

UNPACKING THE DIGITAL VAULT: ESTATE PLANNING CONSIDERATIONS FOR NON-FUNGIBLE TOKENS

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I. INTRODUCTION

In a world where virtual real estate and digital collectibles sell for millions of dollars, a new frontier of estate planning has emerged. The digital world shapes almost every aspect of the way we live, work, invest, and exchange. An estate planner must understand the unique complexities, risks, and issues that arise in a relatively new and emerging virtual asset class. For purposes of this paper, the focus will be on the estate planning considerations for digital assets, predominantly non-fungible tokens (“NFT” or “NFTs”), held by an individual for investment purposes.

NFTs exploded in growth and popularity in 2021 and 2022.¹ In the most basic terms, NFTs are “digital collectibles or digital art . . . [and include] digital items such as artwork, photographs, sound recordings, videos, sports trading cards, and other similar items.”² Fueled by the rise of cryptocurrency and blockchain, the general public’s desire to collect art, a lack of options in “digital ownership interests,” and investor speculation, NFTs burst onto the scene amid COVID-19 and became an investment phenomenon.³ Even major international auction houses like Sotheby’s and Christie’s began to welcome digital art and the exchange of NFTs.⁴ To put the explosion of NFTs into perspective, in 2021 “\$41 billion worth of [cryptocurrency] was spent on the NFT marketplaces”⁵ NFT sales nearly amounted to the total sales of the established conventional art and antique market in 2020 of around \$50 billion.⁶

The hype and speculation around the NFT market at the time drove a surge in prices. For example, on December 2, 2021, 28,983 collectors together purchased an NFT by Pak titled *The Merge* for a cost of around \$91.8 million.⁷ *The Merge* is the highest-priced NFT ever sold.⁸ Another notorious NFT sale, the *Everydays: the First 5000 Days* by Beeple, sold to a sole owner for around \$69.3 million.⁹ The NFT bubble, however, eventually began to pop.¹⁰ From its peak

in 2022, daily trading volume is down ninety-seven percent, due to several factors, including a “loss of public interest,” inflated prices leading to a severe market correction, and saturation of the market.¹¹

Currently, despite the substantial decline in both the valuation of NFTs and their popularity, there are still likely long-term applications for the technology.¹² The technology has the potential to establish and verify ownership of digital assets, helping to prevent piracy.¹³ Moreover, though there is not the same craze as there was in '21 and '22, many investors continue to own NFTs as they see an investment opportunity. NFTs can also help drive the monetization of digital content in industries like gaming and music.¹⁴ In gaming, NFTs can be bought and sold for various in-game items, giving the player an ownership interest.¹⁵ Further, NFTs in the “digital art, music, and other creative works” space may give creators something they have long sought, enhanced control over their digital works.¹⁶

As the uses of NFTs evolve, it will be important to consider the issues that NFTs present in estate planning and taxation. Regulation of digital assets is a rapidly developing area of law and estate planners need to understand the implications of proposed regulation and legislation.

II. BACKGROUND

A. What are digital assets?

Until recently, there was an absence of legislation defining what encompasses a digital asset. Now, Congress has codified it. A digital asset is any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.¹⁷ Generally, digital assets are convertible virtual currencies, cryptocurrencies, stablecoins, and NFTs.¹⁸ In recent guidance issued by the Service, the term

“virtual currencies” was replaced by the term “digital assets.”¹⁹ U.S. taxpayers will see this updated terminology reflected if filing a Form 1040, Individual Income Tax Return.²⁰ Moreover, for federal tax purposes, digital assets are considered property.²¹

B. What are NFTs?

Throughout history, people have collected artwork, coins, books, collectibles, and anything they find interesting or valuable. Factors like rarity, authenticity, provenance, significance, the artist, recognition, and the backstory determine value.²² Digital art, on the other hand, dates back to the 1960s.²³ Unlike tangible art, the “ease of duplication” of digital art made it nearly impossible to verify ownership or assign any value.²⁴ With the invention and expansion of blockchain technology, an opportunity for “ownership of truly unique digital artifacts” is now possible.²⁵

Understanding the nuts and bolts of non-fungible tokens (“NFTs”) is complex and beyond the scope of this analysis. The Service issued guidance defining NFTs, and distributed ledger technology, i.e., blockchain technology, as:

An NFT is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. Ownership of an NFT may provide the holder a right with respect to a digital file (such as a digital image, digital music, a digital trading card, or a digital sports moment) that typically is separate from the NFT. Alternatively, NFT ownership may provide the holder a right with respect to an asset that is not a digital file, such as a right to attend a ticketed event, or certify ownership of a physical item . . . the right that an NFT provides or the ownership of an asset that an NFT certifies is referred to as the NFT's associated right or asset.

