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Generations Winter 2022 - Estate and Gift Tax Planning Strategies for NFTs

With nonfungible tokens (NFTs) becoming more and more prevalent and an eye-popping amount of money changing hands in NFT sales, it is important that people who create or own NFTs understand how to protect and preserve their NFT assets. NFTs transform a digital file, such as an NBA highlight, a digital work of art or another digital collectible, into a verifiable asset (often referred to as "tokenizing"), the ownership of which becomes a discrete thing that can be bought, sold and traded using blockchain technology. The "nonfungible" nature of a token means it cannot easily be interchanged with another token. Because each token is unique, assigning a standard value to a token is nearly impossible due to the lack of comparable products and sales. Boiled down to their essence, NFTs aim to replicate the properties of scarcity, uniqueness and ownership more commonly associated with physical items, such as artwork, but in new and evolving forms.

Some commentators predict that NFTs are the next step for artists seeking to monetize unique mediums or for musicians aiming to increase profits in the era of streaming. Some have suggested that titles to houses, contracts and perhaps even estate planning documents will eventually be tracked via blockchain technology.

Many of the recent newsworthy NFT sales may have been outliers, and it is possible that the value of NFTs has started to descend from its peak earlier this year. Nonetheless, there are still multimillion-dollar sales being reported monthly. Although the market will probably level out at some point, the underlying concept seems to have lasting appeal.

Estate Planning Implications

Many people who own NFTs or advise people who own NFTs may be wondering how NFTs will impact their planning and their advice. Many professionals asked the same question years ago when cryptocurrency was new and untested, but now there are many people holding blockchain-based currencies in their portfolios. As a first step, client intake questionnaires and asset summaries should include a reference to NFTs. Identifying emerging asset classes in a portfolio could trigger an important discussion with implications for tax planning, re-titling and allocations to specific beneficiaries.

Planning With NFTs

In many cases, holding an NFT in a limited liability company (LLC) may be ideal. An LLC can provide for the efficient management of the entity's underlying NFT. The owner can transfer the NFT to the LLC and, subject to certain limitations if estate tax planning is an objective, retain control over the sale and management of the NFT by serving as manager of the LLC. The current owner can also name a successor manager who can take over when the current owner is no longer willing or able to serve.

An LLC can also facilitate transferring ownership of interests in the NFT. As the members (the owners of the LLC interests) wish to sell, gift or transfer interests in the NFT, they will be able to do so by simply transferring membership interests in the LLC, rather than having to go back to the blockchain for each transfer. Moreover, because the NFT will be owned by the LLC rather than the members individually, economic interests in the underlying assets can be transferred (via the transfer of membership interests in the LLC) without also transferring control of the token. This allows for the centralized management of the NFT even if the economic interests are spread across many parties.

An LLC can also provide a mechanism for minimizing transfer taxes by taking into account discounts for minority interests, the lack of marketability associated with a transferred membership interest, and the volatile nature of these assets. It is conceivable that the growth potential of NFTs could make them ideal assets for gifting strategies as part of a well-rounded estate plan.

Finally, an LLC can also be used for asset protection purposes. In most cases, LLCs are used to protect the members' personal assets from liabilities related to the LLC—and that can certainly apply in the NFT context. For liability purposes, an LLC is treated as a limited liability entity—liabilities of the LLC are limited to the assets of the LLC—and the personal assets of the members won't be implicated in the LLC's liabilities (absent fraud). In some cases, however, the NFT may represent a very valuable asset of the members. In such a case, a properly structured LLC in an asset-protection-friendly jurisdiction can protect the NFT from the reach of the members' personal creditors.

Updating Estate Plan Documents

Regardless of whether the NFT is held in an LLC, the language regulating digital assets in wills, trusts and durable powers of attorney should be drafted to be as broad as possible, with the goal of encompassing NFTs and other emerging technologies. It is advisable to incorporate a reference to the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA) into estate planning documents in states that have enacted RUFADAA or a similar state statute.

Care should be exercised in selecting fiduciaries who are knowledgeable with respect to NFTs and who are capable of managing such assets. It may be worthwhile to name a separate "digital fiduciary" who is tasked only with handling digital assets. Clients might also consider directing their fiduciaries to seek the advice of a tech-savvy trusted advisor to help the fiduciaries handle and manage valuable digital properties.

Consideration should also be given to specifically authorizing trustees to retain NFTs as part of the trust, despite the fact that many states have enacted prudent investor rules. Such rules generally require that fiduciaries invest as a "reasonable, prudent person would" after considering the purposes, terms, distribution requirements and other circumstances of the trust and to diversify trust investments to mitigate risk. In the absence of specific authorization to retain an NFT, a trustee may be obligated to sell the token and reinvest the proceeds, particularly in circumstances where the NFT represents a substantial portion of the members' wealth.

Access and Security

The decentralized nature of blockchain technology poses some unique issues with respect to access and control of NFTs. It is absolutely crucial that owners create a system for tracking and locating the personal keys and passwords necessary for accessing these digital assets, both for security during the owners' lifetimes and so that those administering estates and trusts can locate and secure digital assets after the owner's death.

Hacking is also a very real security threat for this type of asset. Although blockchain technology records are very secure, if a hacker is able to access the holdings in a wallet through compromised login credentials, the hacker can then sell or transfer the underlying asset. This sale would be recorded on the blockchain irreversibly. Attorneys can certainly envision how undue influence could be a contributing factor to accessing or hacking an account with a valuable digital asset.

Conclusion

Given the recent popularity of NFTs and their seemingly endless permutations, many of us can expect to be interacting with NFTs in one capacity or another for years to come. Advisors would best serve their clients by understanding this emerging asset class and the planning opportunities that may accompany NFT ownership.

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