# Step Los Angeles

**NFTs: Protection for digital artwork leads to tax and planning complexities**

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# Agenda

I. Introduction.
II. What are virtual currencies and NFTs?
III. Preview of Tax Guidance to Date.
IV. IRS Guidance on Virtual Currencies.
V. Tax Treatment Of NFTS
VI. Compliance and Reporting.
VII. Conclusion.



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# I. Introduction.



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# Introduction

- NFTs (non-fungible tokens) continue to make the news with high sales prices by collectors.
- NFTs are totally unique digital items, which cannot be subdivided. Semi fungible tokens are often included in this category but technically do not fall under the definition.
- Attaching an NFT to a digital representation of art or other digital asset allows for protection, identification and verification of that artwork.
- We have limited guidance as this innovation is a relatively new one.
- The recently passed infrastructure bill includes provisions specific to reporting and enforcement for those in the virtual currency ("VC") arena under the provision titled "Information Reporting for Brokers and Digital Assets."
- The IRS and other federal agencies continue to keep VC companies and investors on their toes, with spotty guidance and sometimes very strict enforcement. A bipartisan group of lawmakers is pushing for the development of a new tax law reporting framework for VC investments to strengthen the IRS and raise revenue.
- This overall VC industry has been in existence for over 10 years, when Bitcoin was released in January of 2009.
- FinCEN proposed rules in late 2020 which would require increased reporting in this area by banks and money service businesses.

# Areas Not Covered

- Securities law issues.
- Most regulatory issues.
- Anti-money laundering and know your client issues.
- Estate planning.
- Family law issues.
- We are aware that extensive other issues exist but due to time limitations will be focused on the tax aspects of NFTs.



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# II. What are Virtual Currencies and Nonfungible Tokens?



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# Definitions – Let's Start With the Basics

- A VC is a digital representation of value that functions as a medium of exchange, a unit of account and/or a store of value but does not have legal tender status in any jurisdiction. VCs are sometimes referred to as CVCs, or convertible virtual currencies, when they are convertible into fiat money.
- A digital token is something that represents a digital asset, whether a VC or a block-chain based smart contract.
- An NFT is a unique digital code, or token, that represents one or more determined items such as text, images or music, often with the rights to and information about that content.
- A digital code is made up of binary digits that represent letters, symbols, and characters in a digital format.
- Minting an NFT is the tokenization or the creation of a digital 'receipt' that is stored on the blockchain. Minting translates into the purchaser being the first person to have ownership of the digital asset. When an NFT is minted it often goes from the creator's website and then stored in a digital wallet.
- A smart contract is a self-executing contract with the terms of the agreement between the buyer and the seller being directly written into a line of code.



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# Definitions – Let's Start With the Basics *(cont.)*

- Blockchain is a system in which a record of transactions made in bitcoin or another VC is maintained across several computers that are linked in a peer-to-peer network.
- Peer-to-peer denotes or relates to computer networks in which each computer can act as a server for the others, allowing shared access to files and peripherals without the need for a central server.
- A digital wallet is a financial account that allow users to store funds, make transactions, and track payment histories by computer.
- A cold wallet is a type of VC wallet where private keys are stored strictly in an offline environment. In addition, digital transactions are also authorized offline as well.
- A hot wallet is a tool that allows VC users to store, send, and receive tokens. Hot wallets are linked with public and private keys that help facilitate transactions and also act as a security measure.

# NFTs Generally

- NFTs have recently grabbed the attention of art and other investors globally.
- As an innovation, much about them is still being explored and defined.
- NFTs can be used for: collectibles; art; gaming; music and film; licenses and certifications; other virtual assets; real world assets; and identity (including financial industry compliance).
- The history of NFTs began in 2012, with the introduction of "colored coins" built into the Bitcoin network. Increasingly, NFTs have migrated to Ethereum, with the first there being CryptoPunks in 2017, followed by CryptoKitties.
- Roadblocks preventing mass adoption of NFTs include: newness of technology;, inaccessibility; regulation; and difficulty of attaching an NFT to a real world asset.
- While the tax treatment of NFTs builds off that for VCs, guidance in this realm remains limited, forcing those participating in the NFT market to rely on more general tax rules at times.

