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By Alice M. Haseltine, JD, and Robert K. Kirkland, JD, LLM

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Cryptocurrency is virtual currency that is created digitally. It is unlike fiat money in that typically it is not backed up by gold or other hard assets, and it also is immune from government regulation. Cryptocurrency relies on blockchain technology to secure transactions and to verify the transfer of units. "Blockchain" is a list of digital records or "blocks" that are linked using cryptography. It consists of a time-stamped series of immutable records of data, commonly called a ledger. Cryptocurrency is created through a process called "mining," with miners that confirm blockchain transactions by solving cryptographic puzzles. Miners are "rewarded" for their contribution to network security with new cryptocurrency.

"Bitcoin" is the most common type of cryptocurrency, and more than 18 million bitcoins are outstanding with an aggregate U.S.-dollar (USD) worth exceeding US$170 million.[1] Bitcoin is undoubtedly the household name in cryptocurrency; however, there are thousands of alternative currencies colloquially referred to as "altcoins" (as in, alternatives to bitcoin). Some of the most popular altcoins include Ethereum, XRP, Tether, Ripple, and Litecoin.[2] According to CoinMarketCap, which is a price-tracking website for crypto-currencies, as of the date of publication, there are more than 5,000 different virtual currencies with a total market cap at around US$260 billion.[3]

New currencies are entering the market constantly. In fact, Facebook, Inc. is preparing to launch a cryptocurrency this year, which will be called "Libra."[4] Libra will be different from other cryptocurrencies in at least a couple of respects: First, it will be backed by financial assets, such as cash, cash equivalents, and short-term government securities.[5] Second, Libra will be governed by an organization headquartered in Geneva, Switzerland, called the "Libra Association" that will comprise member companies.[6]

Wealth planners need to understand virtual currency and be apprised of the unique challenges associated with clients' ownership of this asset class, because cryptocurrency's popularity is trending upward in a dramatic fashion, both as an investment alternative and as a legitimate form of currency that can be used as a means to pay for goods and services. With each passing month, our clients' awareness of, perception of, and propensity to purchase cryptocurrency increases. Perhaps unsurprisingly, the ownership of cryptocurrency is particularly popular among younger demographics. One-quarter of individuals between age 24 and 38, who either have $50,000 of investable assets or $100,000 in annual income, own some form of cryptocurrency.[7] Additionally, a growing number of businesses, including Whole Foods, Crate and Barrel, and Nordstrom, now accept cryptocurrency as payment.[8] By all metrics, the world of cryptocurrency is expansive—and growing—and the fiduciary issues presented by cryptocurrency in the realm of wealth planning and estate and trust administration are complex and deserve attention.

OWNERSHIP OF CRYPTOCURRENCY DURING LIFE

Digital currency can be traded digitally between users (such as through an exchange, like Coinbase or Binance), and it can be purchased for, or exchanged into, USD or other fiat money. However, cryptocurrency does not have legal tender status in any jurisdiction.[9]

There are many ways to store crypto-currency. It is commonly stored in a "wallet," which, in reality, is stored in one of many different ways, including on an exchange or on a mobile device. Broadly, there are two major ways to store cryptocurrency. Offline storage, or "cold storage," typically involves storage on USB drives, offline computers, or "paper wallets" (physical documents that contain access information).[10] In contrast, "hot storage" is online storage that is connected to the internet.[11] Hot storage is generally thought to be a more convenient means of storing crypto-currency because it offers quicker access to cryptocurrency, but it is also thought to be less secure than cold storage.[12]

Each wallet uses a series of random characters called a "public key," which is an address for sending and receiving the bitcoin. The owner of the bitcoin has a separate “private key” that is the only way to access the bitcoin contents of the wallet. This is incredibly secure.

If the owner of the cryptocurrency loses the private key, or fails to pass it on to his or her fiduciary or intended beneficiary, the currency likely will be lost forever because there will be no way to access the wallet. For many investors in cryptocurrency, privacy of ownership is one of the most attractive features of the currency; however, this very feature makes planning for and administering cryptocurrency particularly challenging.

PLANNING FOR CRYPTOCURRENCY AT DEATH

Assisting clients with identifying cryptocurrency held in their portfolios, assisting them in developing and maintaining an inventory of the cryptocurrency, and counseling them to adopt a strategy for the passage of the private key upon death or incapacity is critical to the retention of and the efficient transfer of cryptocurrency.

Estate planning instruments should be tailored to specifically address ownership of cryptocurrencies. Specifically, the management of cryptocurrency should be addressed explicitly in a financial durable power of attorney. Further, clients should provide in their wills or trusts authorization of the fiduciary to access cryptocurrency and administer and retain the cryptocurrency (when retention is anticipated and desired by the client). Additionally, wills or trusts need to specifically provide where such assets should pass upon the client’s death.