Distributed ledger technology, such as blockchain technology, uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded simultaneously on multiple nodes in a network. A token is an entry of data encoded on a distributed ledger. A distributed ledger can be used to identify ownership of both fungible tokens . . . and NFTs.²⁶

It is helpful to break down the major components of an NFT. NFTs are non-fungible in that they cannot be “exchanged for something else of the same kind.”²⁷ Each respective NFT is unique like artwork or real property. The token component resides on a blockchain, generally the Ethereum blockchain, and “represents a unique [digital] asset.”²⁸ The blockchain functions as the database where token transactions are recorded and visible for the unique digital asset.²⁹ The history of the token, connected to a unique digital asset, thus functions to verify ownership and authenticity of the NFT.³⁰ Finally, to complete a transaction on the blockchain, the private key stored within a wallet is necessary to prove the wallet owns the NFT.³¹

To illustrate the major components of an NFT, a simple breakdown of a hypothetical Michael Jordan trading card NFT would look like this: (1) the *unique digital asset* is a digital representation, the digital artwork, of the Michael Jordan trading card; (2) the *token* is a unique digital identifier representing the ownership of the Michael Jordan digital trading card; (3) the *non-fungible* component is that where the Michael Jordan trading card is unique and irreplaceable; (4) the *private key* is held within a wallet and is used to sign off on any transactions involving the Michael Jordan trading card NFT; and (5) the *blockchain* serves as a “decentralized ledger” that records all transactions and ownership changes by the token.³² With ownership and uniqueness in the Michael Jordan trading card NFT established on the blockchain network, an owner could collect it for a digital collection or investment opportunity, trade it with other collectors or investors, display it on digital galleries or platforms, or sell it.³³

C. How are NFTs stored and exchanged?

NFTs represent an innovative advancement that offers the unique possibility of truly free and clear digital asset ownership and exchange. In essence, NFTs are an attempt to recreate the simple sales transaction of tangible collectibles, but instead for unique, intangible digital assets.³⁴

Fundamental to the exchange of NFTs is the secure, verifiable, and reliable means of storage of the NFT and associated private key. To avoid digital piracy, rampant copying, and digital asset theft, the precise issues NFTs are attempting to solve requires an understanding of the mechanisms used to store an NFT. Generally, to store an NFT safely, there are three main storage options: (1) software wallets, (2) InterPlanetary File System, and (3) cold storage hardware wallets.³⁵

A software wallet, or hot wallet, is what it sounds like – software, typically in the form of a web-based or mobile application, accessible on a computer or mobile device via an internet connection that allows an owner to store and manage their NFT from anywhere.³⁶ Software wallets are the most convenient and cater to short-term trading, but also provide the lowest level of security. Software wallets are secured by only “encryption, password, and a 12-24 word seed phrase.”³⁷ And because a software wallet is connected to the internet, it is vulnerable to hacking and digital asset theft. A common example of a software wallet is the Coinbase Wallet.

The InterPlanetary File System (“IPFS”) storage method is exceptionally complex. It works to store an NFT in a decentralized, off-chain storage system that functions to mitigate the likelihood of cyber-attacks.³⁸ In a sense, it operates like another version of blockchain where it utilizes content identifiers to link you to your NFTs. Thus, its extra layers of security make it more secure than software wallets, but it is still susceptible to hacking.³⁹ A common example of an IPFS is Pinata.

A cold storage hardware wallet (“cold wallet”) is considered to be “the best and most secure way to store . . . NFTs.”⁴⁰ All sensitive data on the NFT is stored offline, on a physical device, ensuring the NFT is more protected from potential cyber theft.⁴¹ The physical device is generally a USB stick or smart card that can be plugged into an owner’s computer or mobile

device when access to the NFT is needed. To steal an NFT from a cold storage hardware wallet would require physical possession of the device storing it. For a long-term NFT investor, holding an NFT in a cold storage hardware wallet is the most desirable storage method. A common example of a cold storage hardware wallet is Ledger.

With an NFT safely stored in a wallet, the owner has complete control over their digital asset. The owner has the confidence to know they can transact, sell, or transfer the NFT whenever and however they see fit. The process to transfer an NFT for sale or otherwise is straightforward. In most cases, an NFT is either held in a cold or hot wallet. If an NFT is stored in a cold wallet, the owner must connect the cold wallet to a computer or mobile device connected to the internet by plugging in the USB stick or physical storage device.⁴² From there, the cold wallet can link to a hot wallet which may then be used to transfer the NFT into the hot wallet.⁴³ With the NFT now in a hot wallet, and accordingly connected to the internet, the NFT can be transferred to a variety of destinations.

The most common destinations include: (1) to another cold wallet, (2) to another hot wallet, (3) to an NFT auction, (4) to an NFT marketplace, or (5) to an NFT exchange.⁴⁴ Depending on the aim of the owner, each destination has its purpose. NFT marketplaces are where NFTs are most commonly traded.⁴⁵ The NFT marketplace allows owners to “either display, list, or advertise their NFTs or have users exchange them directly by sending them from one [hot] wallet to another.”⁴⁶ OpenSea is the largest and most popular example of an NFT marketplace.⁴⁷ An NFT auction is another common method of sale. Like an ordinary tangible artwork auction, a price floor is set and the NFT is sold to the highest bidder. Auctioning can be via a digital NFT bidding platform like SuperRare, or even in traditional auction formats like Sotheby’s.⁴⁸

Using the hypothetical transactions above from storage in a cold wallet to its sale, each transfer is recorded and becomes a permanent record to that unique NFT. Because of the transparent nature of the blockchain network, buyers have confidence in knowing the NFT offered for sale is verified and authentic.