# Definition of an NFT

- An NFT is a unique digital code, or token, that represents one or more determined items such as text, images, video or music, often along with the rights to and information about that content.
- A digital code is made up of binary digits that represent letters, symbols, and characters in a digital format. Further defined, NFTs are cryptographic mathematical units whose function is limited to their ownership and have no further utility beyond their "uniqueness."
- Thus, this non-fungibility allows such tokens to be distinguishable from each other, unlike a fungible token, such as bitcoin, in which each bitcoin is the same.
- Essentially, an NFT represents a bundle of property rights that allow the owner to access the asset and potentially exploit the work for commercial purposes.
- The U.S. Patent and Trademark office does not have unique guidance for NFTs.

# Fungibility

- A fungible item or token is interchangeable with another unit of the same thing. Bitcoin is an example of a fungible token.
- Non-fungible items or tokens are not interchangeable with each other, and contain unique properties which make them different even if they might seem to be similar.
- Real world example of non-fungible items include houses, paintings and tickets.
- Non-fungible tokens are: unique, traceable, rare, indivisible and programmable.



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# Use of NFTs

- NFTs may be traded with or without the underlying art or other asset, and the ownership of the underlying asset may remain with the creator.
- The use of NFTs allows for the creation of unique (digital) works of art or other asset, something formerly not possible in the digital world, and the lack of which historically allowed for the easy copying of digital works, each indistinguishable from the next.
- This ability to now insert a particular piece of information into a digital work of art or other item makes that work non-fungible, unique, and transferable.
- Such usage is also increasingly popular for gaming, real estate and other applications.
- Potentially important for tax purposes, the timing of the NFT can be distinguished based upon when an NFT is attached to a piece of art or other asset.
- When the NFT is issued by the artist together with the work, it constitutes the "signature" and uniqueness of the work. If the NFT issued after the work, it becomes a certificate of authenticity, which can be issued either by the creator or by the creator's dealer.



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# Blockchain and Other Underlying Technology

- Blockchain technology is used to create and maintain NFTs.
- Blockchains are systems, or underlying ledgers, in which records of VCs, tokens or NFTs are stored, validated, and maintained by peer-to-peer networks.
- Thus, a record of ownership of the NFT is kept and transferred on such digital ledgers.
- To date, most NFTs have been built on Ethereum but newer ones are increasingly using other blockchains such as Flow, Fast Box or Hyperledger.
- However, actual ownership of the underlying asset may remain always with the creator.
- Meanwhile, the "hex values" (essentially codes) created by the original creator, are owned by the NFT owner, and though the raw digital data can be copied, the hex values remain uniquely owned.



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# Smart Contracts

- NFTs are typically leveraging smart contracts for order sensitive transactions.
- To transfer an NFT, the owner must sign the transaction, including the hash of NFT data, and then sends the transaction to a smart contract.
- At receipt of the transaction by the smart contract with the NFT data, the minting and trading process is initiated.
- When the transaction is confirmed, NFTs are permanently linked to a unique blockchain address.
- Various Ethereum token standards are used for generating NFTs, which allow lines of code to be developed to create unique tokens representing underlying assets.
- The NFT owner then stores the raw data in an external database outside the blockchain or can also leave it stored on the blockchain



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# Verification of Asset

- The ownership and transfer of these NFTs are registered online and are universally verifiable, similar to cryptocurrencies.
- This digital verification provided by an NFT allows for traceability of the work across the blockchain so the artist or creator can be determinably linked to the work itself.
- Thus, outside experts are no longer needed to guarantee the artwork's or other asset's uniqueness or originality.
- This verifiable link reduces the risk of fraud, allowing buyers to be more certain in their purchase. Also, due to non-fungibility, a holder of the token has exclusivity.

# Underlying Intellectual Property Ownership

- A further characteristic that differentiates NFTs from traditional copies of a work is the capability of an NFT to internally incorporate royalty agreements, which then enable the creator to share in profits every time the NFT is licensed or resold.
- Moreover, as artists may sign and hand number tangible lithographs copied from a single drawing, they can also produce many NFTs from the original, each with a unique digital code and set of intellectual property rights attached.
- Other creators can likewise sell a digital renditions while retaining ownership of the underlying intellectual property.



