BIT BY BIT – UNDERSTANDING PLANNING/ FIDUCIARY ADMINISTRATION ASPECTS OF CRYPTOCURRENCY

A Presentation for the Greene County Estate Planning Council
Springfield, Missouri
October 17, 2018

Robert K. Kirkland
Kirkland Woods & Martinsen LLP
132 Westwoods Drive
Liberty, MO 64068
Telephone: 816-792-8300
Facsimile: 816-792-3337
E-mail: bkirkland@kwm-law.com
Website: www.kwm-law.com

I. WHAT IS CRYPTOCURRENCY?

A. Cryptocurrency is virtual currency created digitally, which is not backed up by gold or any other hard assets.

1. The first bitcoin was created in January, 2009. It has been described as a combination of technology, incentives and game theory, which is a form of block chain.

2. Cryptocurrency is stored in a "wallet" that in reality is stored in one of many different ways including on an exchange, on a mobile device, offline, online, or even on paper.

3. Cryptocurrency uses cryptography for security, which makes it difficult to counterfeit. It is also immune from government interference or manipulation.

4. If your client or customer does not store the cryptocurrency on an exchange, and fails to tell anyone else about ownership of the cryptocurrency, there is a huge risk that the cryptocurrency may be lost or undiscovered when the client or customer becomes incapacitated or dies.

B. "Bitcoin" is the most popular and active type of cryptocurrency, and as of this summer, there were over seven billion (7,000,000,000) bitcoin outstanding, with an aggregate U.S. dollar worth exceeding one hundred forty-three billion dollars ($143,000,000,000).

1. However, bitcoin is only one type of cryptocurrency. There are over sixteen hundred (1,600) different virtual currencies in addition to bitcoin, with an additional value exceeding three hundred eighty billion dollars ($380,000,000,000).

2. In 2017 the value of a single bitcoin reached almost twenty thousand dollars ($20,000), peaking the interest of many an aggressive investor.

3. Bitcoin can be digitally traded between users (either through an exchange, like "Coinbase," or not), and can be purchased for, or exchanged into, U.S. dollars or other real currencies. However, cryptocurrency does not have legal tender status in any jurisdiction.

C. Virtual currency is trending in dramatic fashion, as it is being used more and more for payment for goods or services, as well as an investment alternative.

II. OWNERSHIP OF CRYPTOCURRENCY DURING LIFE

A. As indicated above, bitcoin is stored in a virtual wallet.

1. Each wallet uses a series of random characters which are called a "public key", which is an address for sending and receiving the bitcoin.

2. The owner of the bitcoin has a separate "private key" which is the only way to access the bitcoin contents of the wallet.

3. If the owner of the bitcoin loses the private key, or fails to pass it on to his fiduciary or trusted heir, the bitcoin will likely be lost forever as there will be no way to access the wallet.

B. Privacy of ownership is one of the most attractive elements of cryptocurrency, and can also turn into its biggest nightmare.

III. PLANNING FOR CRYPTOCURRENCY UPON DEATH

A. Clearly, assisting our clients and customers with identifying any cryptocurrency held in their portfolio, assisting them in developing and maintaining an inventory of the cryptocurrency, <u>and</u> counseling them to adopt a strategy for the passage of the "private key" upon death or incapacity, is critical to their retention of this cryptocurrency.

1. The management of this cryptocurrency should be specifically addressed in a financial durable power of attorney.

2. Our clients and customers should also provide in their wills or trusts authorization of the fiduciary to access and administer this cryptocurrency, as well as where such assets should pass upon death.

B. Much like the inventorying of the rest of the 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 on a flash drive or other memory stick, or entrusting it with a commercial service that manages cryptocurrency.

1. As indicated above, bitcoin is anonymous, and there are no beneficiary designations attached.

2. If a client/customer loses the private key, or fails to tell any of the family members or fiduciaries about it, it can be akin to throwing money out of a car window.

C. If the client/customer used an exchange service for the purchase of the bitcoin, the fiduciary <u>may</u> be able to access the currency through working with that exchange.

D. Horror stories involving the loss of cryptocurrency are beginning to multiply.

1. A young man passed away suddenly in Colorado in 2017, having done little or no planning. His family began the difficult task of administering his estate. It was discovered later that the young man had been investing in bitcoin, had a price as little as $13.00 per bitcoin in 2013. At the time of the young man's death, the value of the bitcoin was $5,000 per bitcoin. Unfortunately, the family could never find the private key to access the bitcoin.

2. In 2009, a Welsh citizen owned approximately 7,500 bitcoins, which were stored on a hard drive. At the time, the bitcoin were almost

valueless. A few years later the gentleman disposed of the hard drive, forgetting about the storage of the bitcoins thereon. As of early summer of this year, those same bitcoins would have been worth over sixty million dollars ($60,000,000)!