III. ANALYSIS

A. Taxation of NFTs.

1. *General Tax Treatment of NFTs.*

The Service has issued little guidance specific to the tax treatment of NFTs. Guidance has primarily come from Notice 2014-21.⁴⁹ In Notice 2014-21, the Service stated “[f]or federal tax purposes, virtual currency is treated as property” and “[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency.”⁵⁰ The term “virtual currencies” has since been replaced by the term “digital assets,” which includes NFTs.⁵¹ As such, and without guidance to the contrary, the Service’s views on cryptocurrency, digital assets, and virtual currencies extend to NFTs.

2. *Valuation of NFTs.*

The determination of the value of property is critical to nearly all aspects of estate planning. The question of value is also one of the most contested issues. The unique characteristics of an NFT make determining value a complex, ambiguous process. The Service has issued no guidance addressing valuation issues with NFTs. Instead, the general tax principles of property, and general guidance on digital assets, must be applied to NFTs.

NFTs are usually bought and sold using cryptocurrency.⁵² In Notice 2014-21, the Service stated that “transactions using virtual currency must be reported in U.S. dollars.”⁵³ Thus, for

income tax purposes, a taxpayer is required to “determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt.”⁵⁴ With the price volatility of cryptocurrencies, this can be an especially challenging task. Furthermore, with a lack of an established method of valuation of NFTs, the process can feel uncertain.

For the gift and estate tax, the process for determining the value of property is generally identical. It is an objective standard that focuses on the willing buyer and willing seller test. For estate tax purposes, property in the gross estate is taxed based on its fair market value.⁵⁵ Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.⁵⁶ For gift tax purposes, the value of a gift is likewise its fair market value.⁵⁷ The gift tax definition of fair market value mirrors that of the estate tax.⁵⁸ Moreover, for income tax charitable deductions, if a charitable contribution is made in property other than money, the amount of the contribution is generally the fair market value of the property at the time of the contribution.⁵⁹ The question remains, how is the fair market value of an NFT determined?

Valuation depends almost entirely on market forces as the NFT has “no intrinsic value just like other collectible items.”⁶⁰ The characteristics of NFTs that make them appealing to investors and collectors, also make them difficult to value. First, the non-fungible nature of an NFT makes it unique and one of a kind, increasing its value.⁶¹ Comparable to exchanging real property for real property, the NFT cannot be “equally exchanged” for another NFT.⁶² Second, ownership of the NFT is verified by the token on the blockchain adding to its authenticity, and again increasing its value.⁶³ Value is then derived from being the sole verifiable owner of that token.⁶⁴ Third, Blockchain allows for a medium of true global free market trading, selling, and

exchanging.⁶⁵ Like many collectibles, that value is, however, subjective to what a buyer is willing to pay.⁶⁶ NFTs replicate many of the same valuation factors artwork and collectibles consider like scarcity, uniqueness, authenticity, artist, brand recognition, and popularity, just in a digital asset format.⁶⁷

While NFT valuation factors are relatively known, determining an accurate fair market value remains a challenge. Given that most of the relevant factors to valuing artwork, and other hard-to-value assets, also are considered when valuing NFTs, it appears utilizing the procedures issued by the Service to substantiate the value of artwork is most appropriate. Typically, tangible personal property uses retail market value, which is the sales price of the item in the market in which the item is most commonly sold to the public.⁶⁸ It is challenging to apply this approach to artwork as it is considered unique and one-of-a-kind. Faced with this dilemma, the Service issued guidance where the price of an asset sold at public auction or as a result of a classified ad is considered retail value and is an acceptable fair market value.⁶⁹ Thus, when tangible artwork is sold at auction, “the sale price is an excellent indication of value and can be adjusted for downturns or upticks in the art market as of the time of death.”⁷⁰ However, absent sale at an auction, “sales of comparable works by the artist” may be used.⁷¹ With that, an appraisal is likely the best indication of value.

Generally, the burden is on the taxpayer to prove the value of an asset.⁷² For an income tax charitable deduction, a charitable contribution of property in excess of \$5,000 requires a qualified appraisal and an appraisal summary.⁷³ For the estate tax, if there are included among the household and personal effects articles having marked artistic or intrinsic value of a total in excess of \$3,000, the appraisal of an expert or experts, under oath, must be filed with the estate

tax return.⁷⁴ And finally, for the gift tax, fair market value is likewise determined by a qualified appraiser.⁷⁵

A qualified appraisal must be in accordance with generally accepted appraisal standards of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.⁷⁶ The contents of the qualified appraisal must include:

- i. a description in sufficient detail . . . taking into account the value of the property, for a person who is not generally familiar with the type of property to ascertain that the appraised property is the contributed property;
- ii. the condition of the property;
- iii. the valuation effective date;
- iv. the property's fair market value; and
- v. information regarding the appraiser, including the appraiser's (1) name, address, and taxpayer identification number, and (2) qualifications to value the type of property being valued, including the appraiser's education and experience.