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# How is an NFT Created?

- An NFT is created by code - algorithms that rely on cryptography.
- NFT software is decentralized and distributed:
  - The algorithms generally are written to create NFTs, called minting.
  - The code of the NFT defines the minting characteristics, and which is attached to a digital representation of a work.
  - The code for almost all NFTs is verified on a blockchain, so creation can be checked and verified on an ongoing basis.
- NFTs can also be bought, already created.
- Given more regulatory attention, enforcement, and related penalties, these transactions could increasingly fall under financial, securities or commodity related controls.



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# Examples of NFTs

- Early NFTs include the CryptoPunks protocol and the CryptoKitties project. CryptoKitties is generally considered a virtual reality game, made with blockchain technology, in which a user can buy, breed, and sell cartoon digital cats.
- More current NFT sales include the $69 million dollar sale of Beeple's (Mike Winkelmann) "Everydays; The First 5000 Days."
- Auction house Sotheby's recently completed an NFT art auction with a winning bid of $139,000 for a custom piece of digital art from Derrick Adams to commemorate Jay-Z's debut studio album "Reasonable Doubt."
- Sales prices for such digital assets continue to soar, leading many to question the longterm viability of the valuations. Still, uniqueness does have value to others.

# Legal Challenges

- Intellectual property laws.
- Data protection laws.
- Financial market laws.
- Anti-money laundering laws.
- Contract laws.
- Cross-border regulations.
- Tax laws.
- Licensing laws.

# III. Preview of Tax Guidance to Date.



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# Tax Guidance to Date

- Currently, taxpayers have limited guidance about the taxation of NFTs, and thus rely on guidance provided for VCs along with traditional tax principles.
- Guidance is limited to:
  - Notice 2014-21;
  - Rev. Rul. 2019-24;
  - 2019 frequently asked questions (FAQs);
  - Chief Counsel Advice 202114020.
- No Internal Revenue Code sections or Treasury Regulations specifically address VCs and NFTs.
- Within limited parameters, we can address taxation and related compliance.
- Unclear is guidance which will evolve out of the recently passed infrastructure act.

# IRS Position Should Ideally Be Further Defined

- In Notice 2014-21 the IRS clarified that it views VC, and therefore seemingly NFTs, as property for tax purposes.
- NFTs are not specifically classified in the IRC, thus we do not currently have guidance as to whether they are a collectible for tax purposes.
- Whether the NFT is being sold by its creator or someone else impacts the likely tax treatment.

# IV. IRS Guidance on Virtual Currencies.



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# Virtual Currencies: A Tax Perspective

- The core technology underlying virtual currencies – blockchain – is premised on anonymity, which is a conflict for tax reporting purposes.
- Correspondingly, transactions involving virtual currencies are difficult to trace.
- The IRS views noncompliance in reporting VC transactions as a perceived abuse.
- The IRS is concerned about compliance - how and what taxpayers are required to report?
- Steven Mnuchin, former US Treasury Secretary, has said that VC could become "the next Swiss bank account.“
- We should expect continued government focus in this area, with education of the public by the IRS increasingly shifting to enforcement.



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# Virtual Currency

Currency or property?

- US income taxation of financial instruments is generally based on a particular financial instrument's tax classification.
- A part of the Internal Revenue Code (Subpart J of Part III of subchapter N) provides a set of tax rules that applies to transactions concerning currencies.
- Certain issues related to the tax treatment of VC were addressed by Notice 2014-21.
- The Notice refers to VC as "convertible VC."



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# IRS Guidance

- In March 2014, the IRS released guidance in Notice 2014-21 (2014-16 IRB 938).
- Later, in, 2019, the IRS released further guidance addressing hard forks, airdrops and limited other situations (discussed below).
- For federal income tax purposes, VC is treated as "property."
- The sale or exchange of VC is a taxable transaction just like any transactions involving other property. Taxpayers can have gain or loss on the sale or exchange of a VC, which can result in a tax liability.
- Reporting can become tricky for small transactions or when a basket of the same currency was purchased in differing increments. No de minimis exception exists.
- Valuation is likewise an issue. With stock, we have a set price across exchanges. With virtual currencies, pricing can vary across exchanges and the market trades 24/7.

