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CRYPTOCURRENCY, NFTs, AND OTHER DIGITAL ASSETS

CREDITOR CLAIMS AND YOUR DEBT AFTER DEATH

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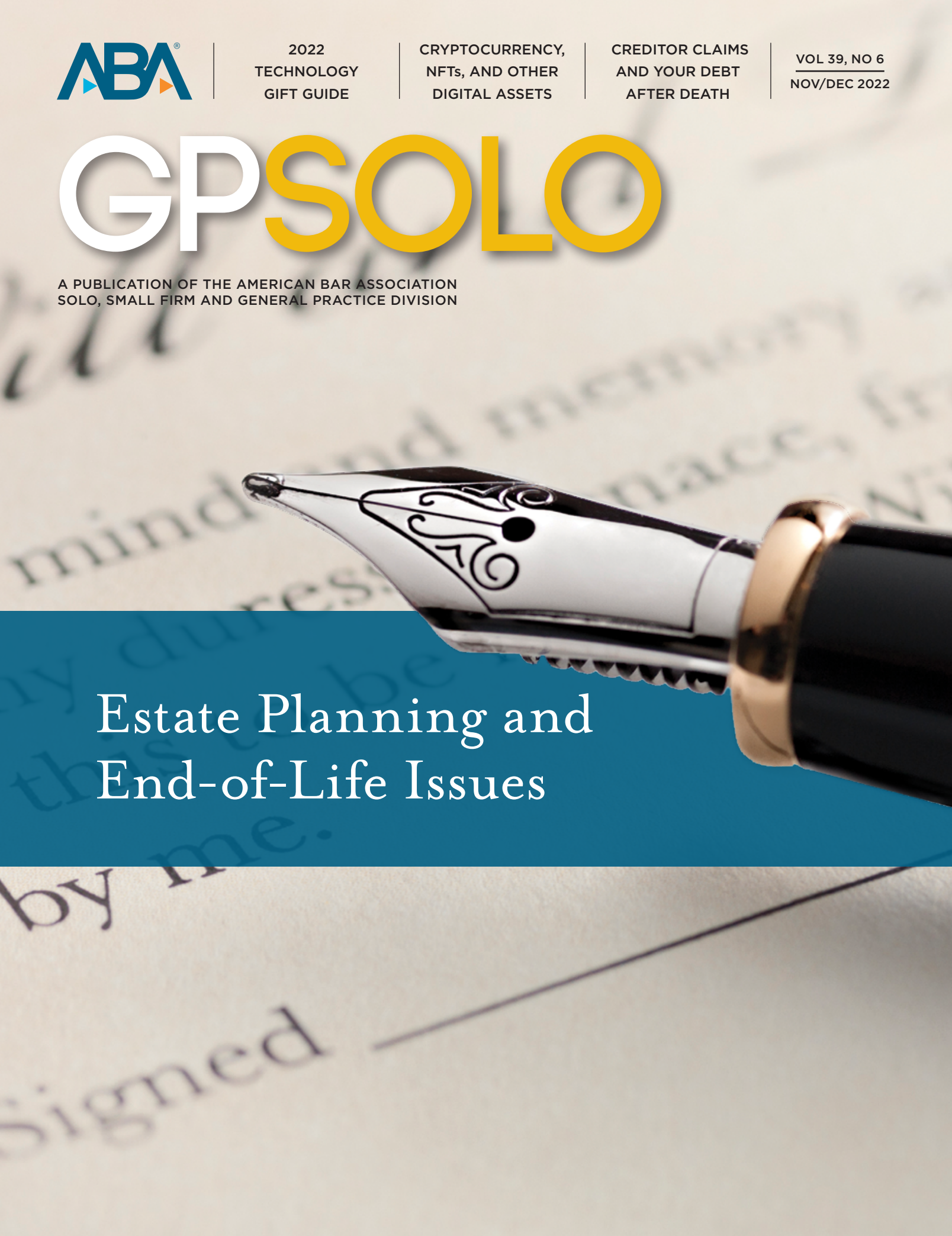

Estate Planning and End-of-Life Issues

Welcome to Your Digital Afterlife

Estate and Tax Planning for Digital Assets, Cryptocurrency, and NFTs

By Stephen Ribble and Lesly Longa Vaillancourt

Our lives have become intertwined with technology, and modern estate planning should include a plan for how digital assets will be administered after death. Failure to plan for your digital afterlife will result in an electronic mess for your representative and heirs.