Much like inventorying the rest of a client’s digital property, the options for securing and disposing of the private key include writing it down and keeping it in a safe deposit box to which the fiduciary of the client will have eventual access, storing it on a flash drive or other external hard drive, or entrusting it with a commercial service that manages cryptocurrency.

The administration of cryptocurrency in an estate or trust is unlike the administration of any other assets. After a client’s death or incapacity, with many financial assets, a fiduciary will take steps to identify the asset, ascertain how the asset is titled, and whether the asset contains a beneficiary designation. The fiduciary would then coordinate with the asset custodian to effectuate the transfer of ownership of the asset. However, ownership of virtual currency is typically anonymous and there is often no custodian or governing authority tracing ownership. Accordingly, if a client loses the private key, or fails to tell family members or fiduciaries about the existence of the currency and the private keys required to access it, the result is akin to throwing money out of a car window. However, if the client used an exchange service for the purchase of the cryptocurrency, a fiduciary may be able to access the currency through working with that exchange.

There are numerous horror stories involving the loss of cryptocurrency in the estate and trust administration context, and the stories seem to be multiplying in number. In 2017, a young man passed away suddenly in Colorado, having done little or no estate planning.[13] As his family began the difficult task of administering his estate, family members noticed bank account transactions with Coinbase, a cryptocurrency wallet and exchange service.[14] Through this discovery, it was determined that the decedent had been investing in bitcoin. It was further discovered that the decedent had acquired bitcoins at a price as low as US$13 per bitcoin in 2013.[15] At the time of the decedent’s death, the value of the bitcoin was US$5,000 per bitcoin. Unfortunately, without the private keys, the decedent’s family members were unable to access the bitcoins.

In a similarly unfortunate story, in 2009, a Welsh citizen owned approximately 7,500 bitcoins that were stored on a hard drive.[16] At the time, the bitcoins were almost valueless. A few years later, the Welsh citizen, having forgotten that the bitcoins were stored on the hard drive, disposed of the hard drive at a landfill in Newport, South Wales, where it was buried. As of the time of this article, those same bitcoins would have been worth approximately US$70 million.[17]

In this regard, the time-tested method of reviewing past tax returns, financial account statements, and credit card statements and searching for transactions with any exchange services that might handle crypto-currency is paramount.

These stories provide lessons for fiduciaries. First, fiduciaries need to carefully review all information that could reveal whether a deceased or incapacitated client owns cryptocurrency. In this regard, the time-tested method of reviewing past tax returns, financial account statements, and credit card statements and searching for transactions with any exchange services that might handle cryptocurrency is paramount. Second, fiduciaries need to carefully analyze digital media before disposing of any property. Specifically, it is extremely important that fiduciaries examine the smartphones, tablets, laptops, and desktop computers of incapacitated or deceased clients to ensure that digital currency is not discarded mistakenly. Finally, fiduciaries must be wary of beneficiaries who might take possession of and walk off with cryptocurrency without disclosing it, much like they might do with cash, jewelry, or artwork.

TAXATION OF CRYPTOCURRENCY

In 2014, the Internal Revenue Service (IRS) issued IRS Notice 2014-21 (the “Notice”), which is, to date, the most comprehensive guidance issued by the IRS on the taxation of cryptocurrency.[18] The structure of the notice is a question and answer format, and the purpose of the Notice is to explain the application of general taxation principles to cryptocurrency. In the Notice, the IRS explained that "[f]or federal tax purposes, virtual currency is treated as property."[19] This means that, to understand the taxation of cryptocurrency, we need to turn to the taxation of property transactions.

This also means that cryptocurrency has a tax basis. In one example provided in the Notice, the IRS explained that the tax basis in cryptocurrency that the taxpayer receives as payment for goods or services is the fair market value of the currency as of the date of receipt.[20] The character of gain on a sale or exchange of cryptocurrency depends on whether it is a capital asset in the hands of the taxpayer. For the very first time ever, the 2019 Form 1040 asks taxpayers whether they traded cryptocurrency in 2019.[21]

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The Notice makes clear that, if the taxpayer is a "dealer" in cryptocurrency, then the income will be ordinary income. Thus, when cryptocurrency is converted into cash, this transaction is treated most often as a capital gains transaction for income tax purposes. However, cryptocurrency is not treated as currency that could generate foreign currency gain or loss for federal income tax purposes.

If clients receive virtual currency as payment for goods or services, they must include the fair market value of the virtual currency in their taxable income. Likewise, this same amount is the recipient's basis for such virtual currency. If a user obtains new virtual currency through mining, then that activity produces ordinary income in the year the new virtual currency was mined. Individuals engaged in mining as a trade or business will have to pay self-employment taxes on the fair market value of any currency received but may be able to deduct or capitalize associated expenses, such as the cost of electricity.

