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# Estate Planning for Digital Wealth

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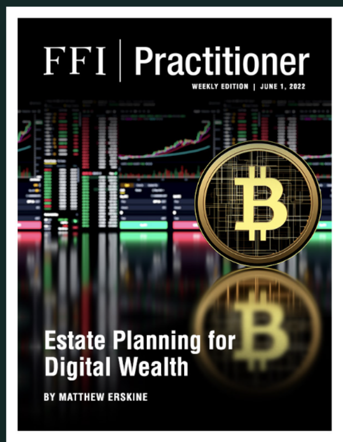


**From *FFI Practitioner***

In this week's edition of *FFI Practitioner*, Matthew Erskine discusses the unique qualities and risks of crypto-asset wealth and provides an introduction to the special considerations to be addressed in the transfer of digital assets.

### Bitcoin is the first truly successful decentralized blockchain network with a secure token-based economic incentive model.

Estate planners, accountants, investment managers, consultants, and clients are slowly becoming familiar with cryptocurrencies, NFTs, and the basic function of blockchain technologies as part of family wealth. Despite the name, cryptocurrency is not currency and is taxed differently in different jurisdictions. It is open to risks beyond the usual market risks applicable to other assets and presents challenges for fiduciary selection and safeguarding these assets. It is worthwhile, therefore, to review the current state of digital wealth.

## Why is Cryptocurrency not Currency?

Currencies can have intrinsic value (known as commodity money), can be legally exchangeable for other items with intrinsic value (known as representative money), as well as having only a nominal value (known as fiat money). In the past, different forms of money have simultaneously served different functions. At best, cryptocurrency has no intrinsic value, cannot be exchanged for assets of value, and, as of now, are not accepted as fiat money, and so it does not fall into any one of the three types of currency.

Tokens are also not currency since they are unique, tradeable, digital assets, often used to incentivize participation in the network or to monetize an aspect of an asset without giving up ownership or control of the asset. Different blockchain networks employ various methods of generating and employing blockchain tokens. For many clients, the primary appeal of cryptocurrency is financial; blockchain tokens create economic incentives for network participants, who can then trade the tokens on the network exchange. The NBA has a successful tokenization of digital clips and images,[1] as does Marvel Comics.[2]

## What is Cryptocurrency?

Blockchain is a decentralized ledger system, and in such a system the network participants—that is, every node that keeps copies of ledger transactions—expends resources to validate all transactions published to the network. In contrast, a centralized ledger system (such as the New York Stock Exchange) verifies each transaction in a centralized process.

Cryptocurrencies carry with them a complete record of each transaction it is involved with; an NFT serves as a digital certificate of ownership and authenticity of the tokenized digital or tangible asset. Both the cryptocurrencies and the NFTs are, therefore, complex receipts—the difference being that cryptocurrencies are fungible properties and tokens have nonfungible properties. An analogy is the difference between a newly minted penny and a newly minted penny showing an error in minting. One is fungible, and one is not.

The treatment of any asset, for legal, especially tax purposes, depends upon its characterization by the jurisdiction that is trying to tax the asset or any related transactions. For cryptocurrency, this is handled differently in different countries:

- In the United States, cryptocurrency is generally treated as tangible property that realizes capital gains or losses arising from trades. Mining income is treated as normal business income. Wash-sale rules are not applicable.
- In the United Kingdom, depending on the nature of the activity, trading activity is treated as corporate tax, income tax, or capital gains/losses.
- In South Korea cryptocurrencies are provided with favorable "start-up" tax treatments, though very little else is publicly available.
- In Japan all gains are treated as miscellaneous income.

## The Unique Risks of Cryptocurrency

One variable that is not present in other property is the threat from hacking an exchange. Although the most reputable exchanges take custodial security very seriously, security vulnerabilities have resulted in the loss of massive amounts of crypto-asset wealth over the years. As a best practice, individuals should only have crypto-assets stored in exchanges if they plan to be exchanging those assets in the near term. "Regular" markets will develop for NFTs, but as each is unique, the "correct" method for establishing fair market value seems uncertain at this time.

### Sidebar


#### Family Offices and Artwork: Mitigating the risks

**by Matthew Erskine**
***FFI Practitioner***

Thanks to this week's contributor, Matthew Erskine, for this edition discussing the most important steps that family offices and their clients can take to mitigate risk to clients' collections of art and other collectibles.

