



PERSPECTIVES

**Crypto After the Crash:
Strategies for Resolving
Valuation and Tax Issues
in Matrimonial and Other
Litigation**



Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

The cryptocurrency market was down approximately 64% for the year 2022, with most of the decline occurring before the FTX collapse. For many, this news may bring a feeling of JOMO (Joy of Missing Out). For practitioners involved with cases involving crypto, however, it just further complicates an already complex subject matter.

This article explores the considerations and strategies to help resolve matrimonial and similar disputes involving financial forensics, asset divisions, income, taxes, and other topics. Each of these are discussed below.

Financial Forensics: Finding Historical Cryptocurrency Data

Finding crypto data is just the beginning, and often involves a separate forensic engagement with qualified analysts to help identify transactions and remaining holdings. While the particulars of these investigations are beyond the scope of this article, the discovery process has improved through a combination of commercially available blockchain analytics tools,¹ tax disclosures,² improved data from centralized exchanges and DeFi protocols, as well as widespread acceptance.³ Regardless, the tracing of these transactions may be expensive and ultimately unnecessary if the funds cannot be seized at the end of the day. That said, there are ways to mitigate the costs via indirect income approaches⁴, detailed document production, additional interrogatories, scope / timeline limitations, etc. This process may also uncover potential tax liabilities from prior transactions and add to the complexity of the case (see further discussion below).

Often, forensic accountants will use the transaction data obtained to prepare balance sheets, income statements, and “statements of crypto flows.”⁵ These reports will help clients understand the flow of funds and remaining balance(s) in the wallets, accounts receiving the funds, who controlled the assets, and more. Once prepared, the reports can then be used in conjunction with the other assets and liabilities in the case to facilitate a property settlement, assess the costs / risks of transferring the crypto assets,⁶ and understand any recurring income (such as staking rewards or interest on crypto deposits). The state and federal jurisdictional rules can help practitioners navigate the division of assets or reimbursement claims.

There are ongoing changes within the crypto space which may further improve transparency. Examples include crypto 401(k)s and social media accounts connecting to crypto wallets.⁷ The Infrastructure Investment and Jobs Act (“IIJA”) also expanded the reporting requirements for “brokers” to report Form 1099-B filings for transfers of digital assets and Form 8300 for crypto payments over \$10,000.⁸ Expect live-like testing of these requirements prior to the effective date of enforcement.⁹

Digital Asset Division Strategies: Cryptocurrency Valuation Explained

After the digital, forensic discovery, the next step in the analysis is to determine the value of the virtual assets. This process is straightforward if the assets are listed on an exchange though an independent valuation may be required if the assets are unlisted or disposed. In addition to currencies, virtual assets may also take the form of a blockchain token, such as Nonfungible Tokens (“NFTs”). NFTs may represent ownership in a unique digital item and

¹ For examples, such tools are provided by Chainalysis, Elliptic, CipherTrace, TRM Labs, Merkle Science, Lukka, just to name a few.

² Beginning with the 2020 Form 1040, the virtual currency question has appeared on the first page of the return. The 2022 Draft Form 1040 updates the language to: “At any time during 2022, did you: (a) receive crypto as a reward, award, or compensation; or (b) sell, exchange, gift, or otherwise dispose of a digital asset?” See: <https://www.irs.gov/pub/irs-dft/f1040--dft.pdf>

³ Half of men between the ages of 18 and 49 said they have dabbled in crypto. One in five Americans have invested in, traded, or used cryptocurrency. Source: Thomas Franck, NBC News poll, March 31, 2022.

⁴ Such as Internal Revenue Service Formal Indirect Methods, Examination of Income §4.10.4.2.9 (08-09-2011), IRS Website: https://www.irs.gov/irm/part4/irm_04-010-004#:~:text=The%20indirect%20method%20involves%20the,logical%20conclusion%20can%20be%20reached

⁵ A phrase coined by Dorothy Haraminac, Partner, GreenVetsLLC. This is like a statement of cash flows but there is no cash on it; instead, it summarizes movement of cryptocurrency.

⁶ Cryptocurrency exchanges charge a fee for transactions. For example, Coinbase charges a flat 1% fee. In addition, the U.S. Government can impose crypto sanctions so the risks of transferring virtual assets should be considered. For example, in August 2022, the U.S. Department of the Treasury’s Office of Foreign Assets Control (OFAC) sanctioned Tornado Cash in a \$7 billion money laundering scheme. Exchanges based in the United States may freeze accounts linked to sanctioned addresses. See <https://home.treasury.gov/news/press-releases/jy0916>.

⁷ Hayward, Andrew and Farren, Tom, *Facebook, Instagram Users in US Can Now Share Ethereum, Flow and Polygon NFTs*, Decrypt, September 29, 2022.

⁸ See Section 80603 of the IIJA which amends IRC §6045(c)(1) and §6050I(d). The IIJA becomes effective for returns filed after December 31, 2023. There is also an Anti-Money Laundering related Financial Action Task Force (“FATF”), as well as jurisdiction-specific transaction reporting rules for virtual asset service providers that increase transparency.

