



CRYPTO-PROOFING YOUR ESTATE PLAN

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Although digital assets have been around for quite some time, we are seeing now, more than ever, a new wave of people who are choosing to invest in digital assets such as cryptocurrencies and NFTs (“crypto-assets”) over more traditional assets such as real estate and securities.

While it is clear that crypto-assets are becoming a bigger part of the investment world, what is not clear is whether the individuals who have or plan to acquire crypto-assets will be prepared to pass on these assets under their estate plans. In seeking to build wealth through the acquisition of crypto-assets, clients must understand the complex challenges that such assets present to securing, transferring, protecting and gifting that wealth, and must take crypto-assets into account in their estate plan to ensure that these assets will pass to their loved ones at death, just like more traditional assets.

What Are Cryptocurrency and NFTs?

Cryptocurrency is a digital currency in which transactions are verified and records are maintained by a decentralized system using cryptography, also known as blockchain technology, rather than by a centralized authority (i.e., a sovereign government). Cryptocurrency is accessed through a private key, which is a series of alphanumeric characters known only to the owner and stored in a digital wallet. Whoever has the private key can buy, sell and use the digital currency.

NFT stands for non-fungible token, which means each is one of a kind and can be anything digital, such as artwork or music files. Like cryptocurrency, NFTs are another digital asset class that are supported by blockchain technology and can only be accessed with a password or personal key.

Unlike traditional investments, there are no traditional ownership or beneficiary designations on crypto-assets.

Crypto-assets are entirely anonymous and the only way to access them is with the password or “private key” to the digital wallet in which the crypto-asset is stored. Without the private key or password, there is no way to access the digital wallet and the crypto-asset could be lost forever.

Ensuring Accessibility to Crypto-Assets

The most sensitive aspect of owning crypto-assets is that the person with the password or private key is the “owner.” Anyone with the key to the digital wallet can access the crypto-asset and move it to some other location which the original owner cannot access.

As an initial step in planning for crypto-assets, clients should document their ownership of such assets as part of their net worth statement and provide a document to their attorney or chosen fiduciary about how to access those crypto-assets after their death or disability. The simple step of keeping an asset inventory and documenting where passwords can be found on an exchange or a “wallet,” can help ensure that crypto-assets are not lost at the client’s death.

Addressing Crypto-Assets in Estate Planning Documents

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Clients who own crypto-assets should create or update their estate plan to outline how crypto-assets are to be distributed at their death and provide their fiduciary with authority and the power to own crypto-assets in the estate.

Given the complexity involved with crypto-assets, it may be appropriate to select a special fiduciary to manage just the crypto-assets. As with all fiduciary selections, clients should select a fiduciary they trust since the passwords and encryption codes are extremely sensitive. Clients should also contemplate who will have the authority to deal with their crypto-assets in the event of their incapacity.

The very features that make cryptocurrency attractive, such as privacy and decentralization, can also increase the risk that a client's fiduciaries may lack access to crypto holdings if not properly documented. Clients should discuss the nature and value of their crypto-assets with their attorney to ensure that they minimize the risks of loss and maximize the opportunities for crypto-assets to be distributed in accordance with their wishes upon their death.

How is Crypto Taxed?

In 2014, the IRS issued Notice 2014-21, 2014-16 I.R.B. 938, explaining that virtual currency is treated as property, not currency, for federal income tax purposes. As general tax principles applicable to property transactions apply to virtual currency, any transaction involving the sale of a cryptocurrency may result in tax liability in the form of capital gains or losses. Similarly, gifts of cryptocurrency are treated as gifts of property in which the donee receives the donor's cost basis in the property, and, like other property assets, cryptocurrency that is not gifted during the owner's lifetime receives a step-up in basis upon the owner's death. The carryover and step-up rules governing these assets should be factored into decisions about what to do with the cryptocurrencies in a client's estate plan.

If you have any questions regarding how to address crypto-assets in your estate plan, please contact your Cummings & Lockwood LLC attorney.