Tax and Estate Planning for Cryptocurrency

In the past year, the global market capitalization of cryptocurrency has grown exponentially, reaching a high of $2.56 trillion on May 11, 2021. Coinbase, the largest cryptocurrency exchange, has more than 68 million verified users. By comparison, TD Ameritrade has 11 million accounts, Charles Schwab has 14.1 million accounts, and Fidelity has 83.4 million accounts.

Although opinions on cryptocurrency differ, this massive gain has led to some investment experts recognizing cryptocurrency as a legitimate asset class. Warren Buffett has referred to Bitcoin (the most significant cryptocurrency) as "rat poison squared." Suze Orman has said cryptocurrency should be part of your investment portfolio as long as you can afford to lose that money and you are going to keep it for a reasonably long time.

In recent months, there has been a wide-scale acceptance of cryptocurrency among large financial institutions, including Fidelity, Goldman Sachs, and Morgan Stanley. In addition, PayPal now allows users to make transactions in cryptocurrency.

Although cryptocurrency is gaining steam within the financial industry, many still see it as a valueless asset. Whether you are bullish on cryptocurrency or think it is a fad — there is no denying that cryptocurrency has become more mainstream, and consideration should be given to estate and tax consequences.

Income Tax Treatment

In IRS Notice 2014-21, the IRS took the position that cryptocurrency is property and should be taxed as such. This position has not changed. Accordingly, a taxable event has occurred whenever one disposes of cryptocurrency, whether for a good, service, another coin, or fiat currency (e.g., U.S. dollar). That is, the taxpayer disposing of cryptocurrency will generally have either a capital gain or loss on the transaction.

Much like other types of property, capital gains and losses apply to cryptocurrency; however, the biggest benefit to the tax treatment of cryptocurrency is that the wash-sale rules arguably do not apply. While the IRS has not officially taken a position on this treatment, many commentators have interpreted the IRS' silence as such. As a result, they effectively allow a taxpayer to harvest losses and eliminate a portion of the taxpayer's gains.

Cryptocurrency is a highly volatile asset. Charitable remainder trusts, such as a charitable remainder unitrust (CRUT), may be used by taxpayers holding highly appreciated cryptocurrency to address cryptocurrency volatility, spread the income tax hit from the sale of cryptocurrency over a number of years, and possibly receive a charitable income tax deduction. A CRUT is a trust designed to pay the grantor a payment based on a fixed percentage of the trust value yearly for a term of years or the lifetime of the CRUT beneficiary. CRUTs allow a taxpayer to receive an immediate charitable deduction upon their transfer of cryptocurrency into the CRUT. The CRUT can then sell the cryptocurrency and reinvest in a more stable asset, such as stocks, bonds, mutual funds, etc. A CRUT does not pay income tax, but the beneficiary will *only on the distributed income*. Upon termination of the CRUT, the balance of the CRUT assets are paid out to charity. In effect, a CRUT allows a taxpayer to stretch out a capital gain tax hit over several years.

Tax Compliance

The United States government has recently taken a strong interest in tax compliance as it relates to cryptocurrency. In fact, the infrastructure bill recently passed in the Senate contemplates financing a large portion of the bill's cost with increased compliance on crypto tax issues.

Cryptocurrency is significantly underreported to the IRS. The laws are new, and many who operate in this space do not realize that the transactions are taxable. Even if every individual who had a taxable cryptocurrency transaction wanted to report such transaction, the reporting documents issued by the popular cryptocurrency exchanges are not user-friendly. To increase compliance with proper reporting of cryptocurrency, a higher audit rate will likely follow.

Estate Planning for Cryptocurrency

Including cryptocurrency in your estate plan is vitally important if you hold such assets. Unfortunately, these assets are not easily accessible like a bank or investment account. Crypto accounts or wallets are generally more secretive, and your family may not understand the breadth of your account or your holdings. Whether this is a discussion with your estate planning attorney, your family, or both, your cryptocurrency holding needs to be known and accessible by a trusted person.

It is not uncommon to hear a horror story where an individual has forgotten the passkey to their wallet, and the coins are gone — forever. Your estate planning attorney can help prevent this from happening. Whether you supply your attorney with your passcode or let your attorney know where your passcode can be located, either may avoid loss of valuable cryptocurrency.

Gifting Cryptocurrency

The benefit of gifting cryptocurrency is that gifting removes future appreciation on the gifted cryptocurrency from your estate.

Gifting cryptocurrency is not free from risk. Anytime you gift a highly volatile asset, like cryptocurrency, there is a chance that the asset may decline in value. This would result in a waste of gift tax exemption used for the gift.

While gifting cryptocurrency may be a viable option, practical issues arise. Many trustees are unwilling to serve as fiduciaries of trusts holding cryptocurrency due to volatility and custody concerns for gifts in trust. Finding the right trustee could take time. Likewise, charitable organizations may be reluctant to hold cryptocurrency for similar reasons. A qualified appraisal is generally required when gifting cryptocurrency to charity. Given the standard to be a "qualified appraiser" and the short time cryptocurrency has been in existence (Bitcoin, the oldest cryptocurrency, was established in 2009), it may be difficult to find a "qualified appraiser."

President Biden has proposed significant reductions in federal estate and gift tax exemptions. Therefore, gifting cryptocurrency in 2021 may be an advisable option for individuals seeking to use up their estate and gift tax exemptions before any reduction in such exemptions. In addition, it is generally advisable to gift assets that will significantly appreciate, thereby removing such appreciation from your estate. Therefore, individuals who are bullish on cryptocurrency may want to consider this option.

While the Sage of Omaha may be correct in describing cryptocurrency as "rat poison squared," you cannot ignore the vast amount of wealth the boom in the cryptocurrency market has created. As the value grows, so must your planning with such assets. Whether planning for income taxes, estate and gift taxes, or just for the transfer of cryptocurrency at death, a Chambliss Tax and Estate Planning attorney can assist you. If you have questions regarding the information in this article, contact David Hunter, Nick Nester, or your Chambliss relationship attorney.