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Planning for Cryptocurrency Investors: Estate Planning, Asset Protection, and Investments

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Planning for Cryptocurrency Investors:
Estate Planning, Asset Protection, and Investments

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Joel J. H. Funk

Joel J.H. Funk is a transactional attorney representing companies and entrepreneurs in connection with mergers and acquisitions, corporate reorganizations and structures, asset protection, and other corporate governance maters. Joel also advises clients with complex estate plans for those with large estates and unique assets such as crypto currency who wish to reduce estate tax exposure and preserve generational wealth. Joel is consistently named one of Illinois' "Top 40 Under 40" by The National Advocates for Corporate and Estate Planning and has recently been named an Illinois Super Lawyer Rising Star for the fifth consecutive year.

M. Lisa Odom

M. Lisa Odom is a transactional attorney representing numerous businesses, entrepreneurs, individuals and families in business and real estate transactional matters and estate planning and trust administration matters. Her corporate practice focuses on all aspects of business law, including formation, contract negotiation, mergers and acquisitions, lease review and negotiations, and employment related advising. She serves as outside corporate counsel to many of her business clients. She also does significant work in business succession planning. She graduated *summa cum laude* from Pepperdine University School of Law and manages her own law firm out of Los Angeles County, California.

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What is Cryptocurrency?

- A digital asset that can circulate without the need for a central monetary authority
- Used to buy products and services / pre-loaded crypto debit cards.
- Technology
- Volatile
- Not intrinsically valuable – value based on speculation
- Not tangible personal property
- Stored electronically.
- Types of Cryptocurrencies
- Exchanges

Cryptocurrency and Your Estate Plan

- Traditional assets v. crypto assets
- Make sure the investment is protected
- Vulnerable asset that could be lost forever
- Sound estate planning practices
- Minimizing tax exposure
- Self-sovereignty

IRS Notice 2014-21

- Cryptocurrency is property and should be taxed as such.
- Common Transactions triggering capital gains
- Tax rules for capital gains
- Unique Tax Opportunities
  - Tax Harvesting
  - Wash Sale Advantage
- Proposed Legislation

Capital Gains

- Create significant tax liabilities
- Capital gains are taxed on a short-term (assets owned less than one year) and long-term basis (assets owned one year or more)
- Current Washington Proposals:
  - Joe Biden's Greenbook proposal
  - Joe Biden was campaigning to increase all capital gains for high income earners
  - Ways and Means Committee

Cryptocurrency, Storage and Security

- Digital Wallet
  - A secure place to store cryptocurrency that is usually in the form of physical hardware device that you can store in a safe place or software device
    - A hot wallet stores cryptocurrency online
    - A cold wallet is disconnected from the internet, which offers great security from hackers and privacy on the assets but requires additional information to gain access
  - These offer more control over exchange services as they are “Non-custodial” and offer great anonymity – for instance, a “Coinbase wallet” can only be accessed by your digital wallet’s private key, which is generated with a 12-word recovery phrase when you sign up.
  - Often recommended for maintaining cryptocurrency due to greater independence
  - Must keep track of your privacy key – great security but also makes for limited accessibility, which can be a problem in the event of death or incapacity
- Exchange Services
  - No physical device that you have to keep track of
  - You can access your account from anywhere
- Advantages of Cryptocurrency Digital Wallets and Exchanges
  - Can verify transactions through blockchain.
  - Faster than a traditional bank.
  - Not tied to the traditional banking hours either.
  - Operates as a global currency, unlike the dollar, Euro, etc.
  - Can be given as gifts.

Cryptocurrency and Security, Continued

- Problems:
  - No physical form of the asset – this is both a plus and a minus.
  - Not all digital currencies can be stored in the same manner
    - For instance, bitcoin and Ethereum can be transferred to a cold wallet, but others must stay in an exchange
  - The problem with digital currencies is that just like anything else digital, they can be copied if no centralized agency is overseeing the virtual currency.
    - Not yet highly regulated – although this is ever-changing.
    - The “agencies” overseeing virtual currency can be expensive and slow, which negates some of the perks we discussed earlier

Lost Cryptocurrency Keys – Example 1

- Remember, the client cannot just make a call to someone and have the password reset.
- If you lose the key, you lose the asset.
- Real life example, #1:
  - Stefan Thomas, a San Francisco man, lost the password to a thumb drive with $220 million worth of bitcoin inside. Stefan is a software developer and CEO. He was an early investor in bitcoin – creating a video in 2011 about how the currency works. Bitcoin gave him 7,002 bitcoins for his efforts – but later that year, he lost the password, which was saved on a USB hard drive. Stefan says: “Bitcoin is a decentralized system. And so if you hold your bitcoins, like I did, in a completely independent wallet — so not with an exchange, not with a bank, not with any kind of institution, but yourself — then it's just like cash. It's like gold. If you lose it, you lose it. There's no recovery process for that.”