Fair market value of cryptocurrency that is listed on an exchange is determined by the exchange rate measured by then-current market supply and demand. In the Notice, the IRS makes clear that all of the normal reporting rules that apply to transactions involving normal currency also apply to cryptocurrency, including withholding, self-employment tax, information reporting, backup withholding, third-party reporting, etc.[22] The 2017 Tax Cuts and Jobs Act amended Internal Revenue Code Section 1031, which makes clear that a swap of cryptocurrency does not qualify for like kind exchange exemption.[23]

To date, the IRS authority on the income taxation of cryptocurrency barely scratches the surface of the tax issues at play, and additional guidance is needed. In recent years, multiple professional organizations have requested additional guidance. In May 2018, the American Institute of Certified Public Accountants requested guidance on several income tax issues including (1) whether charitable contributions of cryptocurrency valued in excess of $5,000 will be treated the same as contributions of publicly traded stock, (2) what types of retirement accounts can own cryptocurrency, and (3) the appropriate accounting method for computing capital gains and losses.[24]

Additionally, in March 2018, the American Bar Association's Tax Section sent a letter to the IRS requesting advice regarding the taxation of cryptocurrency.[25] Specifically, the letter requested guidance on the income tax consequences of a "hard fork," which is a "change to the software of the digital currency that creates two separate versions of the blockchain with a shared history."[26] After a hard fork, the owner of the currency retains an interest in the original coin and also has a right to use the forked coin.[27] A hard fork raises numerous tax questions, such as whether the fork is a realization event for income tax purposes. In October 2019, the IRS issued Revenue Ruling 2019-24 and additional FAQs.[28] Specifically, the new ruling explains that cryptocurrency received from a hard fork must be reported by the taxpayer as gross income, which generally will be treated as ordinary income and will be subject to the taxpayer's highest marginal tax rate.[29]

For federal estate and gift tax purposes, cryptocurrency is an asset that must be included in the gross estate for federal estate tax purposes, or, cryptocurrency must be included on a gift tax return if gifts of cryptocurrency are made. As a general matter, the fair market value of cryptocurrency is to be calculated by converting the virtual currency into USD at the then-current exchange rate, in a reasonable manner that is consistently applied.[30] Application of this apparently simplistic rule proves difficult in practice because the value of bitcoin and other virtual currencies fluctuates by the hour.

INVESTING IN CRYPTOCURRENCY

The thrill of potential double- and triple-digit gains has many investors thinking and talking about investing in cryptocurrency. Almost every state has adopted the Uniform Prudent Investor Act, which governs the investment activity of fiduciaries in those states. Investment in cryptocurrency, however, is so new that it is not specifically addressed in the Uniform Prudent Investor Act. The authors believe that the retention of cryptocurrency by a fiduciary, without express approval from the beneficiaries of the trust or estate, may be deemed imprudent because of the present volatility of cryptocurrency markets. The 28-percent drop in value of bitcoin in January 2020 (which occurred well before the volatility experienced by U.S. markets during the coronavirus pandemic) is enough evidence of cryptocurrency's volatility and likely will keep fiduciaries sufficiently cautious about affirmatively investing in cryptocurrency.

WHAT DOES THE FUTURE HOLD?

Cryptocurrency is a complicated asset class that comes with a totally foreign lexicon, and it is becoming increasingly more complex as the number of currencies, exchanges, and types of transactions multiply. Price discovery or value discovery is an evolving concept with regard to cryptocurrency. Certain events can turn this process into a roller coaster. Consider for example, a fork or "chain split," which occurs when one currency blockchain splits into two separate virtual currencies.[31] An "airdrop" occurs when there is a distribution of new virtual currency tokens to existing owners of a particular cryptocurrency on a pro rata basis.[32] A "giveaway event" occurs when an amount of cryptocurrency is given to a holder for creating an account on a related wallet.[33] Price discovery of these items results in a zero value, the holder has zero basis, and the income tax consequences of these activities have yet to be fully understood. Undoubtedly, even further expansion of IRS Notice 2014-21 is needed to address the constant developments in cryptocurrency.

Perhaps you remember a time when investing in hedge funds was considered ultra-aggressive. Now, these funds are an important part of many investment allocations. Fiduciaries would be wise to carefully follow the development of cryptocurrency because the day likely will come when cryptocurrency too is part of the investment allocation decision equation.

So, what do you do if you become a trustee of a trust that holds cryptocurrency? Perhaps the course is not perfectly charted, but several baseline steps must be taken: The fiduciary should (1) quickly ascertain all available value and basis information for the cryptocurrency; (2) be in communication with the beneficiaries to discuss each beneficiary's desire with respect to the retention or sale of the asset; and (3) take steps to ensure the security of the cryptocurrency while

An 'airdrop' occurs when there is a distribution of new virtual currency tokens to existing owners of a particular cryptocurrency on a pro rata basis.

it is in the fiduciary's custody. Lastly, fiduciaries should document every single move they make with respect to the asset, because cryptocurrency likely may challenge the templates of the fiduciary's current accounting system.

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