# KIDS, CRYPTO, AND TAXES: AVOIDING THE HEADACHES

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Virtual currency is, by most objective standards, a new asset class. The oldest virtual currency is Bitcoin, which launched in 2009. In recent years, there has been a proliferation of technologies developed on Bitcoin's promise of distributed trust. At various points over the last two years, Distributed Autonomous Organizations (DAOs) and Non-Fungible Tokens (NFTs) have all received headlines for both the technology and the dollars invested in what is now being referred to as Web 3.0. For most Americans, these acronyms come across as a foreign language, but many tech-native Gen Z members see them as fun ways to meet friends, create art, and maybe make a bit of money, too.

Occasionally, involvement in these projects turns out to be as lucrative as winning the lottery. For example, the NFTs Cryptopunks, which are digital artworks, could be purchased in early 2019 for as little as $100. In 2021, Cryptopunks routinely traded in the $2.5 million to $5 million range. While these types of potential gains get the headlines, the more common scenario involves teenagers trading low market cap "altcoins" dozens of times a day with their allowance money. Each trade in crypto creates at least two taxable events, even if the trade only gains or loses a fraction of a cent per coin.

Why these taxable events matter, more importantly (at least to most parents), is that the IRS is getting better and better at obtaining virtual currency information from third-party sources and then pursuing compliance actions. Additionally, the "kiddie tax" requires that parents include their child's income on either a separate return or as part of their own return and that income is taxed at the parents' marginal rate. So, a professional couple with a child who made $60,000 from virtual currency trades could have under-reported their tax liability by roughly $30,000 in federal and state taxes without knowing it. Worse yet, based upon the existing-information reporting done by the virtual currency exchange that executed the trades, the IRS may know about the trades before the parents do. And the odds of the IRS learning of the activity before the parents is only going to increase as the exchanges implement the enhanced reporting required by the Bipartisan Infrastructure Bill of 2021.

### Basics of the kiddie tax

The kiddie tax is a long-standing anti-abuse provision designed to prevent wealthy parents from transferring income-producing investments to dependent children in a lower tax bracket. Internal Revenue Code (Code) section 1(g) states that minor children or certain dependents must pay tax at the parent's rate on all unearned income. Unearned income is defined in the negative as income that is not wages, salaries, or earnings that constitute a trade or business. While the kiddie tax has recently been subject to some controversies regarding how a change made as part of the Tax Cuts and Jobs Act impacted payments made to Gold Star families, the fact is that for 2021 and beyond, any investment income received by a minor in excess of $2,200 is taxed at the parents' marginal rate.

## Does a child's virtual currency activity meet a kiddie tax exception?

If a child's activity is a trade or business, they may meet an exception to the unearned income requirement of the kiddie tax. While at first glance it might be tempting to say that a teenager who spends every spare second out of the classroom online talking about virtual currency is both a full-time trader and a full-time student, the legal analysis of a trade or business is more nuanced.

It has been well-settled law for the past 80 years that efforts to manage investments do not amount to engaging in a trade or business.[1] While this used to mean managing real estate or bond portfolios in the hopes that the value would increase substantially over time, in 2022 this could encompass buying a Bored Ape Yacht Club NFT and then posting to Discord and Tik Tok about how much better a Bored Ape NFT is than a Mutant Ape NFT or buying an obscure altcoin and coordinating with your friends to all post about how your recent purchase is "going to the moon" complete with rocket ship emojis. Regardless of how the taxpayer seeks to increase the value of the property, the goal is the same: those actions seek to maximize the appreciation of the assets.

By contrast, "trades" are actions in the trade or business of trading that seek to profit from short-term market swings. Traders are not investors. They do not care about price appreciation, but instead they seek to capture value from short-term market swings. What matters to traders is that they believe they can hold the underlying asset and that, in a matter of weeks, the price will increase or decrease a certain percentage for them to sell for a profit and repeat the process. Factors that would indicate trading activity are the number of trades, the types of assets traded, the strategy used to capture market movements, and how continuous the activity is over the year.

While there is no guidance to indicate that virtual currencies are securities (and the application of Code section 475(f) to a securities trader's trade in a virtual currency trade requires a modest leap of faith), the most useful way of thinking about it is to answer this question: "Is the child in a virtual currency trade or business?"

A trader is considered to be in the trade or business of stock trading if they meet both prongs of a two-prong test: (i) the activity must first be "continuous, regular, and substantial"; and (ii) the goal of the activity is short-term profits based upon the fluctuations of the market.