# IRS Notice 2014-21

- The Notice does not address the classification of property type attributed to VC for tax purposes.
  - Is it a commodity?
  - Is it a security?
- Also unclear is whether the same characterization should apply to all virtual currencies given the differences – in the real world – in economic and other rights. These differences have continued to evolve since 2014.
- The Notice also did not address the valuation issues surrounding virtual currencies.

# IRS Notice 2014-21 *(cont.)*

Under general federal income tax principles applicable to property transactions, VC transactions are reportable to the IRS in the following situations:

**Wages and services**

- Wage, salary, or other income paid to an employee using VC is reportable by the employee as ordinary income, subject to federal income tax withholding, FICA and FUTA. It must also be reported on Form W-2.
- VC received by a self-employed individual in exchange for services is ordinary income subject to self-employment tax.
- VC received in exchange for goods or services by a business is reportable as ordinary income.
- The basis of VC is the fair market value of the VC in US dollars as of the date of receipt.

# IRS Notice 2014-21 *(cont.)*

**Investment**

- The sale of property held as a capital asset in exchange for VC results in capital gain or loss.
- The gain or loss on the exchange of VC for other property is generally reported as capital gain or loss if the property is held as a capital asset and as ordinary income or loss if it is held for sale to customers in a trade or business.
- Payments made in VC are subject to information reporting requirements to the same extend as payments made in real currency or instruments denominated in real currency.



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# IRS Notice 2014-21 *(cont.)*

**Mining**

- The IRS's position is that for a taxpayer who successfully "mines" VC, the fair market value of the VC as of the date of receipt is includable in gross income.
- If "mining" constitutes a trade or business, (and the "miner" is not an employee) the earnings (net of allowable business expense deductions) are self-employment income and subject to self-employment tax.
- The IRS position on this issue, as further articulated in later FAQs, is currently being challenged.
- The Notice does not address other issues relating to mining of virtual currencies, including treatment of mining costs and whether the tokens are inventory of a miner.

# IRS Notice 2014-21 *(cont.)*

**Information reporting**

- A payment made using VC is subject to information reporting to the same extent as any other payment made in property.
- A payment of $600 or more in the course of a trade or business is required to be reported to the IRS and to the payee. (Form 1099-Misc. or W-2).
- Examples include: salaries, wages, rent, premiums, annuities and compensation to an independent contractor.



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# IRS Notice 2014-21 *(cont.)*

**Backup withholding**

- A payment made in connection with a trade or business using VC is subject to backup withholding to the same extent as other payments made in property.
- Payees must give the payor their taxpayer identification number (TIN) and related information.
- Payor must withhold tax from the payment if a TIN is not obtained prior to payment (backup withholding).



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# Tax Basis

- Notice 2014-21 provides that the cost basis of a unit of VC received as a payment for goods or services is equal to the FMV of that unit in US dollars on the date received.
- When do gains become taxable?
  - At the time of sale of VC, or
  - At the time it is exchanged for other property or service.



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# Amount Realized

<u>Sale</u>

- At a sale, the amount realized is equal to the sales price, minus any selling costs incurred in the transaction (such as commissions or wire transfer fees). Gain is realized at the time of sale of the VC. Whether the proceeds from the sale are kept in a bank account is irrelevant.

<u>Exchange</u>

- Realization of gain can occur at the time of exchange of the VC for any type of other property or service. Essentially, any transaction involving VC is a realization event that triggers taxable gain.
- For example, if you purchased a phone on July 31 with bitcoins, the amount realized would be equal to the fair market value of the phone on that date. Fair market value is typically described to be the market price of the asset purchased although an alternative method can be utilized if it yields a more accurate value.
- The only way to avoid realization is to hold VC without selling or exchanging it.



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# Character of Gain

- Notice 2014-21 provides that the character in a sale or exchange of VC depends on the nature of the holdings in the hands of the taxpayer.
- For investors, the gain on the sale or exchange will typically be capital gain. Such capital gain can be either long term (assets held for at least one year) or short term (held for less than a year).
- In other situations, the gain on sale or exchange will be ordinary, such as when the VC is treated as inventory or another trade or business asset.



