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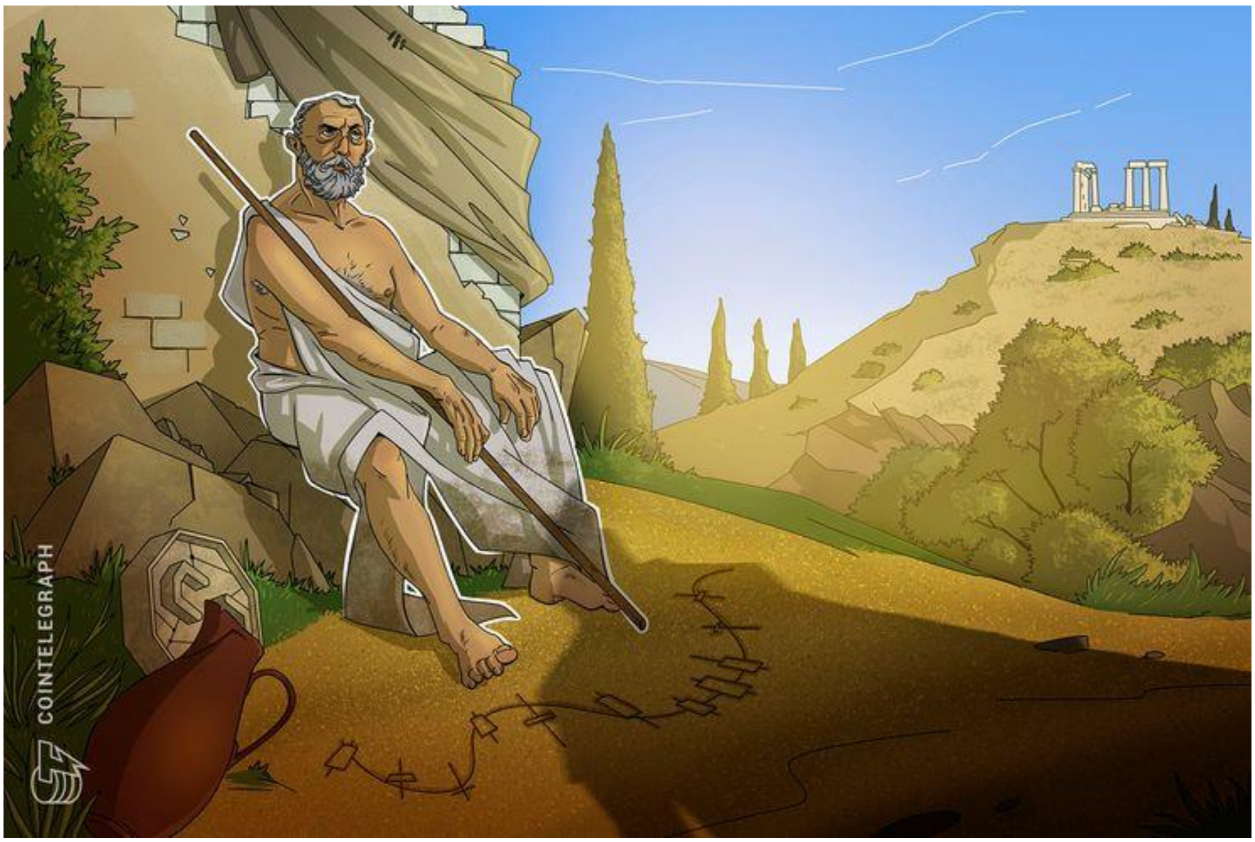
Do Crypto Trusts Save Taxes?



The IRS treats bitcoin and other crypto as property. So, each property transfer can trigger taxes. That can mean tax to the recipient, plus tax to the transferor. It is the latter that catches many people by surprise. The owners of bitcoin and other cryptocurrencies are responsible for paying taxes on transfers.

A key tax question on each transfer is the market value at the time of the transfer. With the wild swings in value that many crypto assets have experienced, that can be a frightening proposition. Some crypto investors resort to putting their crypto in legal entities such as corporations, LLCs or partnerships. These entities can face the same transfer issues, but it is usually possible to contribute the crypto to the entity without triggering taxes.

Then, the thought may be that reporting and accounting with a business entity may be easier. Inevitably, though, there are tough tax issues to address. Another avenue now being considered is a crypto trust. This is really just a trust that holds crypto assets. Trusts can be taxed in several different ways, depending on their type.