Lost Cryptocurrency Keys – Example 2

- Real life example, #2:
  - Romanian billionaire, Mircea Popescu, is thought to have drowned off the coast of Costa Rica in 2021. He is speculated to have had approximately $2.7 billion in Bitcoin at his death. Unfortunately, following his death, rumors persist that his family has no way to access his wealth as no one has access to the key, or knows its location.

Hypothetical

- Bob and Anna Smith have been married for 38 years.
- Bob was a police officer, and Anna had a stay-at-home mom with an at home business, where she makes approximately $25,000 per year.
- They have two children, one son and one daughter. Their daughter, Kelly, is a stay-at-home mom. Their son, Seth, has an MBA in Marketing, and works for a Fortune 500 Company.
- Bob and Anna have a few, modest assets. They own a home, have a few bank accounts, a small life insurance policy on Bob's life, a pension, and a tax-deferred retirement plan from Bob's time as a police officer.
- In about 2012, Seth and Bob were talking about finances and investments, and Seth mentions the concept of cryptocurrency to Bob. Seth explained how everything works to Bob. Bob did not act on this information right away. But later that year, Bob received a modest inheritance of $50,000 from his parents.
- At this point, Bob decided to take approximately $10,000 of the inheritance money and invest it in cryptocurrency based on Seth's previous advice.
- In 2013, Bob invests the $10,000 in cryptocurrency, but does not mention the investment to his wife and daughter. Cryptocurrency is stored in a Ledger Nano X and he conducts all of his bitcoin exchanging through Coinbase

Hypothetical, Continued

- Breaking down the investment:
  - In 2013, we know that Bob invested $10,000.00. At that time, Bitcoin was $13.30* per Bitcoin, which would mean once invested, he owned 751.879699 Bitcoins.
  - Bob retained the Bitcoin until March 29, 2022, when the Bitcoin value for 1 Bitcoin was $47,990.00
    - Remember, in Bob's wallet he has 751.879699 Bitcoin. If you multiply out how much Bitcoin he owns by the pricing as of March 29, 2022, Bob has significantly increased his initial investment of $10,000.00 to $36,082,706.80.
- At this point, remember that Bob has not mentioned the investment to his wife or daughter. What happens if Bob dies, or both he and Anna die before completing any estate planning?

**Bitcoin pricing shown here on this slide is based on reported, historical Bitcoin pricing from: https://www.in2013dollars.com/bitcoin-price.*

Probate in General

- Many problems exist when a person's estate is processed through probate.
- Basic of Probate :
  - Court oversight of the process – no privacy for heirs in assets being inherited or value of such assets
  - Lengthy and expensive – in California, all fees are driven by statute and generally takes 1-2 years to complete
  - If there is no will, decedent's heirs will inherit based on the state intestacy scheme
  - Period of no access to funds for beneficiaries – in the context of cryptocurrency this could mean that coins could lose tremendous value before beneficiaries ever get access to the digital wallet due to the volatile nature of the cryptocurrency markets.

Probate/Cryptocurrency Hypothetical

- If Bob and Anna failed to complete their estate plan before they died, many of the same issues would arise.
  - Their estate would go through the probate process, which is lengthy and expensive and subject to public record.
  - They may face significant estate tax issues because there is no planning for the significant value that has been derived from the investment
  - Family issues:
    - Bob did not share the investment with his wife or daughter. If Seth knows about the investment there is a risk that he could abscond with the crypto wallet without sharing the information with either his mother or his sister.
    - If Seth did not know about the investment, there is a risk that no one would know how or what the crypto wallet was and/or how to access it, potentially losing the asset forever.
    - Even if all parties know about the asset, it is possible that the heirs may lose the opportunity to liquidate the asset when market conditions are favorable to do so.

