CRYPTOCURRENCY

ESTATE PLANNING'S OTHER NIGHTMARE

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Estate planning is becoming increasingly challenging and uncertain. In addition to the unpredictable federal tax laws, we can add cryptocurrency to the list of estate planning nightmares.

What is Cryptocurrency?

By now, most of us have heard of BitCoin, which is a type of cryptocurrency. But what exactly *is* cryptocurrency? Cryptocurrency is a digital representation of value which functions as a medium of exchange. A "coin" is issued for each cryptocurrency unit. The cryptocurrency coins are accessible by a private key, which is a long string of letters and numbers (think of Apple's strong password suggestions). Similar to United States currency, the cryptocurrency coins are stored in a "wallet." There are two types of wallets: cold and hot. A cold wallet is tangible and non-digital — accessible on a hard drive, USB drive, or simply written on a piece of paper. A hot wallet is intangible and digital — accessible through an online exchange website with a username and password, like an Amazon account. Once the cryptocurrency coins are in a wallet, cryptocurrency can be used for two purposes. The first use is for investment purposes, like buying and selling stocks. Cryptocurrency's second use is for payment of goods and services, comparable to how United States Dollars and Cents are used.

Now with a general understanding of what cryptocurrency is, how does it actually *work*? Cryptocurrency is completely decentralized. There is not an institution in charge of managing, maintaining, or administering it. Cryptocurrency is maintained in blockchains. All cryptocurrency transactions are recorded in "blocks," which are then "chained" together from the previous cryptocurrency transaction. Hence, "blockchains." Put simply, a blockchain is an encrypted checkbook ledger, which is accessible online to all of the other cryptocurrency owners. Every cryptocurrency's checkbook ledger is uniform and constantly being updated as new transactions occur. It is always accurate and balanced (how impressive!)

So, what is the big deal? *Why* does cryptocurrency appeal to people? Some individuals are attracted to the decentralized, anonymous nature of cryptocurrency. Other individuals appreciate its security. Cryptocurrency blockchains are verified by validation techniques, which are extremely difficult to hack. ...And, then there are the few who just like it because it's "fire" right now.

What does the IRS think Cryptocurrency is?

Despite its name, in the IRS' eyes, cryptocurrency is not "currency." IRS Notice 2014-21 is the most comprehensive insight we have into the IRS' point of view regarding cryptocurrency. The IRS deems cryptocurrency as property, even if it is being used as payment for goods and services. Therefore, general tax principles applicable to property also apply to cryptocurrency transactions. These property transaction rules involve capital gains, income, and loss. A client bought cryptocurrency two years ago and sold it for a gain — that's a long-term capital gain. A client performed services and was paid in cryptocurrency — that's income.

IRS Notice 2014-21 gives further instruction on how to determine the basis and fair market value of cryptocurrency. Following general tax principles, cryptocurrency's basis is the fair market value (in United States Dollars) on the date of payment or receipt. The tricky part is calculating the fair market value. If the cryptocurrency is listed on an exchange, which is established by market supply and demand, then the fair market value of the cryptocurrency as listed on the exchange can be converted into United States Dollars at that exchange rate. Sounds easy, right? Beware the IRS added the phrase "in a reasonable manner that is consistently applied" to the end of their fair market value calculation answer. Unlike a stock listed on the Nasdaq, the same cryptocurrency can have different values on various exchanges, so valuation may actually require an appraisal in certain circumstances.

Lastly, like-kind exchange rules do not apply to exchanges of one type of cryptocurrency for another. In IRS Legal Memorandum Number 202124008, released on June 18, 2021, the IRS denied like-kind exchange treatment under Section 1031 of the Internal Revenue Code for the exchange of Bitcoin, Ether, and/or Litecoin before January 1, 2018. This Memorandum was specific only to these three types of cryptocurrencies, but it is unlikely the IRS' view on other types of cryptocurrency exchanges would be any different. The 2017 Tax Cuts and Jobs Act restricted Section 1031 like-kind exchanges and made it applicable only to real property exchanges after December 31, 2017. Therefore, any exchanges of cryptocurrencies, no matter which type, on or after January 1, 2018, will not receive this Section 1031 preferential treatment of not recognizing gain or loss from an exchange.