According to the Uniform Law Commission's website (https://tinyurl.com/wnu4fw2d), most states have enacted some form of the 2015 Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA), which allows an executor or personal representative to manage computer files, web domains, and digital assets. RUFADAA provides a fiduciary with access to digital assets unless such disclosure was specifically prohibited by the user in a legal document. Every will, trust, and power of attorney should include a specific provision on access to digital assets and accounts. In some cases, depending on the personal and confidential nature of their accounts, clients may want to grant access to accounts to someone other than the person designated as the executor, personal representative, or trustee. That, too, can be specified in estate planning documents.

Section 2(10) of RUFADAA states that the term digital asset "means an electronic record in which an individual has a right or interest. The term does not include an underlying asset or liability unless the asset or liability is itself an electronic record." Even though your smartphone is not a digital asset, a good portion of your digital life is on your phone. Both Apple and Google have legacy contact features that allow you to designate a person to have access to your phone and accounts after you pass away. Facebook also allows you to list a legacy contact to access your account after your passing.

CREATING A DIGITAL ASSET INVENTORY

How will your personal representative know about the existence of all your digital assets and where to find them? Make a list of all your social media accounts, message board accounts, web domains, file storage, cloud accounts, online financial accounts, and online medical record apps. You now have an inventory of your digital assets to include with your other estate planning documents.

Now add any digital currencies you hold to that inventory. Digital currency is digital cash, which includes cryptocurrency and Bitcoin. Cryptocurrency is electronic money based on a decentralized digital system. The European

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Banking Authority has defined it as a "digital representation of value that is neither issued by a central bank of a public authority, nor necessarily attached to a flat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically" (*EBA Opinion on "Virtual Currencies,"* Eur. Banking Auth. (July 4, 2014), https://tinyurl.com/2p8bfz9c).

Bitcoin was created around January 3, 2009, by a person, or group of people, going by the pseudonym Satoshi Nakamoto. About a week later, Satoshi sent 10 Bitcoin to Hal Finney as a test, marking the first official transaction involving cryptocurrency. The first business transaction involving cryptocurrency occurred on May 22, 2010, when Laszlo Hanyecz bought two pizzas with 10,000 Bitcoin. Fast-forward to today, and Bitcoin is the most popular and most valuable cryptocurrency. Its popularity has created the cryptocurrency investment category and led to thousands of other cryptocurrencies such as Ethereum, Chainlink, Dogecoin, and Tether.

DIGITAL ASSETS AND TAXES

Cryptocurrency's popularity hasn't gone unnoticed by the Internal Revenue Service (IRS) either, as they project billions of dollars of transactions going unreported every year. The IRS has stepped up enforcement activities in cryptocurrency tax reporting, going so far as issuing "John Doe" subpoenas to brokerage firms in order to track down unreported cryptocurrency transactions. This focus by the IRS makes it imperative that individuals understand the tax implications of cryptocurrency so they can properly report taxable transactions to the IRS.

Before we dive into the tax aspects of cryptocurrency in estate planning, we should begin with an explanation of some common cryptocurrency tax events. There are different ways someone can obtain cryptocurrency, which impacts how it is taxed. Some common terms you may hear are forks, airdrops, and mining.