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# Losses

- The IRS Notice clarifies that the deductibility of a loss depends on multiple factors. In general, losses from the sale or exchange of assets held for personal purposes are not deductible.
- A person who utilizes VC exclusively for personal consumption will be required to recognize gain but will be denied deductions for any losses as the transaction was not entered into for profit.
- Losses from the sale of VC held as an investment are subject to the general loss rules under the IRC.
  - Offset gains with losses, when possible.
  - Carryover losses.
  - Restrictions on trade or business losses.

# Rev. Rul. 2019-24

- In August 2017, the bitcoin blockchain "hard forked" for the first time - the IRS defines a fork as occurring "when a VC on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger."
- A hard fork can result in the creation of a new VC, in addition to the old VC.
- Further, the IRS defined an airdrop as "a means of distributing units of a VC to the distributed ledger addresses of multiple taxpayers." A hard fork is not always followed by an air drop.
- At the first fork, the bitcoin blockchain was split into bitcoin and bitcoin cash.
- In practice, all holders of bitcoin as of the date of the hard fork received the right to an equal number of bitcoin cash units.
- In November 2017, another hard fork of bitcoin occurred when bitcoin gold was created.
- Bitcoin cash and bitcoin gold were received by owners of bitcoin as a result of holding bitcoin.

# Rev. Rul. 2019-24 *(cont.)*

- On October 9, 2019, the IRS released Revenue Ruling 2019-24, which provides guidance regarding hard forks and airdrops of VC and new frequently asked questions (FAQs), which provide guidance on these and other VC issues.
- While the guidance is helpful, the FAQs are focused on reiterating the application of basic income tax principles to VC transactions. More complicated technical questions are largely left unaddressed.
- Rev. Rul. 2019-24 and related FAQs supplement the earlier IRS guidance from 2014.
- Both the AICPA and NYSBA provided comments to this guidance, both noting that it was not broadly applicable beyond the scope of the examples discussed, and thus very limited overall.

# Rev. Rul. 2019-24 *(cont.)*

- The revenue ruling addresses (1) whether a hard fork of a VC blockchain creates taxable income under IRC section 61 if the taxpayer does not actually receive the new VC, and (2) whether a hard fork with an airdrop creates taxable income when the taxpayer does actually receive the new VC.
- The IRS's answer is "no" to (1) and "yes" to (2).



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# Dominion and Control

The IRS focuses in the revenue ruling on whether the taxpayer has "dominion and control" over the new VC after a hard fork. As a result, the revenue ruling states that:

- In situation (1) the taxpayer did not have income under IRC section 61 as the taxpayer did not receive new VC and did not have an accession to wealth. (Also covered in FAQ #21.)
- In situation (2) the taxpayer recognizes income under IRC section 61 because the taxpayer actually received a new VC and has accession to wealth. As the taxpayer is able to dispose of the VC immediately, the ruling provides that the taxpayer had dominion and control over the new VC at the time of the airdrop, which occurs at the time it is recorded on the distributed ledger. Such income is ordinary, (and the basis in the new VC is equal to the fair market value of the new VC when the airdrop is recorded on the distributed ledger). (Also addressed in FAQ #22-24.)



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# Dominion and Control *(cont.)*

- The determination of what is considered to be "dominion and control" and “receipt” is critical. The revenue ruling states that the "taxpayer does not have receipt of VC when the airdrop is recorded on the distributed ledger if the taxpayer is not able to exercise dominion and control over the VC."
- The IRS clarifies that the inability to exercise dominion and control over the VC can occur when the VC is in a ‘wallet’ managed through an exchange that does not support the newly-created VC, so it is not credited to the taxpayer’s account.
- The revenue ruling also provides that a taxpayer may constructively receive VC prior to the airdrop being recorded on the distributed ledger, with receipt occurring when the taxpayer is able to transfer, sell, exchange or otherwise dispose of the VC.
- The revenue ruling does not elaborate or provide any additional examples of dominion and control and constructive receipt.