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## Planning for Cryptocurrencies

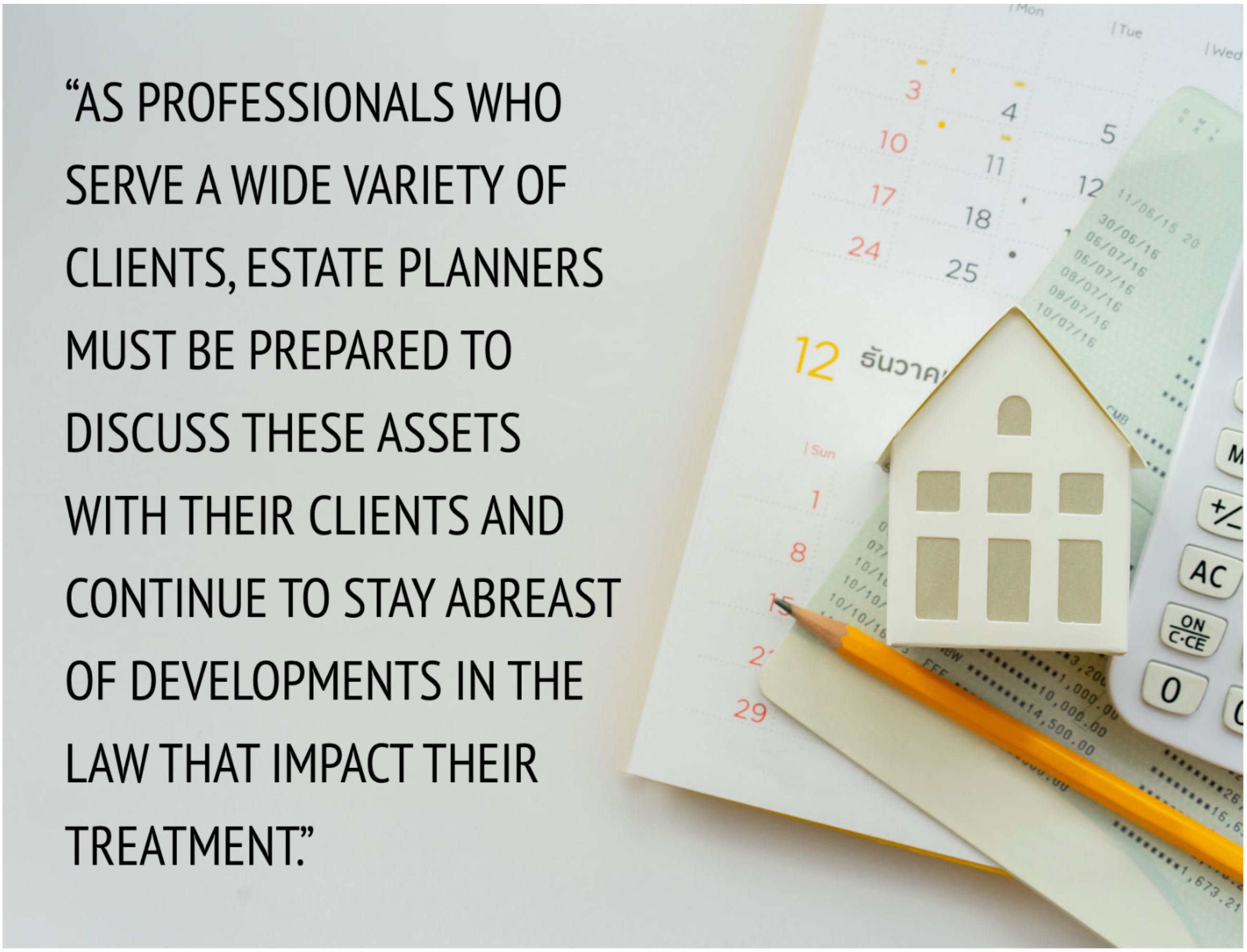
Possession of cryptographically-secured digital assets, whether cryptocurrencies or tokens, is managed through control of a combination of "public keys" and "private keys." Planning, therefore, often revolves around handling these keys. As a new and immature market, there is a diverse and expanding number of companies and decentralized projects that offer options for the storage of private keys for digital assets. Different blockchain protocols require varying processes for storing private keys. This makes planning more difficult.