In determining fair market value, the appraisal must show the valuation method used to determine the fair market value (e.g., the income approach, market-data approach, or the replacement-cost-less-depreciation approach), and the specific basis for the valuation (e.g., specific comparable sales transactions or statistical sampling).⁷⁷

Moreover, “[a] qualified appraiser should have earned an appraisal designation from a recognized organization, and meet certain education and experience requirements . . . [including] being certified for the property in question, with college or professional-level coursework relevant to the property being valued.”⁷⁸ A qualified appraiser determining the value of an NFT, however, encounters numerous difficulties.

First, there is a lack of qualified appraisers who satisfy the education and experience requirements necessary to accurately value an NFT.⁷⁹ Unlike artwork which has an extensive history of comparable sales data and appraisal training, NFTs are a new and emerging asset class

with few individuals possessing the necessary expertise.⁸⁰ Second, the accuracy of the valuations is likely to be easier for the Service to challenge.⁸¹ With a deficiency of market data, the subjectivity of the value, and the overall volatility of the NFT market, the Service “has the benefit of a longer time frame to review past data to test the accuracy of prior appraisals.”⁸²

Ultimately, the lack of guidance from the Service leaves taxpayers with a great deal of uncertainty and confusion. With all suggested methods of valuation posing issues, a need for guidance is crucial. Estate planners must remain up-to-date on any guidance that may emerge, and all supporting evidence used in determining value should be well documented.

3. *Income Tax Implications for NFTs.*

In Notice 2014-21, the Service stated virtual currency, now termed digital assets, are treated as property.⁸³ Digital assets are to be taxed according to general tax principles applicable to property.⁸⁴ Further, transactions using virtual currency must be reported in U.S. dollars.⁸⁵ A taxpayer is required to determine the fair market value of virtual currency in U.S. dollars as of the date of payment or receipt.⁸⁶ As such, “if the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain.”⁸⁷ With that, when a taxpayer holding an NFT as a capital asset uses a digital asset (i.e., an NFT) to dispose of or exchange for another digital asset (i.e., cryptocurrency), or vice versa, the Service “requires the taxpayer to record the amount, allocate cost basis . . . , subtract cost basis from the price, and report the difference . . . , while calculating the taxable long- or short-term capital or ordinary gain or loss on the tax return.”⁸⁸ Effectively, each time a taxpayer purchases or disposes of an NFT, it is likely to be considered a recognition event. While purchasing an NFT with cash is not a taxable event, using a digital asset to

purchase the NFT is. In the vast majority of instances, NFTs are purchased and sold using digital assets. Thus, performing everyday transactions with digital assets is cumbersome.⁸⁹

In News Release 2023-21, the Service again reminded taxpayers, as they did for tax year 2021, that they must answer a digital asset question regardless of whether they engaged in any transactions involving digital assets.⁹⁰ The question appears at the top of Forms 1040, Individual Income Tax Return; 1040-SR, U.S. Tax Return for Seniors; and 1040-NR, U.S. Nonresident Alien Income Tax Return asking, “[a]t any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?”⁹¹ A taxpayer will either answer “yes” or “no” to the digital asset question.⁹² A taxpayer must check the “Yes” box if they:

- i. Received digital assets as payment for property or services provided;
- ii. Transferred digital assets for free (without receiving any consideration) as a bona fide gift;
- iii. Received digital assets resulting from a reward or award;
- iv. Received new digital assets resulting from mining, staking and similar activities;
- v. Received digital assets resulting from a hard fork (a branching of a cryptocurrency's blockchain that splits a single cryptocurrency into two);
- vi. Disposed of digital assets in exchange for property or services;
- vii. Disposed of a digital asset in exchange or trade for another digital asset;
- viii. Sold a digital asset; or
- ix. Otherwise disposed of any other financial interest in a digital asset.⁹³

Beyond checking the “yes” box, a taxpayer must report all income related to their digital asset transactions.⁹⁴ Tax treatment is determined by the digital asset’s character.⁹⁵

Determining the character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.⁹⁶ For most taxpayers, an NFT held for investment purposes will be considered a capital asset. Capital assets are property held by the

taxpayer (whether or not connected with his trade or business), like stocks, bonds, cryptocurrencies, and artwork.⁹⁷ In most instances, a taxpayer holding an NFT for investment purposes will not fall into the capital asset exceptions listed in section 1221(a).⁹⁸ If they do, a gain recognized on an NFT within the capital asset exceptions will be taxed instead at ordinary rates.⁹⁹

On March 21, 2023, the Treasury Department and the Service announced they are soliciting feedback on guidance related to the treatment of certain NFTs as collectibles under section 408(m).¹⁰⁰ Thus, the definition of a section 408(m) collectible is especially relevant to NFTs. Section 408(m)(2) defines a collectible as:

For purposes of this subsection, the term ‘collectible’ means-

- (A) any work of art,
- (B) any rug or antique,
- (C) any metal or gem,
- (D) any stamp or coin,
- (E) any alcoholic beverage, or
- (F) any other tangible personal property specified by the Secretary for purposes of this subsection.¹⁰¹

With Notice 2023-27, the Service issued guidance taking the position that an NFT is within this definition. The classification will have significant implications on the taxation of gains from the sale, disposition, or exchange of NFTs. This is especially so since both the purchase and sale of an NFT with digital assets are considered recognition events.