"Continuous, regular, and substantial" is not an easy test to meet. The first challenge for minors in meeting the continuous and regular portion of this test is that most minors have other, bigger demands on their time. In most Tax Court cases involving ability to make a Code section 475(f) election, the taxpayer seeking the election does not have another job. Although the Tax Court has held that holding another full-time job is not disqualifying, it has held that the substantial hours need to be very substantial, and close to a full-time job, in order to qualify.[2] School and homework are significant time commitments that leave little time for the pursuit of business activities, and if the child is engaged in extra-circular activities, that will also complicate the analysis. This leaves a narrow window for any minor to spend enough time actively engaged in trading activity to meet the continuous test.

"Regular" is another barrier. Teenagers are not known for their perseverance, and the burden is on the taxpayer to show that the activity was regular. Buying and selling virtual currency in between baseball season and football season is unlikely to meet the regular requirement, and a trading history that happens to coincide with a dearth of other activity may be an indicator that the trades were done out of boredom rather than a profit motive.

The final test of "substantial" in the first prong is often the most difficult. It is unclear exactly what number of trades or transactions differentiate substantial from occasional activity but most likely that number is in the high hundreds or low thousands of trades a year. There have been some Tax Court cases that have held that trades in the hundreds were substantial, but the fewer the trades, the more difficult it is to meet the regular and continuous factors.[3]

The second prong is whether the activity sought to generate a profit is based upon the short-term fluctuations in the market. This factor often overlaps with the substantial analysis, in that many of the factors are related. In the securities realm, one of the first factors that is evaluated is the length of the average holding period of the taxpayer. In general, the more trades, the shorter the holding period, especially for younger people without significant amounts of money. Since virtual currency trading often has a social component to it, there is potentially a wealth of evidence that could be used to prove mindset. Whereas in the past, short-term objectives often relied upon taxpayer testimony to discuss the trading system they used and books they read, virtual currency traders may be able to introduce timestamped posts indicating that they were seeking to buy into a hyped virtual currency and cash out as quickly as possible.

## What happens if the activity is a trade or business?

If the virtual currency trading is continuous, regular, and substantial and the activity does seek to profit from short-term fluctuations in the market, the child may meet the exception to Code section 911 and be engaged in a trade or business. That does not mean that the income is not taxed. It does likely mean that the income is going to be taxed at a lower marginal rate. The first reason for the lower marginal rate is that the child's rate should not start at the highest marginal rate for the parents. The second reason is that all of the expenses for the production of income can be deducted from gross income and with virtual currencies those expenses, such as the transaction fees that are incurred during the transactions, may be substantial. These two factors may make a significant difference in the net income and the overall tax liability.

## What questions do taxpayers need to ask dependents?

Despite the fact that taxpayers have an obligation to accurately and correctly report all sources of income, many teenagers or other dependents may not be willing to volunteer the fact that they have substantial taxable gains. Teenagers who have made significant money may not want to tell their parents about the gains because they know that their parents will make them do something they don't want to with the money, such as paying their own college expenses. Regardless of that, the first step is always directly asking the dependent if they have virtual currency or any accounts at a virtual currency exchange.[4]

Alternately, parents might want to ask to see their dependent's phone or laptop. Having an exchange's app downloaded is a good indication that the dependent is engaged in virtual currency trading. Viewing the home Wi-Fi history is also a good way to see what websites a dependent is visiting. If there is significant time spent on virtual currency exchanges or virtual currency discussion forums, that would indicate that virtual currency transactions are likely.

Minors who trade virtual currencies are smart people. It takes time, effort, and intelligence to figure out what is desirable and how to make money from it. A discussion that focuses on the tax consequences of those profits, and the legal requirements imposed by the Internal Revenue Code, is likely to be a productive conversation.

## CONCLUSION

Virtual currency may have a generational divide on acceptance, usage, and even language, but even things that are barely understood are still taxable. Since the kiddie tax requires that a child's unearned income must be reported and taxed at the parents' rate, failure to communicate about a child's unearned income could potentially carry a significant tax liability. Parents who believe that their child might be engaged in virtual currency activity should inquire about what the child is doing and what the proceeds from the sales are. If the taxpayer does find out that their child is trading virtual currencies, the first step is determining how the proceeds are to be reported. If there is a belief that the activity may be sufficient to qualify as a trade or business, thus excluding the activity from the kiddie tax, evaluating the investor-versus-trader-of-securities factors will provide a roadmap for accurate reporting.

Notes

1 Higgins v. Commissioner, 312 U.S. 212 (1941).

2 Poppe v. Commissioner, T.C. Memo. 2015-205.

3 Paoli v. Commissioner, T.C. Memo. 1991-351; Chen v Commissioner, T.C. Memo. 2004-132.

4 While this article is focused on virtual currency, stock trading has become nearly as easy and accessible (mobile apps such as Robinhood have been accused of "gamifying" stock trading). The difference between crypto and stock trading is in the third-party reporting. Stock brokers will issue 1099-Bs; it may also be appropriate to ask about those online accounts as well.