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# IRS VC FAQs – A Brief Summary

- The new FAQs provide information that is consistent with Notice 2014-21 and Rev. Rul. 2019-24 and address certain technical issues, such as mechanisms to determine the value of VC, how to calculate gain or loss in VC transactions and whether a soft fork is a taxable event.
- Overall, the new FAQs appear to reiterate and reinforce the application of basic income tax principles to VC to ensure compliance.
- For these FAQs, the IRS defines VC as a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.
- Convertible VC is VC that is convertible into "real" currency or is used as a substitute for real currency.
- The FAQs apply to various types of convertible VC that are used as a medium of exchange. The FAQs do not address the treatment of contracts for the future receipt of VC.

# "Soft Forks" and Other Non-Taxable Events – FAQs

- According to the FAQs, a so-called "soft fork" occurs when a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger. Holders of VC that undergo a soft fork are treated as holding the same VC after the soft fork as they did before. Accordingly, the soft fork does not result in the realization of income.
- Similarly, if a taxpayer moves VC from one wallet, address or account belonging to the taxpayer to another wallet, address or account, the taxpayer will continue to hold the same VC held before, so there is no taxable event, even if the taxpayer receives an information return from an exchange or platform as a result of the transfer.



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# Identifying the Units of VC Sold – FAQs

- If a taxpayer acquires the same type of VC at different prices and then later sells or exchanges some of that VC, the taxpayer must be careful to identify which units were sold or exchanged.
- The FAQs say that absent specific identification, the taxpayer will be considered to sell the first units acquired (i.e., a first in, first out, or FIFO method).
- However, the FAQs also provide guidance on how to specifically identify the VC sold. A taxpayer can identify a specific unit of VC by documenting its unique digital identifier, including a private key, public key and address, or by records showing the transaction information for all units of the VC held in a single account, wallet or address.
- This information must show the date and time each unit was acquired, the taxpayer's basis and the fair market value of that unit at the time of acquisition, the date and time each unit was sold, the fair market value of each unit when sold and the amount of money or the value of property received for each unit.



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# Fair Market Value of VC - FAQs

- The fair market value of VC can be determinative given the volatility of most VC assets. The FAQs clarify that VC received in a transaction facilitated by a VC exchange is the amount recorded by the VC exchange for that transaction in US dollars. If a transaction facilitated by a VC exchange is not recorded on a distributed ledger, then the fair market value is the amount the VC was trading for on the exchange at the date and time the transaction would have been recorded on the ledger if it had been an on-chain transaction, i.e., a transaction on a distributed ledger.
- If a taxpayer receives VC in a transaction not facilitated by a VC exchange, such as via a peer-to-peer transaction, then the FAQs clarify that the IRS will accept as evidence the value as determined by a VC or blockchain "explorer" that analyzes worldwide indices of a VC then calculates the value of the VC at an exact date and time. The FAQs do not specify which index or data source should be used. In addition, instead of an "explorer value," the FAQs permit the taxpayer to establish the value of the assets under general valuation principles. For VC not traded on any exchange and which does not have a published value, the fair market value of the VC is the fair market value of the property or services exchanged for the VC.



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# Calculating Gain and Loss, and Determining Basis – FAQs

- For purposes of the FAQs and pursuant to Notice 2014-21, convertible VC is treated as property for US federal income tax purposes, rather than as currency, so the rules that apply to transactions involving property also apply to transactions involving VC. Frequently, the FAQs cite IRS publications setting out the general principles for property transactions as providing the relevant authority. As under Notice 2014-21, the FAQs reiterate that the taxpayer will recognize gain or loss when the taxpayer sells convertible VC for real currency, uses convertible VC to pay someone for performing services, or exchanges convertible VC for other property.
- If a taxpayer receives convertible VC as payment for the performance of services, either as an independent contractor or as an employee, the taxpayer will recognize income equal to the fair market value of the convertible VC in US dollars at the time received (reiterated). The FAQs note that receipt of VC is taxable income that must be reported by the employee or contractor, regardless of whether the transferor issues a W-2 or Form 1099 to report the payment.

# Gifts and Donations to Charity

- Under the FAQs, the rules that apply to gifts of property and donations of property to charity apply to gifts to convertible VC and donations of convertible VC. Accordingly, if a taxpayer makes a tax-deductible donation of appreciated VC to a charity, the taxpayer does not recognize the built-in gain on that VC.



