Crypto Corner

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Crypto Currency ("Crypto") remains a "hot" topic.

*A. **No Loss Deduction for a Decline in Value***:

Many investors in Crypto recently saw their holdings decline in value, frozen by exchanges, or suspended in bankruptcy proceedings. For example, Bitcoin reached a high of nearly $65,000 on April 14, 2021, and reached a low recently in 2023 of $13,000. As of this writing, Bitcoin's price is a little above $26,000. Can a holder of Bitcoin, or another Crypto with similar paper losses, deduct the decline in value as an income tax deduction? The answer is "No." While the investor holds the Crypto, there is no "recognized" loss. A "realized" loss occurs when the Crypto declines in value (this is the "paper loss"), a "recognized" loss occurs when the holder disposes of the Crypto, or the Crypto becomes "worthless." However, what is meant by "worthless"? In January 2023, the IRS publicly stated that no deduction is allowed for a decline in Crypto value, unless the Crypto becomes worthless. As might be expected, the devil is always in the details. The facts in the recent IRS guidance are:

Taxpayer A is an individual who purchased units of Cryptocurrency B in 2022 at $1.00 per unit for personal investment purposes on a Cryptocurrency exchange. After Taxpayer A acquired Cryptocurrency B, the per unit value of Cryptocurrency B decreased significantly, such that each unit of Cryptocurrency B was valued at less than one cent at the end of 2022. On December 31, 2022, Cryptocurrency B continued to be traded on at least one Cryptocurrency exchange, and Taxpayer A maintained dominion and control over the units of Cryptocurrency B as evidenced by Taxpayer A's ability to sell, exchange, or transfer the units. **Taxpayer A claimed a deduction on Taxpayer A's 2022 tax return under section 165 and took the position that the units of Cryptocurrency B were either worthless or abandoned. (Bold Added)**

In concluding that the taxpayer could not take a loss because of the decline in value, the IRS relied on the fact that the Crypto was trading on at least on exchange and the Crypto had a positive value. Suppose the Crypto was not trading on any exchange and there were no buyers? It might be argued on these facts the Crypto was "worthless," since there is no willing buyer. The reverberations of a decline in Crypto value can be breathtaking. When FTX crashed, currencies associated with it, Serum, Solana, FTT, also fell in value precipitously.

The situation becomes less clear if a taxpayer had Crypto on an exchange that filed for bankruptcy last year, such as FTX. These taxpayers are in limbo while the bankruptcy proceedings continue. What the taxpayer will receive from the bankruptcy process, if anything, is unknown. One issue that has surfaced is who *owns* the Crypto held by an exchange when an exchange files for bankruptcy. This generally depends on the agreement that the Crypto depositor signed with the exchange. On January 4, 2023, the United States Bankruptcy Court for the Southern District of New York held that ownership of Crypto deposited in "Earn Accounts" with Celsius Network, an exchange that filed for bankruptcy protection in July 2022, after freezing customer accounts in June 2022, was transferred to Celsius by the depositors, and the Crypto depositors became unsecured creditors of Celsius in the bankruptcy. At the time of Celsius' bankruptcy filing, Celsius had $167 million in "cash on hand" but had $1.15 billion in liabilities. In short, the taxpayer/Crypto depositor of Celsius is likely to get something back, but not very much. Thus, no current deduction according to the IRS. What can a Crypto holder on a failed exchange do? Very little. Here are the options:

1. Continue to hold the Crypto that is frozen on the exchange and is part of the exchange's bankruptcy proceeding, and hope for the best;

2. Sell the Crypto for pennies and recognize the loss. One bright spot is the holder of the Crypto can immediately repurchase the Crypto at the depressed value if the holder believes it will go up in value. Unlike securities, Crypto is not subject to the "Wash Sale Rules."

3. Hope that the IRS will issue a Madoff-like relief provision that permitted the holders of Madoff accounts a "safe-harbor" to write off their investments. However, the Madoff situation was different because there was actual fraud and a criminal charge against the main perpetrators. This has not yet been proven in the FTX crash.

Another issue is even if a taxpayer/Crypto holder were able to take a loss, it would be a capital loss, only deductible against capital gains, unless the loss is due to "theft," or the loss is suffered in a transaction that was entered into for profit. This could apply to taxpayers who deposited their Crypto into Earn accounts at Celsius and received weekly interest payments. In any event, the status of the law is not clear, and each taxpayer, and each exchange failure, must be viewed independently.

B. ***Charitable Contributions of Crypto***:

Making a charitable contribution of Crypto or a Non-Fungible Token ("NFT") requires a lot of attention to detail. It is not easy, and the IRS scrutinizes all charitable contributions of property closely. If you plan to make a charitable contribution of Crypto or an NFT, plan well-ahead.

All contributions of property, including Crypto and NFTs, require strict compliance with the Treasury Regulations. *Substantial compliance* is not enough. In the Porzio Tax Letter of January 1, 2023, the following was written regarding the need for compliance for charitable gifts of property:

"The need to strictly follow the substantiation rules for charitable contributions cannot be exaggerated. *"Strict Compliance"* is the law. A taxpayer who does not scrupulously follow the rules will find his charitable contribution disallowed. *Good faith compliance is not enough.* Unlike horseshoes, close doesn't count. The IRS has been on a campaign to audit taxpayers who make gifts, especially gifts of property. The two most common issues are: *(1) Valuation; and (2) Obtaining a Contemporaneous Written Receipt."*

The valuation rules are complex. Further, charitable contributions of property of more than $5,000 require a "Qualified Appraisal" by a "Qualified Appraiser." Thus, the value of a single Bitcoin exceeds this threshold. Charitable contributions of Crypto and NFTs raise the bar because of unique valuation issues. Valuations reported by Crypto exchanges do not qualify as "Qualified Appraisals." On January 10, 2023, the IRS published guidance for charitable contributions of Crypto and NFTs. The IRS confirmed that charitable contributions of Crypto and NFTs require the same substantiation as other property. One of the more challenging issues is finding a Qualified Appraiser for Crypto and NFTs. Further, the appraisal report must be signed no sooner than 60 days before the donation, and no later than the due date of the donor's tax return, including extensions. Most recipient organizations will want to dispose of the contributed Crypto or NFTs upon receipt. However, they may find this difficult to liquidate the Crypto and NFTs because they may first have to set up an account with an exchange.