A gain from a capital asset held for more than one year is subject to long-term capital gain treatment and benefits from preferential capital gain rates.¹⁰² Any gain from a capital asset held for not more than one year is a short-term capital gain and is instead taxed at ordinary income tax rates.¹⁰³ In general, for 2023, the long-term capital gain rates are 0%, 15%, or 20%, depending on the taxpayer’s taxable income and tax filing status.¹⁰⁴ Capital gains from the sale

of a collectible, however, are subject to a higher maximum rate of 28%.¹⁰⁵ With respect to section 408(m) collectibles, section 1(h)(5)(A) provides that:

The terms ‘collectibles gain’ and ‘collectibles loss’ mean gain or loss (respectively) from the sale or exchange of a collectible . . . which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.¹⁰⁶

The determination to define NFTs as collectibles under section 408(m) is accordingly viewed as unfavorable to the majority of NFT investors and collectors.

Moreover, if an NFT is a collectible, adverse tax consequences arise under section 408(m)(1) from the acquisition of an NFT by an individual retirement account (“IRA”).¹⁰⁷ Under section 408(m)(1), the acquisition by an IRA or by an individually-directed account under a plan described in section 401(a) of any collectible shall be treated as a distribution from such account in an amount equal to the cost to such account of such collectible.”¹⁰⁸ Thus, Notice 2023-27 has the effect of barring IRAs from holding or investing in NFTs.

In conclusion, the classification of NFTs as section 408(m) collectibles presents unique income tax implications due to their nature as both a collectible and digital asset. While it depends on the specific facts and circumstances of each transaction, estate planners and taxpayers must understand that each time a taxpayer exchanges or disposes of digital assets like NFTs, it is likely to be a recognition event. Using cash to buy an NFT is not a taxable event, but using a digital asset to buy the NFT is. This awareness is critical to helping taxpayers understand this emerging asset class and minimize their tax liability.

4. *Gift Tax Implications for NFTs.*

From the perspective of the estate planner, in general, all lifetime gifting and estate planning techniques are available when dealing with NFTs.¹⁰⁹ By using lifetime gifts and gift

tax exclusions, deductions, and exceptions, gifting strategies can decrease a taxable estate.¹¹⁰

Given the potential for substantial growth, NFTs may make attractive assets for gifting strategies in an overall estate plan.¹¹¹ However, if not careful, the complexities of NFTs combined with the nuances of the federal gift tax can result in unintended tax consequences. Besides the issue of valuation uncertainty, which is addressed *supra*, Section III(A)(2), the issue of a completed gift of an NFT poses its unique gift tax challenges.

In the majority of state property law statutes, it is necessary for a gift to have three elements: (1) donative intent, (2) delivery, and (3) acceptance.¹¹² While this is a factor in determining legal title to property, it is irrelevant to determining if a gift is taxable under federal tax law.¹¹³ Additionally, under federal tax law, donative intent is not required, “nor is actual delivery.”¹¹⁴ Delivery may be important, however, in determining when a gift is considered complete.¹¹⁵

The federal gift tax is “a tax on a transferor (the donor), for a transfer of property (real, personal, tangible, or intangible), to another (the donee), for less than full and adequate consideration in money or money’s worth”¹¹⁶ The value of a gift is its fair market value at the time of the complete transfer of property to the donee.¹¹⁷ The fair market value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.¹¹⁸ Where property is transferred for less than an adequate and full consideration in money or money’s worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.¹¹⁹

To be recognized as a gift, a transfer must be complete and irrevocable for federal gift tax purposes.¹²⁰ A transfer to a donee can be by trust or outright, direct or indirect, and of any

interest in property, tangible or intangible.¹²¹ The “means or device” to accomplish a transfer are irrelevant.¹²² A transfer is complete and thus recognized as a completed gift when the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another.¹²³ But if the donor reserves any power over its disposition, the gift may be wholly or partially incomplete.¹²⁴ As such, if the donor’s control does not terminate until death, it is no longer considered a lifetime transfer and will remain in the donor’s estate.¹²⁵

The issue of dominion and control, essential to the determination of a complete gift, is governed by state law.¹²⁶ In the case of tangible property, the relinquishment of dominion and control is usually satisfied by the physical act of delivery to the donee.¹²⁷ When an asset like an NFT is intangible, and it is impossible to be manually delivered, delivery can be “constructive or symbolic.”¹²⁸ Delivery is constructive “if the donor gives the donee the means of obtaining possession or control of the subject of the gift, for example by giving the donee the key to the place where the property is located.”¹²⁹ On the other hand, symbolic delivery is “one in which the donor gives the donee an object or item that symbolizes the subject of the gift,” like delivering the “instrument evidencing the claim that constitutes the intangible personal property.”¹³⁰ This can include instruments such as those that evidence intangible assets such as “bonds, shares of stock, insurance policies, and bank passbooks.”¹³¹ Finally, “if the instrument provides that a transfer of the claim can be made only in a specified manner, the preferred method of making a gift of such property is to follow the specified procedure.”¹³²

To address the issue of whether there has been constructive or symbolic delivery of an NFT sufficient to satisfy the requirement of relinquishment of dominion and control, it is best to split the analysis between the two most common NFT storage methods: (1) a cold wallet and (2)

a hot wallet. In a cold wallet, the NFT and private key are stored offline on a physical device, which is generally a USB stick or smart card.¹³³ The easiest method to transfer an NFT to a donee would be to transfer the NFT to the donor's hot wallet and from there irrevocably transfer it to the donee's hot wallet. If instead, the donor delivers physical possession of the USB stick cold wallet, the analysis is less straightforward. Effectively, without the USB stick that holds your cold wallet, you are unable to access the NFT held on it. Similarly, without the private key, an owner is unable to perform any transactions involving the NFT. Accordingly, the USB stick is analogous to a key a donor gives to a donee as the means of obtaining possession of the place where the property is located. With that, it is best to apply the principles of constructive delivery to an NFT cold wallet.

