NFTs, Cryptocurrencies and Crypto Assets Explained

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Exploring crypto assets is akin to visiting the Land of Oz. Outwardly, both seem dazzling, foreign and off-color. However, by removing the technological blinders, equivalent to the emerald glasses worn by the citizens of the Emerald City, attorneys will likely understand that they know all they need to integrate crypto assets into their practice.

There are no statutes, rules or regulations requiring unique treatment for crypto assets. For tax purposes they are treated like property, even if the crypto assets are called cryptocurrency and named Bitcoin (see IRS Notice 2014-21). When appraised, crypto assets are valued at fair market value, traditional contract, tort, property laws, as well as the rules of intestate succession law (common law, community property, or elective community property as normally applied) are applicable to crypto assets.

Since crypto assets may be incorporated into and controlled by legal trusts, they are easily found, subject to valuation, and transferable. In sum, while crypto assets differ from traditional assets in one significant way, they may be treated by attorneys as the same.

All crypto assets are “trustless” assets and thus significantly different from all traditional assets which are “trust” assets. Traditional assets—such as real estate, bank accounts, stocks, personal property and their ownership—may be determined by government (county recorder office), business (bank) or people (court jury). Crypto assets—such as blockchain tokens, crypto payments, and smart contracts and their ownership—cannot be independently determined by third parties.

“Trustless” means no third party (government, business, or person) operates between crypto asset owners. Crypto asset transfers occur with governmental recordings, business records or agreements which might reviewed by a court. In short, crypto assets do not need to “know” or “trust” each other or a third party for the system to function.

Crypto assets require trustless systems and are implemented via computers; they use technology, not third parties, to settle

transactions. More specifically, crypto assets use “distributed ledger technology” (widely distributed information and confirmed validity via math anomalies—prime numbers and statistically significant distributed data is the same) rather than verifiable writings (used by traditional assets). Most crypto assets use blockchain protocol, which is simply a set of computer instructions which blockchain users all agree to use.

These protocols may be combined with additional software to enable ease of use. Some additional software is smart contracts, which are programs run under predetermined conditions. Smart contracts are best thought of as the digital equivalent of traditional vending machines. Both have a single start input (a pull of a lever or button push for a vending machine and an electronic signal—payment made communication—for a smart contract). Both have a single output (the release of a product from the vending machine) and an electronic signal (change distributed ledger communication for the smart contract). Like vending machines, when a smart contract is combined with blockchain protocols, the result (asset transfer) is “self-enforcing” (executed without additional input from trusted third parties).

Two types of crypto assets are widely available, namely, cryptocurrency and tokens. In broad terms, a digital asset is a non-tangible asset that is created, traded, and stored in a digital format. Using this definition, in the context of blockchains, digital assets include cryptocurrency and crypto tokens.

The blockchain terms “token” and “cryptocurrency” are often used interchangeably, as these are both digital assets on blockchains. Both are decentralized, both are a medium of exchange, both use cryptograph signatures (i.e., a digital signature that is a cryptographic value which is calculated from the data and a secret key known only by the signer). However, cryptocurrency uses standard logic (built into blockchain), and tokens use smart contract custom logic (added into blockchain).

As an aside, note that cryptocurrency is an encrypted data string that denotes a unit of currency. It is monitored and organized by a peer-to-peer network called a blockchain, which also serves as a secure ledger of transactions, e.g., buying, selling, and transferring. Recent examples of cryptocurrency include Bitcoin (BTC) Price: $29,440.40; Ethereum (ETH) Price: $2,004.38; Tether (USDT) Price: $1.00. Remember, cryptocurrency is not currency (see IRS Notice 2014-21)—treat it as stocks or gold.

Tokens may be either fungible or non-fungible and associated with either tangible or intangible assets. A security token is a portable device that authenticates a person’s identity electronically by storing some sort of personal information. The owner plugs the security token into a system to grant access to a network service. Security Token Services (STS) issue security tokens that authenticate the person’s identity.

A digital token works in the same way. It represents a specific amount of digital resources you can own, assign to another, or redeem later. Digital tokens are either created by software (Bitcoin) or associated with an asset (a digital copy of a photo).

Fungible tokens are interchangeable. Thus, a fungible token owner is indifferent owning Bitcoin A or B, just as a person is indifferent to owning either of two common dollar bills.