There are living trusts that people usually use for estate planning, and those are by far the most common. Notably, living trusts are not separately taxed. If you transfer Bitcoin to your living trust, it usually isn't a taxable transfer, since your living trust isn't really a separate taxpayer. It is still you.

So you would still report the gain or loss on a later sale on your personal tax return. The trust is not separately taxable, typically until you or your spouse die. But aren't there other types of trusts? Yes, there are non-grantor trusts, where the transferor is not taxed on them. These are separately taxed, and they file a separate trust tax return.

Trust tax rules can be complex, but that means the trust itself pays the taxes. There can be another tax on the distribution to beneficiaries. But leaving distribution issues aside, where does the trust pay taxes? That depends.

Some trusts are foreign, meaning that they are set up outside the U.S. Those rules are complex, but if you are U.S. person, you should not assume that you can avoid U.S. tax with a foreign trust. The most you might consider is that it might be possible at the federal level to have your trust pay the lower corporate tax rate of 21 percent, not your individual tax rate.

Of course, if you are paying capital gain tax, you might be paying up to 23.8 percent. That's not much of a savings. What about state taxes? This is where things get more interesting. Some trusts are being set up with an eye to reducing or avoiding state taxes.

Say you are in California and don't want to move to Nevada before you sell your Bitcoin. You want to cut the sting of California's high 13.3 percent state tax, but you aren't willing to move, at least not yet. You could consider setting up a new type of trust in Nevada or Delaware.

A 'NING' is a Nevada Incomplete Gift Non-Grantor Trust. A 'DING' is its Delaware sibling. There is even a 'WING,' from Wyoming. Let's say you can't move quite yet, so you wonder if a trust in another state might work? The usual grantor trust you form for estate planning doesn't help, since the grantor must include the income on his return.

An emerging answer for the adventurous is a Nevada or Delaware Incomplete Gift Non-Grantor Trusts. The donor makes an incomplete gift—with strings attached—to the trust, and the trust has an independent trustee. The idea is to keep the grantor involved but not technically as the owner. New York State has changed the law to make the grantor taxable no matter what.

California's Franchise Tax Board has not yet ruled on the issue. Some sellers hold significant assets and move states before they sell. California may have a claim on some of the sales proceeds even if the move is well-timed, bona fide, and permanent. Indeed, California can also dispute the move, arguing that a move in March really was not a move until July.

Thus, some marketers of NING and DING trusts offer it as an alternative or adjunct to the physical move. The idea is for the income and gain in the NING or DING trust not to be taxed until it is distributed. At that point, the distributees will hopefully no longer be in California. The chosen trustee must not be a resident of California.

If the NING or DING trust is formed to facilitate a business sale and the proceeds will be capital gain, there is the federal tax of up to 20 percent. Then, there is also the 3.8 percent Obamacare tax on net investment income. It makes the current federal tax burden on capital gain up to 23.8 percent. California taxes all income at up to 13.3 percent, and there is no lower rate for long term capital gain. It is one reason Nevada, Texas, Washington, Florida and other no tax states have always loomed large for California sellers.

Tax-deferred compounding can yield impressive results, even if it is only state income tax that is being sidestepped. If the NING or DING trust is being used to fund benefits for children and will grow for years, it may make even more sense. Parents frequently fund irrevocable trusts for children, and may not want the trust to make distributions for many years. The parents might also remove future appreciation of the trust assets from their estates.

For tax purposes, most non-grantor trusts are considered taxable where the trustee is situated. For NING and DING trusts, one common answer is an institutional trust company in Delaware or South Dakota. For trust investment and distribution committees, the committee members should also not be residents of California. Even if you jump through all the requisite hoops, the NING or DING trust may still pay some California tax. For example, if the trust has any California source income, it will still be taxable by California. Gain from California rental properties or the sale of California real estate is sourced to California no matter what.

Outside of New York residents, the jury is still out on NING and DING trusts. The facts, documents, and details matter. California tax lawyers know that the state rarely takes moves that short the state lying down. Still, California seems more likely to attack these trusts in audits rather than through the legislature. Even so, state tax fights in California can be protracted and expensive. But if one is careful, willing to bear some risk, and there is sufficient money at stake, the calculated risks may be worth considering.

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