Forks are essentially software updates to the blockchain code of the cryptocurrency. There are two types: "soft forks" and "hard forks." A soft fork is a software update to the existing blockchain; it has no tax impact on the coin holder. For example, in September 2022 Ethereum went through a soft fork that resulted in a validation switch from proof-of-work to proof-of-stake, resulting in massive computer power (energy) savings associated with the blockchain's validation process—but did not change the taxable value of the coins themselves. A hard fork is an update that results in a new cryptocurrency that may be distributed to the coin holder. Bitcoin Cash was the result of a hard fork in Bitcoin back in August 2017. Hard forks are taxable to the coin holder in two different ways. Initially, upon receipt of the new cryptocurrency, the taxpayer has reportable miscellaneous income in the amount of the value of the coin. This value then becomes the cost basis in the coin, which, when the taxpayer sells, is used to calculate the capital gain or capital loss. For example, XYZ cryptocurrency undergoes a hard fork, resulting in a new coin with a value of $1,000. Taxpayers would report the $1,000 as miscellaneous income on their tax return. The $1,000 then becomes the cost basis in that coin. If taxpayers sell the coin later in the year for $2,000, they would have a reportable capital gain of $1,000.

Cryptocurrency's popularity hasn't gone unnoticed by the IRS.

Airdrops are typically promotions often sent to early users of a new cryptocurrency platform or service. Airdrops are similar to cashback rewards offered from credit cards or cash bonuses for opening a checking account with a bank. Coins are distributed to taxpayers, who are often unaware of receipt. Airdrops are taxed the same way as hard forks: miscellaneous income upon receipt and capital gain or loss upon the sale of the coin.

Mining is the process of verifying cryptocurrency transactions by means of specialized software. Successful miners receive rewards (small amounts of cryptocurrency) for their efforts. These rewards are taxed as ordinary income and reported on Schedule C. The net profit from mining is subject to federal income tax, as well as Social Security and Medicare taxes. Social Security and Medicare taxes, also known as self-employment tax, add an additional tax of 15.3 percent on top of federal income tax.

Businesses that receive cryptocurrency as a form of payment in exchange for goods or services would report the amount received the same way they would report a cash transaction. The amount received is treated as income to the business. However, just like mining coins, once the business sells the coins and converts them

to U.S. dollars, there would be a capital gain or loss reported. The cost basis would be the value of the coins received in the original transaction. For someone who is self-employed, this income is included on Schedule C and subject to self-employment taxes.

The most common way for an individual to have reportable cryptocurrency transactions is through buying and selling for investment purposes. Cryptocurrencies are treated as property and taxed as capital gains or capital losses when sold, just like common stocks. Taxpayers would report these transactions on Form 8949.

Cryptocurrencies can be held in brokerage accounts or in private digital wallets. The wallets are secured by a private key known only to the owner. That key unlocks the wallet, enabling the owner to access the coins to sell or transfer. Many individuals have multiple crypto wallets, each one requiring different private keys. Transfer of coins from one wallet to another is not a taxable event and does not have to be reported.

A word of caution is needed here. Many cryptocurrency platforms do not provide taxpayers with good records for tax purposes. Transfers of coins from one wallet to another can make it difficult to ascertain the cost basis when that coin is sold. It is important to keep good records of all cryptocurrency transactions as backup documentation in the event of an IRS audit and to ensure proper reporting for tax purposes.

Another digital asset that is becoming increasingly popular is the non-fungible token (NFT). NFTs are digital assets that are unique collectibles, such as artwork, music, images, and social media posts. NFTs are electronic representations of property, much like a casino chip is a physical token representing a certain number of dollars. Professional sports leagues, such as the NBA, have been creating and selling digital images of players as NFTs. Single NFTs have sold for millions of dollars. There was even a home sold as an NFT in Florida recently. NFTs are capital assets and are taxed similar to cryptocurrencies. When the NFT is sold or transferred, the owner would report a capital gain or loss on Form 8949. Owners of NFTs should keep good records of the purchase and sale for tax purposes.

TRANSFERRING DIGITAL ASSETS

When it comes to estate planning and the transfer of digital assets, cryptocurrencies and NFTs both will receive a step-up (i.e., an increase to the current market value) on cost basis upon inheritance by the heirs. For tax purposes, NFTs are treated the same as other property, such as stocks and real estate. However, as previously discussed, there are other aspects of cryptocurrency and NFTs that should be considered for estate planning.