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# Chief Counsel Advice 202114020

- Dated March 22, 2021.
- Addresses the tax consequences for an individual who received bitcoin cash as a result of a bitcoin hard fork on August 1, 2017.
- A taxpayer had gross income as an accession to wealth under IRC section 61 at the point the taxpayer had dominion and control over the bitcoin cash.
- A taxpayer who did not have dominion and control at the time the bitcoin cash was received in their account hosted by an exchange which did not support the new protocol did not have an accession to wealth until the time the exchange did support bitcoin cash (when the taxpayer therefore had dominion and control).

# V. Tax Treatment Of NFTS



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# Recognizing Income or Gain

- NFTs raise a host of tax issues.
- One salient aspect of an NFT is that it is individually owned, with a record of ownership of the NFT maintained and transferred on such digital ledgers.
- Thus, this asset and related transactions can be tracked, if only on a decentralized network, which can be helpful for tax purposes.
- Its intangible nature does create unique complexities as the definition of what is traded can be opaque.



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# Character Matters

- As with any asset class, taxation of NFTs is based upon the character of both the asset and the transfer or recognition event.
- However, arguably, NFTs are not only a new asset class, not contemplated in the tax code, but they also allow for many different transactions that can occur at different times.
- Some examples of possible NFT timing of recognition events include:
  - NFTs issued separate from any work done, such as intellectual property rights.
  - NFTs issued in conjunction with physical or digital work.
  - NFTs arising out of someone else's, or the creator's own, work.
  - NFTs combined with other NFT work.
  - NFTs resold.
  - NFTs split into different assets.
  - The rights of an NFT split among individual parties.
  - NFTs created with no intellectual property rights attached.
  - Other possible iterative configurations, which can be governed by a smart contract evolving over time.



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# Types of Sellers

- Three types of sellers of an NFT are currently most common, with each being taxed separately. They are the:

1. Initial creator, who issues an NFT, called "minting." This process is the production from "creation" of a token with a cost equal to the sum of cryptocurrency, or another measure of value, used for the creation. At this first NFT transfer, intellectual property rights can arise, being either transferred to a limited degree (as with a royalty) or sold outright (a full sale).
2. Subsequent seller (collector or investor). Subsequent assignments of the NFT can include the original rights transferred or lesser rights, depending upon the rights held by that selling owner. However, the NFT is likely no longer "self-created" and thus could likely get a different tax treatment.
3. Broker/dealer, or someone who holds the inventory of such assets. This circumstance could lead to the NFT's being held as an asset used for a trade or business.

Unclear is the impact of splitting rights, and the related deductibility at further sales.



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# Tax Treatment Generally

- The Internal Revenue Service has issued very limited guidance regarding the tax consequences of transactions involving virtual currencies.
- An NFT is generally considered a digital token, similar to VC; however, the Treasury Department and IRS arguably still have not provided a comprehensive definition of a VC that has kept pace with innovations in the industry.
- As above, under current guidance, VC transactions are treated as property transactions for federal tax purposes, and specifically not as currency transactions.
- Therefore, a recognition event gives rise to short- or long-term capital gains treatment without a de minimis exception.
- While the Treasury Department and IRS have aimed to provide guidance for certain areas within the VC arena, such as hard forks, airdrops, and, most recently, 1031 exchanges before the enactment of the Tax Cuts and Jobs Act, NFTs have not to date been directly addressed.
- The limited and very specific guidance provided thus far is often impractical as it is either not on point of fails to take into account most of the innovation in the industry (or both).



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# General Tax Principles Still Apply

- Given the lack of specific guidance with respect to NFTs, we must rely on more general tax principles to provide tax answers.
- Encouragingly, in contrast to cryptocurrencies (a medium of exchange), NFTs typically actually display more characteristics of property, albeit intangible property, than do cryptocurrencies.
- Since NFTs can arise by the actions of the creator of a piece of work when completed or can be attached by that same creator or someone else entirely at a later date, the creation of an NFT might not give rise to a taxable event as the NFT only attaches to the work, with no transfer of that work occurring.
- In this process, the artist or someone else can “tokenize” through an NFT a piece of art that has been created, making that work more valuable than the original, as it has been certified by the artist as his or her work (like a signature, but in digital form).
- The Internal Revenue Code (IRC) does not tax imputed income arising from a self- created work, only realized income.