3. As fiduciaries, and attorneys for fiduciaries, it is critical that all digital media be reviewed thoroughly before disposing of them, including smart phones, tablets, laptops and desktop computers of our incapacitated or deceased customers or clients. Additionally, much like the "old days," review past tax returns, financial account statements, and credit card statements, looking for transactions with any exchange services which might handle cryptocurrency.

4. Finally, fiduciaries should be wary of beneficiaries who might take possession of bitcoin without disclosing it, much like what they might do with cash, jewelry or artwork.

IV. TAX ASPECTS OF CRYPTOCURRENCY

A. Income tax consequences.

1. In 2014, the IRS issued IRS Notice 2014-21, wherein the IRS defined cryptocurrency as "property" for federal income tax purposes.

a. 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.

b. If the taxpayer is a “dealer” in cryptocurrency, the income will be ordinary income.

2. 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.

3. If a client/customer receives virtual currency as payment for goods or services, he or she must include the fair market value of the virtual currency for income tax purposes. Likewise, this same account is the recipient’s basis for such virtual currency.

4. If a user obtains new virtual currency through a process called “mining” then that activity produces ordinary income in the year the new virtual currency was “mined”, and the expenses of mining should be deductible as they are incurred (as recently suggested by the AICPA).

5. Fair market value of cryptocurrency which is listed on an exchange is determined by the exchange rate measured by then current market supply and demand.

6. In IRS Notice 2014-21, the IRS makes clear that all of the normal reporting rules which apply to transactions involving normal currency also apply to cryptocurrency, including withholding, self-employment tax, information reporting, backup withholding, third party reporting, etc.

7. The 2017 Tax Cuts Act amended IRC Section 1031, which makes clear that a swap of cryptocurrency does <u>not</u> qualify for like kind exchange exemption. See I.R.C. §1031.

B. Estate and Gift tax consequences.

1. For federal estate and gift tax purposes, cryptocurrency is an asset that must be included in the estate tax, or included on a gift tax return if gifts of such cryptocurrency are made.

2. The fair market value of cryptocurrency is to be calculated by converting the virtual currency into U.S. dollars at the then current exchange rate, in a reasonable manner that is consistently applied. IRS Notice 2014-21. There is clearly a need for more guidance in this area, as bitcoin value fluctuates by the hour!

3. There are sources that keep historical records of the value of cryptocurrency as of a certain date which can be used for these valuation purposes.

V. INVESTING IN CRYPTOCURRENCY

A. The lure of double digit and triple digit gains has many people talking about investing in cryptocurrency.

B. Almost every state in the union has adopted the "Uniform Prudent Investor Act" which governs investment activity of fiduciaries in those states.

1. Of course, the concept of cryptocurrency is so new, it is not specifically addressed in the Uniform Prudent Investor Act.

2. This author believes 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 the cryptocurrency markets.

3. The twenty-eight percent (28%) drop in value of bitcoin in January of this year is enough evidence of such volatility to keep you sufficiently cautious about affirmatively investing in cryptocurrency currently.

VI. WHAT DOES THE FUTURE HOLD FOR CRYPTOCURRENCY?

A. You think this is complex now? "I have seen the future, and it is a lot like the present, only longer." (Anonymous)

B. Price discovery or value discovery, is an evolving concept as to the cryptocurrency. Certain "events" can turn this process into a roller coaster.

1. A “chain split,” occurs when one currency block chain splits into two separate virtual currencies (i.e., in 2017, a couple of bitcoin splits occurred, resulting in “Bitcoin Cash” and “Bitcoin Gold”).

2. 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.

3. A “giveaway event” occurs when an amount of cryptocurrency is given to a holder for creating an account on a related wallet.

4. Price discovery of these times results in a zero value. Likewise, the holder has zero basis in these items. Similarly, the income tax consequences of these activities has yet to be formally ruled upon.

a. Presumably, once the client assumes dominion and control over these new items, an income recognition event may have occurred.

b. At the least, a “chain split” impacts the taxpayer’s tax basis in the resulting two chains.

c. Clearly, an expansion of IRS Notice 2014-21 is in order to address these events.

C. Remember when investing in hedge funds was considered ultra-aggressive? Now, these funds are an important part of many investment allocations.

1. Cryptocurrency may follow a similar path.

2. Fiduciaries would be wise to follow carefully the development of this new category of assets. The day will likely come when cryptocurrency is part of the investment allocation decision equation.

D. What if you become a current trustee of a trust which holds cryptocurrency?!

1. You should quickly ascertain value and basis information.

2. You should be in quick communication with the trust beneficiaries as to the retention/sale of such assets.

3. Be sure to ensure the security of the cryptocurrency while it is being held.

4. Document every move you make with respect to this asset; such an asset will likely challenge the templates of your current fiduciary accounting system!