Probate/Cryptocurrency Real Life Example

- Death of Matthew Mellon
  - Lack of planning can cause a lot of problems for an estate with a lot of cryptocurrency.
  - Matthew Mellon, a member of the famous family of bankers, inherited $25 million through a trust created for his benefit at age 21.
    - He developed dangerous and costly habits, dying at age 54 while on his way to rehab.
  - At some point, Mellon began investing in cryptocurrency, eventually becoming a billionaire.
    - At the time of his death, his crypto holdings were estimated to be worth around $100 million.
    - He did not have proper estate planning for his cryptocurrency and his estate is being probated
  - During his probate, his holdings have fluctuated more than 30% in value, causing his estate to seek permission to sell the cryptocurrency now in case the value of the holdings crashes.

Cryptocurrency and Estate Planning

- If Bob and Anna had completed an estate plan, the outcome may be different.
- Estate Planning in general, offers:
  - Flexibility and certainty to the smooth flow of business during periods of incapacity or after death.
  - Levels of creativity to design a plan to meet each unique client needs.
  - Privacy for the heirs in the assets being inherited
  - Tax planning to avoid estate tax and other tax savings strategies
  - Probate avoidance for assets properly transferred to a trust

Cryptocurrency & EP Basics

- For estate planning purposes, cryptocurrency is taxed similar to real estate or stock.
- Estate planning and tax advisers must consider this tax treatment when documenting gifts, utilizing trusts, and structuring transactions.
- Counsel must consider unique planning factors that apply to cryptocurrencies, such as:
  - The rules regarding the custody;
  - The rules regarding security;
  - The rules regarding the accessibility of digital assets;
  - The Uniform Prudent Investor Act; and
  - The complex tax regulations.

Estate Plan Strategy: Revocable Living Trusts

- Revocable Living Trusts ("RLTS"):
  - Avoid probate after death and can avoid conservatorship/guardianship during life.
  - Have flexibility – easy to modify or revoke
  - Tax planning
  - Offer privacy because generally no court oversight on trust administration
  - Irrevocable upon death
  - Apply to all assets transferred to the trust

EP: How Cryptocurrency Differs from Traditional Assets

- Traditional Assets covered by the revocable living trust in an estate plan are:
  - Cash;
  - Real Estate;
  - Securities;
  - Interests in Family Businesses.
- Traditional assets are funded into a trust by changing the titling of the asset
- This is not possible with virtual currency due to “KYC” Rules
- The value of virtual currency fluctuates regularly and can be unpredictable, making tax planning challenging.
  - Remember that Bob’s $10,000 initial investment in 2013 is worth $36,082,706.80 as of March 29, 2022.
- There are anonymity and security issues that are not present with traditional cash accounts (bank accounts, CODs, money market accounts, etc.)
- Protecting the security of the asset during the grantor’s lifetime while also making sure that the heirs/beneficiaries can access the monies after grantor’s passing

Funding Cryptocurrency into RLT

- RLTs avoid probate with assets funded into the trust – critical to estate planning process
  - Cryptocurrency can be funded into a trust.
    - Had Bob and Anna set up a trust, all their assets we discussed could be placed in the trust, including: their house, their bank accounts, the small life insurance policy, the tax-deferred retirement plan, and the cryptocurrency.
  - Specific authority needs to be given to trustee to access digital assets.
  - Cryptocurrency needs to be specifically listed/included in estate planning documents, generally a schedule of assets. Without this, people may not know it exists.
  - To transfer a Cryptocurrency asset, the trustee will need access to the key and the password(s) in order to access the crypto wallet.
    - May want to consider a step-by-step guide of how to access, and where to access it (i.e., if it has to be accessed on a particular device or not);
    - Cryptocurrency can only be accessed by public and private keys that are dozens of characters long so grantor may consider providing critical information in a memorandum to the Trustee that provides any necessary information to access the wallet.
  - If placed into an irrevocable trust, any recognized increase in value can be free of additional estate or gift tax.

EP & Cryptocurrency Anonymity Issues

- Client Discussions re Crypto Currency
  - Estate planners should at least request that Clients provide some information about the crypto accounts during estate planning so as to make their existence known and identifiable, as well as what they'd like done with the accounts in their estate planning documents.
  - Consider advising clients to include memorandum or instructions to trustee/executor on how to access crypto accounts and wallet.
  - The benefit of the trust, unlike probate, is that the successor trustee may have immediate access to cryptocurrency assets immediately with the proper information – whereas the probate process can take time to access.
- **That means that the key must be safely stored and included in an estate plan and language needs to be included in the estate planning documents granting access**.