## Cryptocurrencies and Fiduciaries

With other assets, both real and personal, there are well-established procedures of transferring legal title either during one's lifetime or at one's death. This involves a will, one or more trusts, and other legal arrangements which requires the services of a fiduciary. For wills to transfer digital assets and trusts to hold digital assets, the process is much less well-defined. Since there are undefined risks involved in being a fiduciary for digital assets, many institutional fiduciaries, such as banks and trust companies, refuse to take digital assets; or, if they are the successor fiduciary to an individual fiduciary that held digital assets, they will insist on the immediate sale of the digital assets. Individual fiduciaries may insist upon special and specific authority to retain, hold, hedge, trade, and dispose of cryptocurrencies and NFTs and may broadly relieve fiduciaries from liability for doing what is authorized. To counter this trend, some jurisdictions have adopted "Directed Trust" legislation which provides a limitation on the trustee's liability for breach of trust, to the extent that the trustee acts at the direction of the trust director. A trust director is usually an individual that is appointed to instruct the fiduciary what action to take, or not to take, with respect to blockchain assets (cryptocurrency and NFTs).

## Valuation of Cryptocurrencies

The value of cryptocurrencies has been increasingly volatile. This raises the risk that their value may fall so far and so rapidly that the liquid assets in the estate (or trust) may be insufficient to pay creditors, including the government for taxes owed on pre-tax income and for estate taxes. In estates, there is an insolvency procedure for settlement of claims against the estate, but it is less clear how this applies to cryptocurrencies.




## Possession of Cryptocurrencies

Also important, particularly for those who advise fiduciaries, are the issues involved in handling blockchain assets as part of a trust and estate administration. As professionals who serve a wide variety of clients, estate planners must be prepared to discuss these assets with their clients and continue to stay abreast of developments in the law that impact their treatment. Just as currency of now defunct political entities, such as the former Soviet Union or the Confederate States of America, are worthless as a medium of exchange (though not as a collectible), so to, are cryptocurrencies and tokens, which may become the equivalent of Imperial Russian Railway Bonds—valueless except as curiosities.

That said, digital assets should be held securely in what are called wallets. Different types of wallets have varying levels of security, and different types of crypto-assets require different wallet solutions. (It is worth noting that the parent company of the New York Stock Exchange, Intercontinental Exchange Inc., recently purchased an interest in tZero, a trading platform for tokenized securities.)

Each of these wallets is locked by a "key." How the key is handled varies widely. Some write it on a piece of paper, some place the key on a USB drive, some opt for a "multi-party computational" wallet framework. This is analogous to creating multiple copies of the complete treasure map, storing the treasure map in a safe deposit box, and then giving keys to the safe deposit box to multiple individuals. Others divide the key into fragments and gift them to several individuals, like having fragments of the treasure map stored in multiple locations rather than having the entire treasure map kept in the safe deposit box.

One issue raised by the recent losses at Coinbase[3] is the rights of investors in cryptocurrency which is held in a "hot" wallet with an exchange like Coinbase. Although it is unlikely to happen in the case of Coinbase, if an exchange filed for bankruptcy protection, the investors who have cryptocurrency held by the exchange will be treated like investors who hold securities with brokerage houses in street name—that is, they are unsecured creditors and stand behind the secured creditors of the exchange. Unlike brokerage firms, however, the process for making investors whole has not been tested in a real-case situation, which creates another level of uncertainty.

The estate planning of cryptocurrencies is too vast a topic than can be briefly summarized here, but the takeaway is that there is a need to adopt new strategies for handling the purchase, ownership, gifting, and inheritance of digital assets.

## References


[1]Young, Jabari. (2021, 28 Feb). "People have spent more than $230 million buying and trading digital collectibles of NBA highlights." *CNBC*. https://www.cnbc.com/2021/02/28/230-million-dollars-spent-on-nba-top-shot.html

[2]*Marvel and VeVe Collaborate to Offer Digital Collectibles Experience for Marvel Fans Worldwide*. (2021, June 24). https://www.marvel.com/articles/gear/marvel-and-veve-collaborate-to-offer-digital-collectibles-experience-for-marvel-fans-worldwide

[3]Ott, Matt. (2022, May 11). "Coinbase loses half its value in a week as crypto slumps." *The Associated Press*. https://apnews.com/article/cryptocurrency-technology-earnings-b13ce487cf95ccc0df2b8a69279bf8e8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## About the Contributor


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