In numerous cases, delivery of keys as a form of constructive delivery has been held to be sufficient delivery of the contents the keys unlock. In *Clark*, it was held to be sufficient delivery when the donor instructed the donee to find a house key, enter the house, and take possession of certain documents.¹³⁴ In *Bynum*, the delivery of a lock box and the keys to a donee was found to be sufficient delivery of the contents of the lock box.¹³⁵ In *Newman*, any article of furniture, and the contents within, that could be locked or unlocked by any of the keys given to the donee was found to be valid constructive delivery.¹³⁶ Since the means or device to accomplish a transfer are irrelevant, it appears that a donor delivering physical possession of a USB stick containing a cold wallet should be considered a valid constructive delivery to the donee. As such, the donor has so parted with dominion and control of the USB stick, and the contents within, as to leave in him no power to change its disposition.

In contrast, a hot wallet is a web-based or mobile application accessible via an internet connection.¹³⁷ Similar to a cold wallet, the easiest method to transfer an NFT to a donee would

be to irrevocably transfer the NFT from the donor's hot wallet to the donee's hot wallet. Another viable method would be to transfer from the donor's hot wallet to a donee's cold wallet on a physical USB stick or smart card. In both instances, the transfer is complete and irrevocable. It is less certain, however, if a donor were to instead provide the login credentials to the hot wallet. For a transfer to be complete, the donor must relinquish dominion and control to leave in him no power to change its disposition.¹³⁸ Providing a donee with the login credentials to a hot wallet is unlikely to meet this requirement. The gift must be irrevocable, and a donor still has within his power the ability to exercise control over the login credentials to alter its disposition, transfer the NFT to another wallet, or manage it however desired. In that case, the gift may be wholly or partially incomplete. Should the donor's control not terminate until death, it would not be considered a lifetime transfer and will remain in the donor's estate.¹³⁹

Finally, a U.S. taxpayer who makes a taxable gift must file a gift tax return for the year the gift was made.¹⁴⁰ The gift tax is only imposed on the donor of a completed gift.¹⁴¹ Gifts made during the calendar year to a donee are fully excluded under the annual exclusion if they are all gifts of present interest and they total less than the gift tax annual exclusion.¹⁴² A prudent estate planner should advise a donor to keep detailed records of any gifts to ensure they are adequately disclosed. To adequately disclose a gift, a taxpayer should provide the following:

- (1) A description of the transferred property and any consideration received by the donor.
- (2) The identity of, and relationship between, the donor and each donee.
- (3) If the property is transferred in trust, the trust's employer identification number (EIN) and a brief description of the terms of the trust
- (4) Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift.
- (5) If a position taken is contrary to a published regulation, including proposed and temporary regulations, or a published revenue ruling, disclosure of that fact.¹⁴³

Ultimately, NFTs present unique and uncertain challenges for federal gift tax purposes. The implications of the gift tax for NFTs underscore the importance of careful planning. By leveraging gift tax exclusions within the overall estate plan, taxpayers can effectively reduce a taxable estate. However, the issues of valuation uncertainty and the requirements for a completed gift necessitate a strategic approach. Estate planners must adapt their strategies to ensure compliance with the ever-evolving gift tax landscape of digital assets.

5. *Estate Tax Implications for NFTs.*

The estate tax implications of NFTs are fairly routine. The most significant issue concerning the federal estate tax and NFTs is the determination of value. Valuation of NFTs, specifically the challenges in determining an accurate fair market value, is addressed *supra*, Section III(A)(2). Beyond valuation, many of the NFT and estate planning issues that arise stem from drafting for NFTs or post-mortem estate administration involving NFTs. Drafting for NFTs or post-mortem estate administration involving NFTs, is addressed *infra*, Section III(B). For this analysis, the focus will be on the taxation of an NFT in an estate.

In general, the federal estate tax is a tax on property that a decedent transfers at death.¹⁴⁴ The gross estate includes all property, real or personal, tangible or intangible, wherever situated, that the decedent beneficially owned at death.¹⁴⁵ The property included in the gross estate can generally be broken into three categories: (1) “property that was directly owned by the decedent . . .”; (2) “property whose disposition was subject to the decedent’s control . . .,” i.e., a power of appointment; and (3) “property that the decedent transferred by gift, but that is nonetheless subject to the estate tax, because the decedent did not give up complete control or ownership of the property at the time of transfer.”¹⁴⁶ In the majority of instances involving a retained interest at death, concerning NFTs and the estate tax, either categories (1) or (3) apply.

