Virtual currency has real impact on planning

By Steven Schindler

The hottest holiday gift of 2017 might well have been bitcoins. Last December, after the meteoric rise in the value of bitcoins, curious readers could easily find step-by-step instructions on how to give bitcoins and other virtual currencies to family and friends. Now, both those who have amassed significant virtual currency holdings and those who have yet to enter the market should understand a few estate planning implications of these newly mainstream assets.

There are now more than 1,000 virtual currencies, also called cryptocurrencies. Some of the most popular include Bitcoin, Ethereum, Ripple, Bitcoin Cash, and Litecoin. In total, the virtual currency market is valued at approximately $400 billion, an increase of about twentyfold since February 2017, but a decrease of about 50 percent since early January 2018.

Each virtual currency has its own unique features, but most share a few common characteristics. Individuals or entities own virtual currencies through digital “wallets,” which are identified publicly, on the blockchain, by a string of letters and numbers. An owner transfers virtual currency to other wallets by using a private encryption key that unlocks the owner’s wallet. Computers host identical copies of electronic ledgers and track and validate all transactions through encryption technology. Knowledge that a transfer occurred between wallets, but not the wallet owner’s identity, becomes publicly available.

Virtual currencies have several compelling applications. They also present several estate planning opportunities and pitfalls, of which the following are just a few:

**Overseas gifts.** As individuals become more mobile and families become more geographically dispersed, transfers of value across borders occur with greater frequency. Cryptocurrency may be transferred across borders quickly and at relatively low transaction. For example, a grandparent in the United States may make an annual exclusion gift of $15,000 to a grandchild living overseas in cryptocurrency, which the grandchild may convert to local currency or spend directly at a vendor that accepts the cryptocurrency.

**Shifting of taxable income.** The newly increased federal gift tax exclusion amount enables more families to shift taxable gain to family members with lower income tax rates without adverse estate or gift tax consequences. Giving away assets with built-in taxable gain before a sale can reduce the family’s income tax cost of selling the assets. This is especially true for owners in high income tax states, such as California, who may consider giving appreciated cryptocurrency to beneficiary residents in Washington before liquidating the cryptocurrency, effectively lowering the applicable income tax rate. Owners might also transfer appreciated cryptocurrency to charitable remainder trusts, which would generate an immediate income tax deduction, convert the appreciated cryptocurrency into a lifetime income stream, defer or avoid the capital gains tax liability, and transfer the remainder value at death to charity.

**Charitable gifts.** Owners should take care when using cryptocurrency for charitable contributions. Because cryptocurrency is taxed as property, a donor who contributes
appreciated cryptocurrency that has been held for more than a year to a public charity may
deduct the fair market value of the cryptocurrency. This can be an attractive option, but there
are some pitfalls. If the gift is valued at more than $5,000, the donor must obtain a qualified
appraisal of the cryptocurrency to qualify for the deduction. The donor should also ensure that
the charitable organization is classified as a public charity and not a private foundation. A gift of
cryptocurrency to a private foundation would limit the deduction to the donor’s cost basis.

Wealth transfers. Several estate planning strategies for transferring wealth in a tax-efficient
manner leverage asset volatility. For example, a grantor retained annuity trust (GRAT) enables
an owner to transfer the future appreciation of an asset to beneficiaries without using a
significant lifetime gift tax exclusion. If the asset contributed to a GRAT declines in value, then
the owner effectively reclaims the asset at its lower value as if the owner had never established
the GRAT. If the cryptocurrency market sustains its volatility, cryptocurrency may continue to
be an ideal asset for GRAT planning. A similar plan involves the sale of cryptocurrency to a
grantor trust that the owner creates in exchange for a promissory note. But success with this
plan requires continued appreciation.

Control at death or incapacity. An owner should plan carefully for the transfer of control of the
owner’s cryptocurrency to an agent, trustee, or executor in the event of death or incapacity. An
owner’s failure to plan in advance, either by transferring the private encryption keys associated
with each of the owner’s digital wallets or by ensuring access to the owner’s host or exchange
account that hosts the owner’s wallets, could result in permanent loss.

Notwithstanding recent volatility in cryptocurrency markets, or precisely because of that
volatility, owners and prospective owners should bear in mind the opportunities and pitfalls
associated with this unique asset class. Owners can also safely assume that the characteristics
of and rules governing cryptocurrencies will continue their rapid pace of evolution.

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