Non-fungible tokens are not interchangeable. Non-fungible tokens represent an ownership, or partial ownership, of a unique asset. Thus, a non-fungible token owner would not be indifferent to exchanging one non-fungible token for another, just as an owner of an original Rembrandt oil painting would not be indifferent to exchanging said painting for a photo of an unsigned water color painting.

Some non-fungible assets are stored on the blockchain like a digital photo. Some non-fungible assets are rights to a physical asset held by another like a tungsten cube. For example, Midwest Tungsten, a supplier of metal for industrial uses, recently paired a blockchain with a 14.545-inch, 2,000-pound cube of tungsten to produce a non-fungible token (NFT).

Assets that are digitally transferrable between two parties via blockchain are commonly referred to as “tokens.” An NFT is a crypto asset or “token” that represents or points to a physical or digital asset such as art, videos, land or, in this case, a cube of

tungsten. NFT for tangible assets give rise to a range of legal liability issues including those related to asset storage, transfer, visitation rights (in the case of tangible NFTs), privacy rights, as well as related costs.

For collectors, a non-fungible token is a digital representation of a collectible, in a tangible or intangible form, that entails uniqueness or digital scarcity. An example of a tangible NFT collectible would be a token that represents ownership, or partial ownership, of a baseball card.

The main difference between fungible assets and non-fungible assets resides in the content they store. While fungible tokens like Bitcoin store value, non-fungible tokens store data like an academic title or an artwork.

While attorneys will likely understand that they know all they need to integrate crypto assets into their practice, some practical advice may still be useful. Since crypto assets are transferred as a result of a computer transaction between owners (where the identities of each are not required), attorneys should advise their clients to take this lack of information into account.

While traditional assets transferred via documents with the help trusted third parties (banks, courts, etc.) where the identity of each is required, this is not the case for crypto assets. The crypto asset holder may be sufficiently savvy to access and manage the ever-changing value of their virtual assets, others including their beneficiaries (and related estate professionals) may not be. Thus, for tax, probate, exchange and contract purposes, an attorney should advise the client to keep records of crypto asset exchange records including identity of crypto asset, transaction date, assets / money exchanged, location of token and access procedure.

At a minimum, estate professionals should encourage cryptocurrency holders to keep a dynamic written record of what cryptocurrency they own, where it is located, what they paid for it, from whom they acquired it, and, if they sold their cryptocurrency, the amount it was sold for. Most importantly, estate professionals should encourage cryptocurrency holders to record the private digital key needed to access it.

This recommendation is particularly true of timely interaction between a cryptocurrency holder and an estate professional. Failure risks losing everything for their heirs due to a number of circumstances. Hence, the estate professional must make specific inquiries as to cryptocurrency holdings and prepare cryptocurrency clauses.

The next practical advice is for attorneys to treat crypto assets as traditional assets. The specific inquiries as to cryptocurrency holdings must address the fact that crypto-currency is treated as property rather than currency for tax purposes.

Just like traditional financial assets, the Internal Revenue Service has found that crypto-currency is subject to tax. Specifically, Notice 2014-21 describes how existing general tax principles apply to transactions using virtual currency.

Another suggestion is for attorneys to use trusts for the transfer of crypto assets. One supplemental action might be for an attorney to recommend to a crypto-asset holding client is the use of a business service that allows a third party to transfer cryptocurrency to an entity other than the cryptocurrency holder upon the demise of the cryptocurrency holder. Such a transfer service could avoid an unwanted legal duty for an executor or trustee to diversify out of cryptocurrency. It will relieve them of the need to be cryptocurrency savvy, along with the attending liabilities.

Yet another practical recommendation is that attorneys should apply contract and tort law rather than property law to properly adjudicate crypto assets.

While the word “asset” within the term “crypto asset” may sound like property, the lack of writings and third-party help forces the law to rely on agreements (contract law) and acts (tort law).

Unlike property law, wherein courts rely on trusted third-party information, courts applying contract or tort law need only secure

information from the parties directly involved, and do not need property systems to apprise them of the terms of their own deal. Courts can adjudicate disputes by applying contract rules, designed to foster bilateral information disclosure, or tort laws, which regulate bilateral duties of care. Thus, it is recommended that attorneys consider applying contract and tort law (not property law) to resolve crypto-asset legal difficulties.

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