Under the first category, the decedent's gross estate includes all property in which the decedent had a beneficial interest at death.¹⁴⁷ This includes tangible interests like real estate, automobiles, jewelry, and artwork, and intangible interests like business interests, brokerage accounts, and bank accounts. Accordingly, an NFT owned by a decedent at death would be includable in the gross estate.

Under the third category, what is includable in the gross estate is more complex. These provisions of the Code are commonly referred to as string provisions as "they have the effect of pulling the property back into the estate"¹⁴⁸ String provisions apply to the following transfers of property by gift where the donor has retained one of the following interests: (1) transfers with a retained life estate;¹⁴⁹ (2) transfers taking effect at death;¹⁵⁰ or (3) transfers with a retained right to alter, amend, revoke, or terminate the transfer.¹⁵¹ Moreover, the gross estate includes the value of any of these string provision retained interests transferred within three years of death.¹⁵² Likewise, in the case a gift is deemed to be wholly or partially incomplete and the donor's control does not terminate until death, it would not be considered a lifetime transfer and will remain in the donor's estate.¹⁵³ The issue of a completed gift of an NFT is addressed *supra*, Section III(A)(4). To avoid the inclusion of an NFT in the gross estate, an estate planner must be aware of the restrictions imposed by sections 2035 to 2038 and Treasury Regulation section 25-2511-2.

If property is deemed to be includable in the gross estate, the value of the asset for estate tax purposes is its fair market value.¹⁵⁴ Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.¹⁵⁵ Property is valued on the date of the decedent's death.¹⁵⁶ However, given the high volatility of

NFTs, a substantial decline in the value of a decedent's NFT holdings between the date of death and the alternate valuation date may make for a good candidate for an alternate valuation election. Generally, a decedent's representative may irrevocably elect to value all property still in an estate six months after the decedent's date of death if doing so will reduce the value of the gross estate and the amount of estate tax payable.¹⁵⁷ While the lesser tax payable is likely disproportionate to the value of the actual estate that remains to be distributed, it is not always practical for a fiduciary to immediately after death convert an NFT to cash. Therefore, an estate planner handling an estate with significant NFT holdings should be mindful of this strategy.

Finally, an estate planner should be conscious of income tax basis issues with volatile NFTs.¹⁵⁸ Generally, the beneficiary of an NFT passed from a decedent will take with a stepped-up tax basis equal to the fair market value at the time of death, or in the case of a section 2032 election, the alternate valuation.¹⁵⁹ In contrast, the donee of a lifetime gift generally takes the carryover basis, i.e., the same basis that the donor had.¹⁶⁰ For an individual with NFT holdings that have substantially appreciated, the stepped-up basis may save the decedent's recipient significant income taxes when eventually sold.¹⁶¹ However, if an individual anticipates a taxable estate, it still may be more advantageous to shift the appreciation to the donee via a lifetime gift. Consequently, estate planners must weigh the potential income and estate tax consequences.

In brief, the estate tax implications of NFTs demand careful consideration and planning. Valuing NFTs poses a unique challenge, and opting for an alternate valuation election can be a useful strategy. Understanding the complexities surrounding the inclusion of digital assets in the gross estate is vital for estate planners. Moreover, the considerations related to income tax basis further complicate the analysis. It is crucial for estate planners to navigate these complexities effectively when dealing with estate plans that involve substantial digital assets.

B. Common Estate Planning Issues with NFTs.

The following section will briefly explore some of the common obstacles an estate planner may face when drafting for NFTs, as well as potential post-mortem estate administration considerations.

1. *Identification and Drafting for NFTs.*

Planning for NFTs, and digital assets in general, is crucial to ensure fiduciaries can locate, access, and secure the asset after the owner's death. In a sense, maintaining an inventory of NFTs is like maintaining an inventory of an individual's tangible property. However, certain characteristics make identifying NFTs unique and more difficult. Likewise, drafting and updating estate planning documents to legally give fiduciaries access and ensure proper disposition of digital assets poses additional challenges.

What questions should an estate planner ask the client to identify all NFTs owned? To identify all NFTs and digital assets necessary for effective planning, an estate planner should ask the client the following initial questions to supplement their standard client intake questionnaire:

(1) Do you own any digital assets like cryptocurrency, NFTs, Bitcoin, or blockchain-related assets? If so, please list the various digital assets you own.

(2) Please list every platform, exchange, wallet, or physical device where your digital assets may be stored on.

(3) How are you currently preserving your private keys, usernames, passwords, secret questions, and physical storage devices?¹⁶²

What documentation and records of NFTs should be maintained in an estate plan? For a variety of reasons, an estate planner should be aware that individuals may be hesitant to reveal all aspects of their digital lives in one place.¹⁶³ If an individual prefers not to directly provide

sensitive login details, it may be suggested that they instead create instructions for how a fiduciary can access the login credentials.¹⁶⁴ For example, they may instruct how to access a safe deposit box containing all relevant login information. Regardless, for an estate planner to have the option to utilize all available estate planning strategies in their repertoire, a client should be informed of the importance of providing and maintaining a thorough digital inventory. Of equal importance is the need to keep the estate planner apprised of: (1) any subsequent login credential updates; (2) any new digital asset purchases; (3) any plans to acquire new digital assets; (4) any new accounts or wallets created; (5) any changes to where a physical storage device is stored; and (6) any transactions involving previously identified assets.¹⁶⁵ Of course, it is also critical to document what the client would like to happen to each digital asset in the event of their death or disability. Finally, for income, gift, and estate tax planning purposes, meticulous records of the purchase date of each digital asset and the purchase amount should be provided.