EP Provisions for Cryptocurrency Assets

- Typical provisions to consider:
  - Give the fiduciary authority to access, modify, control, archive, transfer, and delete digital assets.
  - Be sure to include broad language that covers almost everything included in a person's "digital footprint."
    - This includes: digital photos, videos, or music; file-sharing accounts, domain registrations, online accounts, blogs, financial accounts, etc.
    - Future-proof this provision to include anything that currently exists or that may be developed as technology advances.
  - Give the fiduciary authority to access, modify, control, archive, transfer, and delete assets stored in the cloud or on personal devices.
  - Be sure to include broad definition of what a "digital device" is, and again, futureproof this provision for new hardware or technology that is developed.

EP Considerations for Transferring Digital Assets

Strategies for transactions:

- M of N Transaction
  - Generally, only one digital signature (or key) is required in a standard cryptocurrency transaction. However, most major exchange platforms also support M of N transactions, which require 2+ signatures to sign off on a transaction before any money can be moved. Requiring multiple signatures has the advantage of providing added security to cryptocurrency transactions because they eliminate the single points of failure.
    - If a client would like to leave their assets to a beneficiary, then they might consider having a 1 of 2 transaction where they would share a joint cryptocurrency address and the signature of either person is sufficient to spend the funds. This way, if one key is lost then the other person can still access the funds.
    - It also protects against a beneficiary having immediate access to the assets.
- Dead Man's Switch
  - This option is similar to M of N transaction, but instead of including another person on a transaction, a computer acts as the third, verifying party. In this instance a program periodically sends messages asking if the cryptocurrency user is still alive. If there is no response after a specified number of tries then the program will activate a switch and transfer the virtual coins to an inheritor's account.

Advanced Planning Strategies

- Self directed IRA
- Charitable Remainder Trusts

Self Directed IRA

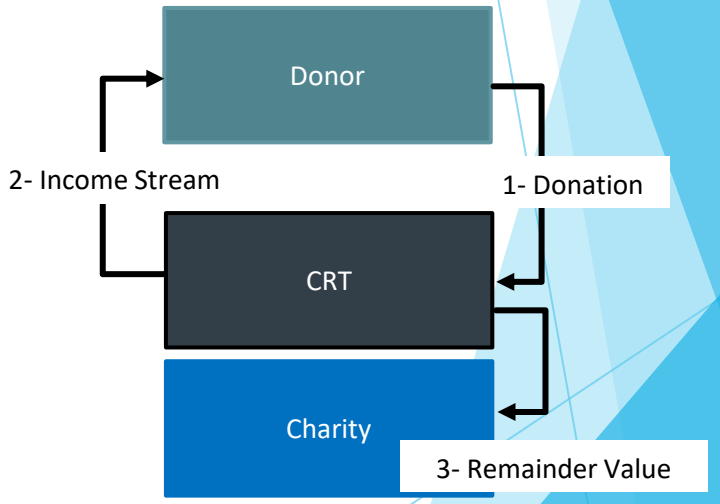
- Defer or eliminate tax on crypto investments
- Onshore and Offshore
- Set-up of IRA LLC
- Must follow all IRS rules as the manager of the IRA LLC
- Investing directly from IRA

What is a CRT?

- Irrevocable trust to where you donate assets that generates a potential income stream for you, or other beneficiaries, with the remainder of the donated assets going to your designated charity or charities upon your demise.
- Immediate first year income tax deduction
- Used by investors to
  - Address volatility
  - Spread income tax hit over number of years
  - Receive charitable income tax deduction