C. ***Did You Lose Your Keys***?

The story of Stefan Thomas is well-known. In short, he owns hundreds of millions of dollars of Bitcoin but cannot access it because he lost his "Password Key." As Emeril Lagasse would say, "Let's take it up a couple of notches." Imagine you are the Executor of an estate and you know the decedent owned substantial amounts of Crypto at his death, but the decedent forgot to pass the password to you? Is the non-accessible Crypto included in the decedent's estate for Estate Tax purposes? The Estate Tax is an excise tax on the transfer of a decedent's taxable estate. It is a tax on the *transfer* of wealth. It is ***not*** a tax on the decedent's wealth which, unless it is properly apportioned, would be unconstitutional. If property is included in a decedent's estate, the value must be determined. The loss of access to Crypto because of a failure to pass the password leads to the following obvious questions:

4. Although the decedent may have known the password at his death, his failure to provide the password to his personal representative prevents the transfer of the wealth. If the wealth cannot be transferred can the Estate Tax apply?

5. Suppose the password is found after the Statute of Limitations expires on the decedent's estate. What are the consequences?

Generally, the IRS has 3 years after the filing of a Federal Estate Tax return to make an assessment for additional taxes. If the omission is large enough, the period is extended to 6 years. Unless there is fraud, the Statute of Limitations expires after 3 years, or 6 years if the omission is large. While there is no direct IRS guidance on the issue, a strong argument can be made that the Federal Estate Tax cannot apply if the password was lost while the decedent/taxpayer was alive, or was known to the decedent at death but not conveyed to the personal representative at death. In the first case, the decedent did not own the property at death, and, therefore, his estate had no property to report. In the second case, the failure to transfer the password prevents the transfer of property, a fundamental requirement for the Estate Tax to apply. This issue is in its infancy and its sure to be discussed in the future. Recently, it was the central issue in the NBC television show, *The Blacklist.*

*D. **Can a Walton GRAT Help***?

In 2000, the United States Tax Court sanctioned the use of a “Walton GRAT,” and the IRS has approved its continued use, although President Biden would prevent its use in his Budget Proposals. At its core, a Walton GRAT, also known as a “Zeroed Out GRAT,” permits a taxpayer to make a gift tax free, or nearly gift tax free, of the appreciation of property held by a Walton GRAT during its term, usually 2-3 years. This strategy is effective if a taxpayer currently holds Crypto, or other property, that he believes will appreciate significantly in the next two years. The Walton GRAT is implemented as follows.

Example**:** A Taxpayer holds Bitcoin that he believes will increase from its current value of $25,000 to $50,000 in the next two years. The rate of interest required by the IRS for this transaction is 5%. The Taxpayer receives one-half of the value of the property he contributed on the first anniversary of the trust ($50,000), plus 5% interest ($5,000), and he receives the balance on the second anniversary of the trust ($50,000), plus 5% interest ($2,500) (**the following is simplified and for illustration purposes only**).

6. The Taxpayer forms a Walton GRAT with a term of 2 years. At the end of the two years, any remaining amount in the GRAT passes to the Taxpayer's two children, or remains in trust for the benefit of the Taxpayer's two children, free of gift taxes;

7. Taxpayer contributes $100,000 of Bitcoin (4 Bitcoins valued at $25,000 each) to the trust;

8. The Taxpayer receives approximately one-half of the Bitcoin contributed to the trust at the end of year 1, and the remaining one-half of the Bitcoin contributed in year 2, plus 5% interest. The Taxpayer is not considered to make a taxable gift because the Taxpayer received what he transferred, $100,000, plus 5% interest on the outstanding balance of the Bitcoin he contributed.

9. At end of year 1, The taxpayer receives approximately $55,000 (one half of the $100,000 of the Bitcoin transferred into the trust plus interest of 5% of $100,000.

10. At the end of the second year, the Taxpayer receives $52,250 (the $100,000 of Bitcoin value transferred into the trust, reduced by the payment at the end of the first year of $50,000, not including the 5% interest), plus 5% interest on the remaining $50,000).

11. Assume that the value of the Bitcoin remaining in the trust after the payments of $55,000 and $52,250 is $80,000 because the Bitcoin has appreciated since it was transferred to the trust. The $80,000 can continue to be held in trust for the beneficiaries, distributed to the beneficaries, or sold, all gift tax free. If the Bitcoin is sold, the gain is taxable to the trust or the beneficiaries when sold. If some or all of the Bitcoin is sold during the two years, any gain is taxed to the grantor.

12. The use of a Walton GRAT is effective whenever a taxpayer has property that he believes will significantly appreciate in the next two years. If the property appreciates as expected, the increase in value passes to the beneficiaries of the Walton GRAT free of gift tax. If the property fails to appreciate, the Taxpayer gets his contribution to the trust back without tax consequences. The only expense is the cost of setting up the Walton GRAT.

If you are interested in exploring this strategy and how it may fit into your estate plan please contact Phil Siana or Deirdre Wheatley-Liss at Porzio.