What is RUFADAA, and how does it affect the estate planning process? In general, the decedent's state of domicile has jurisdiction over persons and property, including intangible personal property like digital assets, within the state.¹⁶⁶ With that, nearly all states have enacted the Revised Uniform Fiduciary Access to Digital Assets Act ("RUFADAA") which is model legislation that outlines a fiduciary's authority to legally manage, control, and access digital assets.¹⁶⁷ In RUFADAA, emphasis is placed on "whether the deceased or incapacitated user expressly consented to the disclosure of the content of the digital assets."¹⁶⁸ Accordingly, the estate planner should be aware of the act and consider evidencing this intent in a client's estate planning documents. By including key RUFADAA provisions in a "broadly drafted power of attorney" as well as in a client's will and trust, a fiduciary will have the necessary powers over a client's digital assets to manage in accordance with the decedent's wishes.¹⁶⁹

Can NFTs be held in trust, and if so, what provisions should be included? Yes, NFTs and digital assets may be held in trust. It is important to note that a will admitted to probate is a public record so an estate planner should be careful to avoid including any key digital asset access information in a will.¹⁷⁰ As such, it may be desirable to place NFTs, digital assets, and pertinent account information in trust. Beyond the distribution provisions detailing how assets are to be distributed, as mentioned, provisions referencing the RUFADAA should also be included to allow for the trustee's lawful access. Moreover, while many assets give an owner the option to use a payable-on-death or transfer-on-death mechanism, in the emerging digital asset space, it is unlikely to be something an estate planner can expect.¹⁷¹

2. *Estate Administration with NFTs.*

When it comes to post-mortem estate administration, NFTs in an estate can present unique challenges for estate planners and fiduciaries. Even with an effective estate plan that incorporates NFTs, the ensuing access, control, and disposition of assets in accordance with estate plan documents can leave a fiduciary with a great deal of uncertainty. With a lack of clear guidelines, and the inherent complexities of NFTs, administration of digital assets can appear to be a daunting task.

Could someone reject their appointment as a fiduciary due to the complexities of managing NFTs and digital assets? The presence of NFTs in an estate can create a significant burden on a fiduciary, who is tasked with accessing, managing, and disposing of digital assets. Due to the intricate nature of NFTs and digital assets, there is a significant possibility that someone appointed as a fiduciary may reject their appointment if a decedent has substantial digital assets.¹⁷² To minimize such possibility, an estate planner may consider suggesting or requiring a fiduciary to hire a digital asset manager with the necessary expertise in NFTs and

digital assets.¹⁷³ Alternatively, it may be advisable to appoint a separate digital fiduciary dedicated solely to handling NFTs and digital assets in the estate.¹⁷⁴ In either case, this can help to ensure that NFTs and digital assets are properly managed and disposed of while also decreasing the possibility of a fiduciary rejecting their appointment.

How does the prudent investor rule apply to NFTs? Investing in NFTs is especially risky due to their speculative nature and volatile valuations. A trustee may be concerned about the risk associated with NFTs and their proper post-mortem management. The duty of prudence is a fundamental principle of trust fiduciary law, which imposes on a trustee an objective standard of care in which a trustee must administer the trust as a prudent person would.¹⁷⁵ Under the Uniform Prudent Investor Act, which is widely adopted in some variations in all states, the rules generally provide that a trustee has a duty to invest and manage property as a prudent investor would by considering all the circumstances of the trust.¹⁷⁶ With that, investment decisions made by a trustee are “in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.”¹⁷⁷ Thus, under the prudent investor rule, NFTs are likely to be considered too risky.¹⁷⁸ Without express authorization by a settlor in the trust instrument to retain, authorization from the beneficiaries to retain, or a general or specific gift of identifiable NFTs, a trustee may be obligated to sell the NFTs and reinvest the proceeds.¹⁷⁹

IV. CONCLUSION

The emergence of NFTs as a new class of digital assets presents unique challenges and uncertainties for estate planners, fiduciaries, and tax authorities alike. The tax treatment of NFTs is complex, ambiguous, and evolving, particularly concerning valuation and gifting strategies.

Moreover, proper drafting and administration of an estate with NFTs require a deep understanding of their intricacies. Despite the challenges associated with NFTs, the technology offers an interesting opportunity for collectors, investors, and digital creators. As the technology matures, it should be expected that new applications will inevitably arise.

Looking ahead, it is clear that estate planners must be familiar with NFTs and digital assets, as well as have a basic understanding of the underlying technology. As the world becomes increasingly digitized, NFTs and digital assets will become even more prevalent in estate planning. An estate planner, if they have not already, will certainly have clients who have a substantial part of their wealth tied to digital assets. Therefore, estate planners must remain informed of developments in this rapidly evolving asset class. By taking a proactive and informed approach to NFTs, estate planners can help their clients navigate this challenging digital landscape.

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