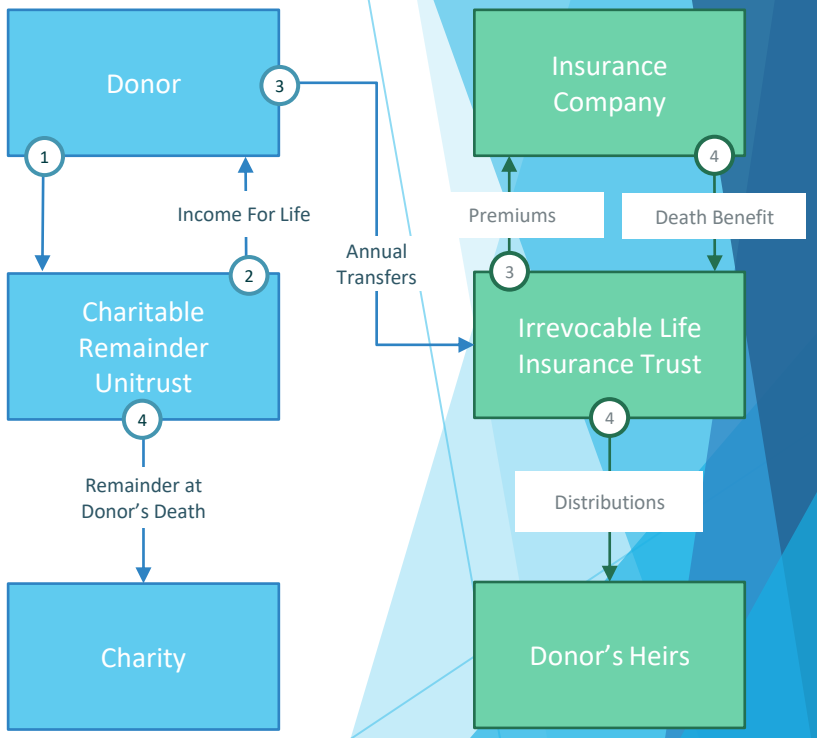
How does a CRT Work?

- Investor/donor makes donation
- Donor selects a charity of choice for remaining of CRT assets to be distributed
- Donor receives immediate federal income tax deduction
- Donor/beneficiaries receive income stream
- Donor during life can use income generated from CRT
- Can sell assets inside the CRT
- Tax exempt



CRT with Wealth Replacement Tool

- The donor transfers cryptocurrency to the CRT in return for a federal income tax deduction for the present value of the charity's remainder interest.
- The CRT pays the donor an income for life, or a term that does not exceed 20 years.
  - The trustee of the CRT can sell the cryptocurrency without paying capital gains.
- The donor uses the income from the CRT to make annual gifts to an Irrevocable Life Insurance Trust (ILIT). The trustee of the ILIT can us these proceeds to pay premiums on a life insurance policy on the owner's life owned in the ILIT.
- When the donor dies, the charity receives the property remaining in the CRT and the ILIT receives the death benefit of the insurance policy.
- **Result -** The donor receives a current income tax charitable deduction and increased cash flow for life and the donor's heirs are made whole with life insurance that replaces the donated capital. The donor also makes a significant gift to charity at their passing.



Real Life Example
Term - Max Deduction

Assumptions	
Trust Type:	20yr Term
7520 Rate:	2.00%
FMV of Trust:	5,000,000
Growth Rate	5%
Optimized Payout:	5.00%
First Year Income Tax Deduction	**1,815,915**

					Wealth Replacement Tool	
Year	Beginning Principal	Trust Growth at 5%	Distribution to Investor	Remainder to Charity	Insurance Premium	Insurance Death Benefit
1	5,000,000	245,313	250,000	4,995,313	133,098	10,000,000
2	4,995,313	245,083	249,766	4,990,629	133,098	10,000,000
3	4,990,629	244,853	249,531	4,985,951	133,098	10,000,000
4	4,985,951	244,623	249,298	4,981,276	133,098	10,000,000
5	4,981,276	244,394	249,064	4,976,606	133,098	10,000,000
6	4,976,606	244,165	248,830	4,971,941	133,098	10,000,000
7	4,971,941	243,936	248,597	4,967,280	133,098	10,000,000
8	4,967,280	243,707	248,364	4,962,623	133,098	10,000,000
9	4,962,623	243,479	248,131	4,957,970	133,098	10,000,000
10	4,957,970	243,250	247,899	4,953,322	133,098	10,000,000
11	4,953,322	243,022	247,666	4,948,678	133,098	10,000,000
12	4,948,678	242,795	247,434	4,944,039	133,098	10,000,000
13	4,944,039	242,567	247,202	4,939,404	133,098	10,000,000
14	4,939,404	242,340	246,970	4,934,773	133,098	10,000,000
15	4,934,773	242,112	246,739	4,930,147	133,098	10,000,000
16	4,930,147	241,885	246,507	4,925,525	133,098	10,000,000
17	4,925,525	241,659	246,276	4,920,907	133,098	10,000,000
18	4,920,907	241,432	246,045	4,916,294	133,098	10,000,000
19	4,916,294	241,206	245,815	4,911,685	133,098	10,000,000
20	4,911,685	240,980	245,584	4,907,080	133,098	10,000,000
Summary:		4,862,798	4,955,718	4,907,080	2,661,960	10,000,000

*Underlying insurance policy assumes male, age 45, Illinois, standard non-tobacco.
*Death benefit remains inforce for life.

