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INSIGHT: Transfer Tax and Estate Planning Considerations for Clients With Cryptoassets (Part 1)

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Cryptoassets make up a modern, rapidly expanding asset class that is challenging jurisdictions across the globe to come up with appropriate regulatory and tax regimes that fit its nuanced contours. Recently, many jurisdictions, including the U.S., have begun to take steps to articulate income tax rules, anti-money laundering guidelines, and other regulations directed at cryptoassets. In the transfer tax area, however, the IRS has released only nominal guidance, leaving estate planners and other tax practitioners with little to go by when crafting estate plans and pursuing other transfer tax reduction strategies for clients rich in cryptoassets, particularly nonresident aliens.

This article is the first in a two-part series covering transfer tax and estate planning issues for clients with cryptoassets. This article summarizes the different U.S. transfer tax rules applicable to U.S. citizens and domiciliaries versus nonresident aliens with regard to cryptoassets, while Part 2 will offer several practical estate planning considerations for advisors with clients who own cryptoassets.

To properly evaluate the U.S. tax treatment of lifetime gifts and deathtime transfers of cryptoassets, it is important to understand the starkly different estate and gift tax treatment the U.S. affords to U.S. citizens and domiciliaries, as opposed to nonresident aliens. While the top estate and gift tax rate for U.S. citizens and domiciliaries and for nonresident aliens is 40%, the breadth of assets subject to that tax rate is dramatically different for nonresident aliens depending on the ''situs'' of those assets.

Overview of Estate and Gift Tax Rules for U.S. Citizens and Domiciliaries

U.S. estate taxation of cryptoassets depends heavily on whether the decedent was a U.S. citizen or domiciliary versus a nonresident alien. The combined exclusion from U.S. estate and gift taxes available to U.S. citizens and domiciliaries in 2020 is $11.58 million per person or $23.16 million per married couple. U.S. citizens and domiciliaries are subject to U.S. estate taxation on all worldwide assets, regardless of their location or situs, including cryptoassets. A U.S. citizen or domiciliary's assets, including cryptoassets, are included in his or her taxable estate at their fair market value at the time of the decedent's death.

Gifts of cryptoassets by U.S. citizens and domiciliaries follow the same rules as gifts of any other assets. Gifts valued at $15,000 or less ($30,000 or less by married couples) are never subject to U.S. gift tax and do not count against the combined exclusion amount. So if a U.S. citizen or domiciliary makes a gift of cryptoassets valued at less than these thresholds, no gift tax applies, and no gift tax return must be filed.

If a U.S. citizen or domiciliary makes a gift of cryptoassets exceeding these thresholds, he or she must report the excess amount on IRS Form 709, and the excess amount is deducted from the combined U.S. estate and gift tax exclusion amount available at death. If the

combined exclusion is used up entirely during life, gifts of cryptoassets are subject to an immediate gift tax at the applicable 40% rate.

Overview of Estate and Gift Tax Rules for Nonresident Aliens

The combined exclusion from U.S. estate and gift taxes for nonresident aliens is just $60,000 unless superseded by treaty. Nonresident aliens, however, are subject to U.S. estate taxation only on assets located, or ''sitused,'' within the U.S. at the time of death, including cryptoassets. Assets of nonresident aliens sitused outside the U.S. are not subject to U.S. estate taxation.

In addition, nonresident aliens should not be subject to U.S. gift tax on gifts of cryptoassets during life. According to IRS Notice 2014-21, cryptoassets are treated as property for tax purposes, with general tax principles that apply to property transactions applying to transactions involving cryptoassets. Under tax code Section 2501(a)(2), nonresident aliens may make lifetime gifts of intangible U.S. situs property free of U.S. gift taxation. Nonresident aliens are not subject to U.S. gift tax when they make lifetime gifts of non-U.S. situs property either. Therefore, no U.S. gift tax will apply to gifts of cryptoassets by nonresident aliens regardless of their situs.

Importance of Situs to Estate Taxation of Cryptoassets Owned by Nonresident Aliens

Situs is generally considered to be the place an asset belongs to for purposes of legal jurisdiction or taxation. While this definition seems clear on its surface, its practical application to cryptoassets is not, which is particularly troublesome given the dramatic effect that the situs of cryptoassets can have on estate tax liability for nonresident aliens.

In the United States, as in many other countries, there is an utter lack of guidance or rules about determining the situs of cryptoassets. Neither the IRS guidance released to date related to cryptoassets (IRS Notice 2014-21, Revenue Ruling 2019-24, and two sets of FAQs) nor the situs rules related to uncategorized intangible property found in Treasury Regulations 20.2104-1(a)(4) and 20.2105-1(e) offer clear direction on the correct situs for cryptoassets. In addition, inherent difficulties exist in determining the location of intangible assets, so without sufficient guidance from the relevant authorities, it's nearly impossible to properly identify situs.

If advisors for the estates of nonresident aliens cannot identify the situs of cryptoassets, how are they to know whether such assets are subject to U.S. estate taxation? There are several defensible approaches advisors may take for determining the situs of cryptoassets, none of which is dispositive. Popular cryptoasset exchanges such as Coinbase allow users to hold cryptoassets in ''exchange accounts'' on their websites. The locations of these exchanges could be deemed to be the proper situs of cryptoassets, but it's not always easy to identify the location of less-established exchanges. Further, the ''location'' of the exchanges could be identified as the location of the server where the accounts are held, the location of the exchange's headquarters, or the location where the corporate entity housing the exchange is registered to do business, among other possibilities.

In addition, owners of cryptoassets may also hold such assets in ''wallets.'' There are two forms of wallets—software and hardware. With software wallets, owners download software onto their computers or smart phones and then transfer the private keys to their cryptoassets to those software wallets, which are offline and stored on the hard drive of the computer or smartphone. With hardware wallets, owners transfer private keys to access cryptoassets to an external hardware device, such as a USB drive, which is neither on the Internet nor on the owner's computer. In each case, using the location of the wallet at the owner's death is a defensible approach to identifying the location of the cryptoassets, but absurd results are possible if the owner was traveling with the wallets at the time of death.

Without more guidance, consistent identification of the situs of cryptoassets seems impossible. This leaves practitioners who represent nonresident aliens with substantial cryptoassets in a lurch with no clear path to follow. Absent a clear path, nonresident aliens run the risk of over- or underpaying estate taxes on cryptoassets, and the IRS runs the risk of over- or undercollecting taxes on the same assets. With the rapid increase in the prevalence of cryptoassets, the IRS would be well advised to issue guidance clarifying the situs rules as soon as possible.

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