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At Tax Time, Who Really Owns That Crypto Anyway?

Bitcoin and other cryptocurrency is a property for federal tax purposes. That can be painful since just about any transfer of property can trigger taxes. Even crypto for crypto swap cannot qualify as a tax-free 1031 exchange, according to the Tax code.

For tax purposes, transfers are treated as sales unless you can find some other way of transferring cryptocurrency tax-free. The fact that the Internal Revenue Service (IRS) marks crypto as property might prompt you to consider the concept of ownership.

If you are holding crypto for someone else, is it really yours, or not? In other words, if you are holding the crypto for the benefit of someone else, who has to pay the taxes? The answer may be not 100 percent clear.

Start with the proposition that federal income tax liability is generally allocated based on ownership under local law. The issues can be intensely factual. Who has to pay can turn on who has control over and benefits and burdens of the property. The same thing can happen with bank accounts.

There may be one nominal owner, but the money might effectively be held in trust for someone else. Who has to pay tax on the interest, may be questionable. To make matters more confusing, local law ownership and beneficial ownership are not always the same. The IRS can try to tax the beneficial owner of an account, regardless of that person's rights to the funds under the prevailing local law. Federal income tax liability is presumptively allocated based on the law of the prevailing foreign jurisdiction.

But the IRS and the courts often look beyond the local law to impose taxes on the party who is the beneficial owner. In one case a man was subject to income tax as the beneficial owner of a bank account, even though he was not the owner of the account under local law. Conversely, if you are just holding something as an agent, you shouldn't be taxed.

If someone "holds legal title to property as an agent, then for tax purposes the principal and not the [agent] is the owner," one tax case put it. A nominal owner is not the owner for federal income tax purposes.

In general, income should be taxed to the principal, even if the agent is a joint signatory. The Supreme Court said that "the law attributes tax consequences of property held by a genuine agent to the principal." The Court enunciated a three-part agency safe harbor. Under it, you won't be treated as the owner for tax purposes if:

1. A written agency agreement is entered into with the agent contemporaneously with the acquisition of the asset;
2. The agent functions exclusively as an agent with respect to the asset at all times;
3. The agent is held out as merely an agent in all dealings with third-parties relating to the asset.

What if you don't meet all three of these conditions? Fortunately, the Tax Court has said that these factors are non-exclusive. Even an oral agency agreement might suffice, although if you're in a tax fight, you surely want to have it in writing.

Assuming a true agency, the agent should not face taxes on income over which he has no control and no beneficial right. The Tax Court has defined beneficial ownership as the

"freedom to dispose of the accounts' funds at will." Courts may weigh factors including: (1) which party enjoys the economic benefit of the property; (2) which party has possession and control; and (3) the intent of the parties.

The taxpayer opened four bank accounts in the names of his four children. He deposited money into the accounts but later withdrew it to facilitate his own business ventures. He continued to claim that his children owned the four accounts, so he did not report any of the income they generated.

The IRS said taxes were due, but the father argued that the accounts were solely for the benefit of his children. He claimed that the withdrawals were mere loans and would be repaid. Not surprisingly, the Tax Court determined that the father was the beneficial owner, so he had to pay the taxes. The court reasoned that:

"Our finding here is based on the identity of the true owner of the income-producing property. In such an inquiry, we look not to mere legal title, but to beneficial ownership. It is command over the property or the enjoyment of its economic benefits that marks the real owner. When transactions are between family members, special scrutiny of the arrangement is necessary, lest what is in reality but one economic unit be multiplied into two or more."

"While we do not doubt the sincerity of [the taxpayer's] long-term intentions, we nevertheless have found that [the taxpayer] owned the accounts in question during the years in issue. The circumstance that [the taxpayer] may have viewed the funds as the eventual property of his children does not change the nature of the dominion and control he exercised over those funds during the years in issue. [The taxpayer's] access to, and use of, the money in the children's bank accounts to facilitate his own business ventures establish him as the constructive owner of those funds. As such, we hold that he is subject to tax on any income earned on the children's accounts...."

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