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What every divorce lawyer needs to know about cryptocurrency

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As the market capitalization of all cryptocurrency approaches $300 billion, it seems a primer on cryptocurrency for divorce practitioners is timely, if not overdue.

The basics

Digital currency, a form of currency that is available only in digital or electronic form, and not in physical form, can be used to buy goods and services from persons and companies who are willing to accept it. It can also be bought and sold like a stock for investment purposes.

The first currency, Bitcoin, was invented in 2009 to operate without a centralized institution such as a bank or the Federal Reserve. Instead, the underlying framework for Bitcoin is the blockchain: a peer-to-peer immutable distributed ledger to generate computational proof of the chronological order of the transactions.

The blockchain is essentially a single agreed-upon history of the order of transactions. It works much like when a buyer swipes a credit card at Starbucks and the transaction is approved after communication with the credit card company. Although an oversimplification, for our purposes here it is enough to know that both buyer and seller know the transaction is a good one when the blockchain substantiates it.

Cryptocurrency can be obtained in a few different ways. It can be "mined." These "miners" help work on the blockchain so that each transaction gets approved. Miners have to solve complex mathematical algorithms in order to do so and are rewarded with Bitcoins or other cryptocurrency for their efforts.

More commonly, however, people can buy cryptocurrency on exchanges. This can be as easy as opening an account at, say, Coinbase or Kraken, and buying cryptocurrency with a credit card.

Also critical for the divorce practitioner to know: Many of these exchanges have "know your customer" requirements requiring identity verification. Further, U.S.-based exchanges (such as Coinbase or Kraken) report certain transactions to the Internal Revenue Service. The company completes a 1099-K for customers receiving at least $20,000 in cash for sales of virtual currencies that are related to at least 200 separate transactions in a calendar year.

Some states have their own requirements. Massachusetts, for example, requires that institutions complete the 1099-K for Massachusetts customers with transactions of $600 or more in a calendar year.

The IRS treats cryptocurrency as property and not currency for purposes of taxation, and, as such, long-term and short-term capital gains rules apply as they would, for example, with shares of stock. When individuals use cryptocurrency to buy goods or services, those transactions, too, are treated as sales for tax purposes, so there may be taxes related to capital gains or losses that apply.

There are more furtive ways to acquire cryptocurrency as well. A person can buy anonymously through a source (often an individual) listed on a decentralized peer-to-peer network such as LocalBitcoins.com. In contrast to the exchanges like Coinbase, this modality permits transactions without identity verification.

Cryptocurrency can be purchased via credit card and bank wire but also for cash; in many cases, the buyer will meet the seller at an agreed upon physical location and the exchange will take place there.

In the context of a divorce, this can be very difficult to discover. Moreover, it should be noted that issuing subpoenas would be ineffective in most cases as the website would have no information on the transacting spouse. That is because these sites operate effectively as classified advertising; a prospective buyer typically responds directly to the seller's offer by email, text or cell and not within the website.

People can store their cryptocurrency, essentially long alphanumeric keys, in different places. A popular storage option is in a mobile wallet app on a cellphone such as Edge, Mycelium, Bither and Breadwallet. (Exchanges such as Coinbase have their own built-in wallets; Coinbase customers, therefore, would not necessarily need a separate wallet app.)

In addition to storing currency, users can send and receive it from these apps. Users can also store, send and receive cryptocurrency from a hardware

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digital wallet, a physical device made by companies such as Trezor and Ledger. These two options, connected to the internet, are popularly called "hot wallets" and can be vulnerable to hacking.

Users also have a "cold storage" option, which means storing the currency offline. That could be on a thumb drive, on a computer, or even on a piece of paper.

Cryptocurrency and divorce

With some of the basics behind us, let's consider how cryptocurrency relates to divorce.

First, it is property for purposes of equitable division. Second, in the rare event that spouses are paid in cryptocurrency for their labor, it would likely be treated as income for support purposes.

The discovery process is most vexing when it comes to cryptocurrency and divorce. Certainly, practitioners may inquire as to cryptocurrency in interrogatories, document requests and depositions. By examining bank or credit card statements, for example, the attorney might discover payments to cryptocurrency exchanges (e.g., Coinbase).

But in dealing with the cunning spouse, a more aggressive tack may be appropriate. Practically speaking, for the spouse who believes that the other spouse is hiding cryptocurrency, there may be no better discovery tool than an examination of that spouse's computer laptop and/or mobile phone.

Often, the first step is to send a "preservation letter" to the spouse's attorney reminding that spouse to preserve evidence on phones and computers. In the event that evidence is not preserved, the letter helps in establishing a claim for spoliation, an element of which is bad faith and a conscious disregard of the duty to preserve relevant evidence. If a court finds spoliation, it may preclude evidence or make an adverse inference should the matter go to trial.

Because there is the potential that relevant data is overwritten every time a person continues to use a computer or phone, the letter should remind the opponent to "image" (copy) his or her drives immediately so that there is a record of them at or about the point in time that the preservation letter was received.

Once a court orders that a party may examine the contents of a hard drive, several considerations come into play as a party is not going to simply hand over a hard drive to the other side.

Therefore, it is critical to work with a computer forensic expert to draft pleadings or enter into a stipulation by which a protocol can be established. The protocol must have search parameters such as keywords (e.g., "Bitcoin," "Mycelium") and a date range as well as a procedure to deal with privileged communications and irrelevant data.

Remember that although the world of cryptocurrency is cutting-edge, in terms of discovery the fundamental rules about breadth and scope (Rule 26(b)(1)) and the use of protective orders (Rule 26(c)) still apply.

A forensic examination may yield evidence of past or present use of wallet apps (e.g. Mycelium) or exchange apps (e.g. Coinbase). The very fortunate attorney may discover the long alphanumeric keys associated with the cryptocurrency. In that case, a forensic expert may be able to examine the blockchain, the public ledger, and trace the movement and amount of funds.

A word about dissipation is in order. Because the cryptocurrency market is especially volatile, some courts may regard cryptocurrency losses as dissipation of the marital estate. Practitioners, however, ought to be wary of that characterization and consider *Kittredge v. Kittredge*, 441 Mass 29 (2004).

In *Kittredge*, the husband had $400,000 in gambling losses and the Supreme Judicial Court affirmed the trial court's refusal to treat most of the losses as marital waste because, for the most part, the losses never affected the lifestyle of the parties.

As increasing numbers of people invest in cryptocurrency, divorce practitioners will likely see more and more such assets (or income) in their practices. Accordingly, they would do well to continue to keep current on technical and legal developments. MLW