Regardless of what it states in your will, trust, or power of attorney, unless you have already given someone the ability to access your digital currency or NFT, it will be lost upon your death or incapacity. Digital currency transactions are recorded, tracked, and processed on a decentralized ledger, referred to as a blockchain. All information on the ledger is public domain, but transactions are only identified by a user's key, making it nearly anonymous if you know what you are doing.

Access to the digital asset is stored in a wallet. There are two main categories of crypto wallets: hot and cold. Hot wallets are connected to the Internet, while cold wallets are kept offline. Hot wallets can include web-based wallets, desktop wallets, and app-based wallets. Although hot wallets are convenient, they are vulnerable to hackers because they are connected to the Internet. Cold wallets can include paper wallets (where the key is written down and stored somewhere) or hardware wallets (external hard drives). Cold wallets are less convenient to use; however, they are more secure.

If an owner dies without sharing the location of his or her wallet and key with anyone, then it may never be discovered. In one reported incident, an individual threw out an old computer, forgetting his cryptocurrencies were stored in a wallet on his hard drive. He spent five years looking in various dumps but was unable to recover the millions of dollars of coins he carelessly threw away.

Attorneys should advise their clients to provide a method of transferring access information to the beneficiary outside of their will or trust. A few different strategies can be used to transfer digital assets to beneficiaries:

1. A secondary hardware wallet initialized to be an exact replica of the primary hardware wallet can provide access protection for digital assets. Investors can record the 24-word recovery phrase, PIN code, password, and other access information for their hardware wallets and inform the agent or personal representative of the secure location where all this information is located.

2. Multisign, also known as a multisignature or M-of-N transaction, requires a transaction to have two or more signatures before it can be executed. The additional signature or signatures can ensure that the transaction is only fully executed when all parties are satisfied that the terms of the transaction have been met. This adds an extra element of security to the transaction. To leave the digital assets to a beneficiary, individuals can consider having a 1-of-2 transaction in which they would share a joint cryptocurrency address, and the signature of either person is sufficient to spend the funds; even if one key is lost, the other person can still access the funds. Multisign can be dangerous if all the parties are not completely trustworthy.
3. A "dead man's switch" allows for the assets to be transferred automatically to a designated beneficiary's account upon the asset holder's death (if there is not a response from the asset-holder after a specified number of tries, then the switch is activated), but this requires the heirs to be able to manage their keys for an indefinite period of time. Moreover, anytime owners buy, sell, or transfer their digital assets, the heir's keys would have to be updated, making this option unreliable in the real world.
4. A separate document of instruction or a letter to the beneficiaries can be used to explain what they will have to do to access the digital assets. Remember that a will may become part of the public record, so you do not want to include private keys in the actual will. Be sure to include the name of all digital asset accounts and wallet services used in your separate inventory of digital assets.

When advising clients on estate and tax planning for digital assets, consider these key questions:

- Where are the cryptocurrencies and NFTs stored? Are they accessible? Who has the private keys to unlock any wallets?
- Are any of the cryptocurrency holdings being staked? (Crypto staking is the process of allocating cryptocurrency through an exchange that uses it to validate blockchain transactions. Stakeholders typically receive income from the exchange, usually additional cryptocurrency.) Does the estate need to file a tax return due to staking income? Is the deceased's final tax return impacted by any staking income?
- Was the deceased mining cryptocurrency? Does a Schedule C need to be filed?
- Did the cryptocurrency undergo any hard forks? Were new coins issued?
- Where are records of all transactions being recorded for tax purposes? These records should include dates, times, dollar amounts, name of the cryptocurrency, and whether it was a buy or a sell. Keep track of wallet-to-wallet transfers, and make note of the cost basis of the coins that were involved.

CONCLUSION

Cryptocurrencies and NFTs have exploded in popularity in the past decade, with thousands of people owning and trading them for investment purposes. Looking back in time, no one could have envisioned the growth of the digital asset marketplace. Revisiting Laszlo's pizza purchase in 2010, he spent the equivalent of $188.1 million in today's Bitcoin value on those two pizzas! Estate planning attorneys must become well versed in the transfer issues and tax implications of our digital afterlife. ■

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