractors, payers engaged in a 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.

The person paying the independent contractor with crypto just sold it. Whether that triggers a gain or loss depends on the payor's tax basis. The gain might be capital or ordinary. If you hold it for more than a year, the best deal is long-term capital gain treatment. But actually, gain or loss depends on whether the virtual currency is a capital asset in your hands. Most people can probably say they are investors in crypto, not a dealer or someone using it in their trade or business. But it is worth considering. Ordinary income vs. long term capital gain treatment can spell a big difference. You might have to pay only 15% on long term capital gain. But top long term capital gain rates are 20%, plus the possibility of the 3.8% net investment income tax under Obamacare.

Every time you transfer crypto, you might trigger gain or loss. Tax basis and holding period are important, as is record keeping. 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 "mine" virtual currency, you have income from mining, and the fair market value of what you produced is income. Arizona and Georgia may encourage other states to follow. But remember: consider your basis and holding period, and keep good records.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.