⁹ This is also referred to as a Crypto Regulatory Sandbox. See <https://cryptonews.net/glossary/crypto-regulatory-sandbox/>

have become popular Web3 investment vehicles, with an estimated market of \$46 billion in 2022.¹⁰

Both cryptocurrency and NFT values are reported on major exchanges, though precision is required to accurately measure the value due to the continuous trading of the assets.¹¹ Note that the asset division should include any offshoots from the main currency that resulted from a “fork” in the blockchain that may not be initially disclosed. For example, clients may have received Bitcoin Cash, Bitcoin SV, or Ethereum Classic without an identifiable external funding source.¹²

For crypto that has been transferred or sold, the court may face various dates from which to ascribe disputed asset values (time of transfer, conversion, separation date, trial, etc.). The selection of the measurement date and corresponding value may depend on the facts and circumstances of the case. The party who initiated the transaction may bear the burden to provide documentation to support their position for how the

funds were used. This dilemma is compounded during times of uncertainty and illustrated in the following example.

Example 1

Prior to the pandemic, Party A purchased 10 bitcoins at \$10,000 each. In January 2021, the entire balance was transferred to an unknown account when the price was \$35,000. Party B moves out and files for divorce in October 2021 when bitcoin was \$50,000. The trial took place in October 2022 when the price was \$20,000. Which is the correct value to use for this disputed transaction for the property division (excluding tax considerations)? Party B may advocate for the higher value at the separation date, although the reduced value at the trial date complicates the issue. This illustration is shown on the following bitcoin price chart:



¹⁰ Businesswire, December 1, 2022, <https://www.businesswire.com/news/home/20221201005627/en/Global-NFT-Non-Fungible-Token-Market-Intelligence-Report-2022-Market-Is-Expected-to-Grow-by-51-to-Reach-US46157.4-Million-by-the-End-of-2022---Forecasts-to-2028---ResearchAndMarkets.com>.

¹¹ Note that the crypto world runs on Coordinated Universal Time (UTC) so the exchange reports may need to be converted to your time zone.

¹² Hard forks are unique blockchains when they split off from the original cryptocurrency. From that point forward, the two currencies will trade under separate symbols, have their own transaction history, and develop unique values. See: Bennington, Ash, *Why a Bitcoin Fork is Not a ‘Stock Split’*, August 2, 2017, <https://www.coindesk.com/markets/2017/08/02/why-a-bitcoin-fork-is-not-a-stock-split/>.

The Parties in the above example may look to the date other financial accounts (bank, investment, credit cards, etc.) are divided to resolve the situation. Party A's actions — especially if there is intentional concealment — may be considered an advance to his / her portion of the marital estate, resulting in a disproportionate division of assets. If the actual transaction date is used, it may alleviate the need to address why Party B would have continued to participate in a high-risk investment despite significant price volatility.¹³

Income Considerations

Determining historical income from virtual assets can be as simple as looking at the tax returns. However, the crypto “tax gap” is estimated to be \$50 billion per year so a deeper investigation of the situation may be required.¹⁴ There are generally no dividends or interest payments from cryptocurrencies unless lent or borrowed; rather, the gains or losses are calculated when transacted.¹⁵

The due diligence process for assessing historical / future income may include an understanding of the following:

- The account holder's qualifications
- Unrealized capital gains
- Account addresses
- Transaction history
- Trading frequency
- Types of transaction activities (mining, NFTs, conversions, etc.)
- Assets received or receivable from hard forks
- Any recurring receivables, such as staking rewards or NFT royalties
- Type of payment (gambling winnings, payroll, services rendered, etc.)
- Any “airdropped” tokens¹⁶
- Development history of digital assets.

The practitioner can use these and other factors to assess the likelihood of recurring income from crypto-related activities. For example, a bitcoin miner would be expected to have recurring revenue compared to a long-term investor with a one-time capital gain. Even so, mining bitcoin offers diminishing returns going forward. There are roughly 2 million bitcoins left to be mined compared to the 19 million currently in existence.¹⁷ With fewer coins available to be mined and depressed prices in 2022, practitioners face increasing complexity with predicting income.¹⁸

If the parties have developed digital assets such as NFTs there may be a royalty component that affects the determination of future income. While estimating royalty income can be difficult, even for seasoned valuation analysts, the workaround may be to set up a mechanism whereby the parties periodically settle up if and when the digital asset generates income.¹⁹ There are other items affecting income if the parties are *Influencers* or receive funds from their YouTube or other social media accounts though this subject is beyond the scope of this article.

Taxes and Crypto

Virtual currencies and NFTs are taxed as personal property which may involve gains or losses. The IRS has issued some guidance on the taxation of digital currencies and is “actively addressing potential noncompliance.”²⁰ As indicated above, the personal income tax forms require disclosure about virtual currency activities which, along with the return's supporting schedules, can be used by practitioners to reconcile with the bank accounts, exchange activity reports, etc. In October, the Financial Accounting Standards Board (FASB) issued guidance that recommends companies report crypto assets and digital currencies at fair value.²¹

¹³ The historical price volatility for bitcoin approximated 70%-75% since 2014.