Real Life Example
Life - Max Distribution

Assumptions	
Trust Type:	20yr Term
7520 Rate:	2.00%
FMV of Trust:	5,000,000
Growth Rate	5%
Optimized Payout:	11.01%
First Year Income Tax Deduction	**500,100**

					Wealth Replacement Tool	
Year	Beginning Principal	Trust Growth at 5%	Distribution to Investor	Remainder to Charity	Insurance Premium	Insurance Death Benefit
1	5,000,000	239,677	550,538	4,689,139	133,098	10,000,000
2	4,689,139	224,776	516,310	4,397,606	133,098	10,000,000
3	4,397,606	210,801	484,210	4,124,197	133,098	10,000,000
4	4,124,197	197,695	454,105	3,867,787	133,098	10,000,000
5	3,867,787	185,404	425,873	3,627,319	133,098	10,000,000
6	3,627,319	173,877	399,395	3,401,801	133,098	10,000,000
7	3,401,801	163,067	374,564	3,190,303	133,098	10,000,000
8	3,190,303	152,929	351,277	2,991,955	133,098	10,000,000
9	2,991,955	143,421	329,437	2,805,939	133,098	10,000,000
10	2,805,939	134,504	308,955	2,631,488	133,098	10,000,000
11	2,631,488	126,142	289,747	2,467,883	133,098	10,000,000
12	2,467,883	118,299	271,733	2,314,449	133,098	10,000,000
13	2,314,449	110,944	254,838	2,170,555	133,098	10,000,000
14	2,170,555	104,047	238,995	2,035,607	133,098	10,000,000
15	2,035,607	97,578	224,136	1,909,049	133,098	10,000,000
16	1,909,049	91,511	210,201	1,790,359	133,098	10,000,000
17	1,790,359	85,822	197,132	1,679,049	133,098	10,000,000
18	1,679,049	80,486	184,876	1,574,659	133,098	10,000,000
19	1,574,659	75,482	173,382	1,476,759	133,098	10,000,000
20	1,476,759	70,789	162,602	1,384,946	133,098	10,000,000
Summary:		2,787,252	6,402,306	1,384,946	2,661,960	10,000,000

*Underlying insurance policy assumes male, age 45, Illinois, standard non-tobacco.
*Death benefit remains in force for life.

Benefits of CRT's

- CRT's have several benefits
  - Address cryptocurrency volatility.
  - Convert any appreciated asset into something that offers lifetime income
  - Spread the income tax hit from the sale of cryptocurrency over several years.
  - Eliminate capital gains when assets are sold
  - Earn protection against creditors for assets inside the CRT
  - Benefit a charity
  - Receive a charitable income tax deduction.

Downfalls of CRT's

- CRT's do have some drawbacks
  - Substantial assets needed
  - Can't remove the assets later
  - Could lose control of the assets inside the CRT
  - Higher income payments may reduce income tax deduction

Beware of Appraisals

- Donating crypto is not as straightforward as donating publicly traded stocks
- A donation of cyrptocurrency that exceeds $5,000 will require a qualified appraisal
- Appraisal must be done no more than 60 days prior to the donation
- Cost of appraisal

Summary Recap of CRT's

- Contribute highly appreciated assets and forego paying tax on the appreciation
- Charitable donation income tax deduction
- Diversification away from cryptocurrency assets to income-producing assets
- Annuity from the trust is paid to the investor
- The balance of the trust is distributed to the charity
- The CRT is irrevocable, and the assets are not included in the taxable estate of the investor.

Hypothetical: Bob and Anna

- Can see the impact of planning versus not planning.
- We know that modest clients can end up with large assets, depending on the timing of their investment, and what is invested in.
- Without planning, could have some pretty tragic consequences.
  - Lost key or lost wallet could mean a lost asset.
  - Bob and Anna could leave the key with a successor trustee but could set a proscribed transaction type. This gives the trustee and beneficiary access but not wholly unfettered and immediate.
- Bob and Anna's estate plan can plan for future developments in technology and/or cryptocurrency, by including language broad enough to cover future tech devices or services.
- Bob and Anna also have tax implications, and capital gains implications.

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