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Three Tax-Free Crypto Transfers

Selling crypto can obviously trigger taxes, but even *buying* something using crypto—a house, a car, a new suit of clothes—can trigger taxes. Even paying *taxes* in crypto can trigger taxes. The tax paradox started when the IRS ruled that cryptocurrency is property in Notice 2014-21. That classification has some big tax consequences, accentuated by wild price swings. If you pay off a $5,000 debt with crypto, as long as the crypto is worth $5,000 when you pay, you're home free, right? Not really. You need to consider the *sale* you just made. The transfer of the crypto to pay your debt 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 the debt, there's no gain. But if you aren't paying a debt but buying something, it's even worse.

Paying employees or independent contractors in crypto results in taxes to them when they receive it. And when you pay them, you too can have a tax hit, since on your side of the equation, you just sold your crypto. If you are paying with crypto, remember that most transfers of crypto are taxable, unless the transfer qualifies as a gift or a charitable contribution. We'll get to those, but first, how about transfers to legal entities?

Transfers to Controlled Companies. How about contributing your cryptocurrency to a corporation or partnership you will control? In general, transferring property into a corporation in exchange for its stock is a taxable event. It is as if you sold the property to the corporation in return for cash. The difference between the stock value you received, and the tax basis in the property you transferred to the corporation, will result in a gain or loss. However, Section 351 of the tax code generally allows people to transfer property to a corporation in exchange for stock without triggering tax, even if the property is appreciated. The corporation can be either an S corporation (basically taxed as a flow-through) or a C corporation (that itself pays taxes). The corporation can be newly organized or already existing. Of course, some requirements must be met, but if you meet them, some gains on an exchange of property for stock can be delayed. The IRS can tax it later when the shareholder eventually sells the stock received in the exchange.

No gain or loss is triggered as long as you receive only stock in exchange for your property and you are in control of the corporation immediately after the exchange. The control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of outstanding shares of all other classes of stock of the corporation. If you, along with others, transfer property into a corporation, you can do this as a group. So you don't have to have control personally.

The same kind of thing can work for partnership or LLC. Contributions of property or money in exchange for partnership interest are usually non-recognition events. In a way that is similar to the rule for corporations, the contributions can be tax-free, both to the contributing partner and to the partnership. For partnerships, this non-recognition rule is contained in Section 721(a) of the Tax Code. It generally applies regardless of whether the contribution is made on the formation of the partnership or after it has been in existence and operating for some time. But there are some potential traps, more so with partnerships than with corporations.

For example, this non-recognition rule does not apply to transactions between the partnership and a partner acting outside his capacity as a partner, or when the purported contribution is a disguised sale. Moreover, under Section 721(b), the no tax rule also does not apply to gain realized upon a contribution of property to a partnership "investment company," where the contribution results in the diversification of the transferor's assets. All of these issues that can trigger taxes can be hard to spot.

Gifts. You can give crypto as a gift, and it doesn't trigger income taxes. That's right, no income tax to you as the donor, and no income tax to the recipient. Of course, when the recipient transfers or sells it, there would be income taxes *then*. And at that point, the donee would need to calculate gain or loss. What is his or her tax basis, since it was a gift? The tax basis is the same as it was in your hands when you made the gift. However, keep in mind that to avoid income taxes, a gift has to *really* be a gift. The tax law is littered with cases of people who claimed something was a gift, but who got stuck with income taxes. With gifts not being subject to income taxes, it can seem tempting to try to characterize money or property you receive as gifts. But be careful: the IRS hears this 'it was a gift' excuse a lot. And the IRS is unlikely to be persuaded unless you can document it. Plus, the IRS usually expects a gift to occur in a normal gift-like setting. For example, if an employer or former employer gives a loyal employee $10,000 is that a gift? No, it is a bonus, treated as wages. Even trying to document it as a gift may not change that result.

True gifts may not trigger any *income* taxes, but there could be *gift* taxes involved. If you give crypto to a friend or family member—to anyone really—ask how much it is worth. If the gift is worth more than $15,000, it requires you to file a gift tax return. For 2021, $15,000 is the amount of the "annual exclusion." You can give gifts up to this amount each year to any number of people with no reporting required. Any gifts over that $15,000 amount require a gift tax return, even though you may not have to pay any gift tax. Rather than paying gift tax, you normally would use up a small portion of your lifetime exclusion from gift and estate tax.

Charitable Contributions. What if your gift isn't to a person, but to charity? If you give to charity, that can be very tax-smart from an income tax viewpoint. If you give crypto to a qualified charity, you should normally get an income tax deduction for the full fair market value of the crypto. If you bought it for $500, and donate to a 501(c)(3) charity when it is worth $15,000, you should get a $15,000 charitable contribution deduction. What's more, you won’t have to pay the capital gain or income tax on the $14,500 spread. That’s a good deal. It’s why most savvy people—think Warren Buffett—want to donate appreciated property rather than money to charity. Remember, if you use crypto to *buy* something, the IRS considers that a *sale* of your crypto. You have to calculate gain or loss. You might have *bought* something with your crypto. But you made a *sale* in the process. Be careful, the IRS is still on the hunt for taxpayers not paying taxes on crypto in a big way.

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