¹⁴ Vega, Nicholas, *The IRS may be missing out on \$50 billion a year in unpaid crypto taxes and a crackdown is underway*, CNBC Website, May 18, 2022.

¹⁵ More complex cryptocurrency investments may earn dividends or interest but are beyond the scope of this article. There are also staking rewards for Proof-of-Stake cryptos which may be significant, especially over longer periods of time. Gains from staking may far outweigh capital losses.

¹⁶ Airdrops involve blockchain-based projects and developers sending out free tokens to members of their communities as part of a broader marketing initiative. Sergeenkov, Andrey, *What is a Crypto Airdrop?* Coindesk.com Website: <https://www.coindesk.com/learn/what-is-a-crypto-airdrop/>

¹⁷ Tardi, Carla, *How Many Bitcoins Are There?*, Sofi Website, July 18, 2022: <https://www.sofi.com/learn/content/how-many-bitcoins-are-left/#:~:text=As%20of%20June%202022%2C%20there,19%20million%20currently%20in%20existence.>

¹⁸ Mining equipment may have an end-of-life resale value or may be converted to mine cryptocurrencies other than bitcoin. Note: lower block rewards are naturally associated with higher prices long-term.

²⁰ Internal Revenue Service Website: <https://www.irs.gov/newsroom/virtual-currency-irs-issues-additional-guidance-on-tax-treatment-and-reminds-taxpayers-of-reporting-obligations>. See also Notice 2014-21 and Revenue Ruling 2019-24 for hard forks. Note: minting NFTs is not a taxable event.

²¹ See Financial Accounting Standards Board (“FASB”) Tentative Board Decisions, October 12, 2022 Board Meeting, <https://fasb.org/Page/PageContent?pageId=/meetings/pastmeetings/10-12-22.html&bcpath=tff>.

Unlike U.S. dollars, using cryptocurrency triggers a gain or loss on most transactions due to the price fluctuations. These transactions are subject to taxes (either ordinary income for short-term holdings or capital gains for long-term). Any unreported activity would likely face interest and penalties. Since Bitcoin has been around since 2009, there may be significant tax-related liabilities depending on the volume of transactions in the case as the blockchain maintains a record of all the transactions that have ever occurred on the platform. If there is evidence to support unreported crypto-related activities, the case negotiations may shift to innocent spouse relief, quantifying / funding the tax liabilities and estimated penalties, amending tax returns, current year reporting, indemnification, etc.

Example 2

Using a similar fact pattern from Example 1, Party C received 10 bitcoins valued at \$35,000 each in January 2021 for payment on an invoice. Party C then converts the currency to Ethereum in October 2021 when the value of bitcoin was \$50,000 (total of \$500,000 transacted). The gain on the conversion was properly reported on the business return. In October 2022, the assets are scheduled to be divided with a business partner, Party D when the account value was \$200,000. How should the (\$300,000) loss (\$500k-\$200k) be considered in the division?

Assuming a combined federal and state long-term capital rates of 20%, the value of the settlement could potentially be increased by \$60,000 for the benefit of the unrealized loss deduction (\$300k X 20%). If the assets are not likely to be sold, this may be a negotiated point.

Other Practical Considerations

There are questions to be addressed in the court filings or final agreements. Practical questions to address include:

- Who owns the account / digital wallet?
- Where is the private key?
- What are the steps to ensure the private key is protected?
- How do you take custody of virtual assets?
- How much of the holdings, passwords, data, etc., should be disclosed in the agreements?
- Should the assets be converted to U.S. dollars?
- Is there any trading on margin?

- Are any digital assets secured / pledged as collateral for loans?

Sometimes the line between business and personal transactions can be blurred. For example, a recent case by the author involved a personally owned Coinbase account that was recorded in the business general ledger. Many of the issues identified above may also apply to business disputes though additional factors include:

- Should business holdings be discounted in a business valuation (DLOM, DLOC, etc.)?
- Does the business report gains / (losses) on appreciated/ (depreciated) virtual assets when distributed?
- Should the virtual assets be sold / converted at the business level or personally?
- Are wages paid to employees and independent contractors using virtual currency taxable?
- Does statutory interest apply to damages?

These and other questions should be addressed in the litigation proceedings or settlement negotiations. For readers who are unfamiliar with crypto, utilizing a receiver may be a logical choice to ensure the assets are protected. In addition, there may be other specialized consultants needed to successfully navigate the situation, including crypto forensic experts, tax specialists, and valuation analysts, among others.

CONCLUSION

Digital assets are fast-moving targets and the factors involved are nuanced. The strategies and considerations discussed above address the complexities of litigation in the age of Web3. Dividing digital assets is an important outcome for cases but needs to be put in context with the parties' income, taxes, financial forensics, risk preferences, and other factors. Practitioners should be prepared to analyze the data, quantify taxes both past and present, and communicate the risks of continued investigations with the benefits of settlement. Uncovering contingent tax liabilities likely means penalties, interest, and other fees will follow. Clients may face unfavorable outcomes for their positions absent compelling reasons and supporting documents, especially during times of uncertainty.

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