The Nightmare

Apart from the lack of IRS guidance, cryptocurrency is showing up in estate planning advisors' nightmares for three primary reasons. The first reason is cryptocurrency's volatility is just straight up scary. BitCoin's value has ranged from about .08 cents per coin in 2010, to a peak of about $65,000 per coin in April 2021. As of October 2021, BitCoin was worth about $55,000 per coin. If a client's net worth is over or close to the current/proposed federal estate tax exemption, his or her cryptocurrency should be monitored closely. Cryptocurrency's rollercoaster values can send a client over the federal estate tax exemption and cause unwanted federal estate tax liability.

If a client has highly appreciated cryptocurrency and charitable intent, an advisor should discuss with the client possibly donating the cryptocurrency directly to charity. Cryptocurrency is a good option for charitable donations for several reasons. The charity will not be subject to capital gains tax on the cryptocurrency's appreciated value. Therefore, the charity will actually receive the full value of the cryptocurrency to do good in the world and use towards its charitable purposes. In exchange for the donation, the client will receive a charitable income tax deduction (subject to a limit of 30% of the client's adjusted gross income in 2021) for the fair market value of the cryptocurrency. The client will not be entitled to utilize the full 100% charitable income tax deduction available for cash donations in 2021 because again, the IRS does not view cryptocurrency as "currency" or "cash."

However, this strategy has a couple of requirements. First, the cryptocurrency must have been held as an asset by the client for at least one year. Secondly, the charity must be able to and/or willing to accept the cryptocurrency as a donation. If the client's charity is adverse to accepting cryptocurrency, several donor advised fund sponsors are willing to accept the donation of cryptocurrency, and the client could then recommend cash grants from his or her donor advised fund.

The second cause of nightmares is the alarming uncertainty of probate avoidance. Since cryptocurrency is considered property, if it is titled in a client's individual name without a beneficiary or payable on death designation, it will be included in a client's probate estate.

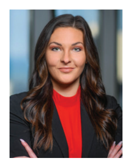
Currently, there is not an established solution to this problem. A client may attempt to purchase and title cryptocurrency in his or her trust. Further, if the cryptocurrency is held in an investment account, a client can add a joint with rights of survivorship owner or payable on death designation to the account. However, if a client's cryptocurrency is held only on a cryptocurrency exchange, this may not be an option.

Estate planning attorneys should add cryptocurrency to the definition of tangible personal property in their last will and testaments and trust agreements. Further, estate planning attorneys should specifically include "cryptocurrency and any other similar digital currency" in their assignments of tangible personal property. Keep in mind if these provisions are included in estate planning documents, a client's cryptocurrency will be distributed under the tangible personal property provisions and not under any residuary provisions. Estate planning attorneys should ensure these provisions align with the client's intentions. Lastly, estate planning attorneys should also grant fiduciaries access to cryptocurrency wallets and any other cryptocurrency accounts in their estate planning documents.

The last and most spine-chilling nightmare of them all is cryptocurrency's ghostlike existence. First and most importantly, advisors need to actually be aware a client owns cryptocurrency. Being aware is half the battle. Advisors and fiduciaries also need to be knowledgeable of how to gain access to a client's cryptocurrency. Remember, there is not a "1-800 number" for a fiduciary to contact to inquire about a client's cryptocurrency or a mailing address to send letters of authority. If a client owns cryptocurrency in a cold wallet (tangible and non-digital), the private key should be stored with the client's other important documents, for example, in a secure fireproof box. If a client has a hot wallet (intangible and digital), the client should create a list of online account usernames and passwords, which can be accessed by a fiduciary.

In an effort to ensure due diligence, all advisors should amend their initial questionnaires to request information regarding a client's cryptocurrency ownership and how/where it is located. Lastly, advisors who provide clients with a digital asset inventory list to complete all of their accounts' usernames and passwords, should also add a cryptocurrency section to this list.

Careful and thoughtful planning for cryptocurrency may help clients and their advisors sleep (a little) better at night.



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