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# Intangible Nature is Key

- NFTs constitute intangible assets. Intangible assets are treated differently for tax purposes depending upon whether they are (self) created or purchased.
- Music, as an intangible, has its own set of unique characteristics under the tax code.
- Thus, if the NFT is created by or for the taxpayer, the IRC generally precludes its adjusted basis from being amortized; however, if an NFT is purchased, then IRC Section 197 rules applicable to intangible assets apply.
- Should IRC Section 197 apply, and the NFT is used in a taxpayer's trade or business to generate income, a taxpayer can typically amortize its adjusted basis in the NFT, utilizing the straight-line method over a 15-year period beginning in the month in which the NFT was acquired.
- Amortization deductions would also be allowed, and potential losses generated as a result of such deductions would also be allowed if the taxpayer meets the requirements under the loss limitation rules.



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# Activity Engaged in for a Profit?

- For individuals, pass-through entities, or trusts holding NFTs, there is a special consideration as to whether their use constitutes an activity not engaged in for profit instead of an actual trade or business.
- For activities not engaged in for profit, such taxpayers are allowed to take deductions that would be allowable if the activities were engaged in for profit only to the extent that the gross income from those activities exceeds the deductions that would be allowable without regard to whether the activity is engaged in for profit.
- Additionally, deductions allowed under IRC Section 183(b) are considered miscellaneous itemized deductions subject to a threshold of 2 percent of adjusted gross income, which are currently not allowable.
- While the burden of proof is on the taxpayer to demonstrate that an activity is engaged in for profit, IRC Section 183(d) provides that if the activity in question produces profits for three more years over a five-year period ending with the tax year, the activity is presumed to be engaged in for profit unless IRS can establish otherwise.
- Regulations allow that the determination of whether an activity is engaged in for profit is based on facts and circumstances, listing nine factors to consider, with no one factor being determinative.



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# NFT Sale or Exchange

- The tax consequences of a sale or exchange of an NFT is determined based upon whether the NFT is deemed to be a capital or noncapital asset.
- All "property held by the taxpayer" is defined as being capital with several important exceptions.
- For example, one exception includes "a patent, invention, model or design…a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by…a taxpayer whose personal efforts created such property."
- As a result, an NFT in the hands of its creator could be considered a noncapital asset, whereas an NFT held by taxpayers other than the creators is deemed a capital asset.
- Gains and losses on the sale or exchange of an NFT held by its creator would therefore be ordinary gains and losses, while gains or losses on the sale or exchange of an NFT held by taxpayers other than the creators would be capital gains and losses.

# Gross Income?

- Further, if a buyer pays an artist creator not just for the artwork but also for its conversion to an NFT, the entire purchase price would be taxable to the artist under as gross income.
- Under the IRC, all gains or undeniable accessions to wealth, clearly realized, over which the taxpayer has complete dominion, are included in gross income.
- In this situation, the sale is treated for tax purposes as if the buyer had paid the ordinary purchase price for a tangible artwork plus a premium for the NFT added per the buyer's request (so the total value is taxable).

# Limited Rights and Smart Contracts?

- What if only limited rights transfer, making the event more like a royalty than a transfer?
- Again, ordinary income treatment for the creator would attach, with a more complex analysis required for others.
- Due to the digital characteristics inherent in an NFT, even after the artist has sold or otherwise transferred an NFT, the work could potentially continue to produce taxable income for both the artist and the new owner.
- Any transfer of intellectual property rights could be customer-tailored at the transfer of the NFT and underlying work to execute the transaction details agreed upon among the parties.
- Thus, either party could collect payments from viewers of the NFT, including subsequent other disbursements or ways of generating revenue.
- Smart contracts embedded in the blockchain technology underlying the NFT can automatically carry out payments as agreed upon among the parties.
- Ultimately, the iterations that split the rights of the work are limitless and can be fully automated.



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# Business Operations

- In other instances, the determination of the NFT as it relates to the business operations of its owner will impact the related tax treatment.
- If an NFT is treated as a capital asset, and a taxpayer (other than the NFT's creator) uses the NFT in a trade or business, the NFT would seemingly be classified as an IRC Section 1231 asset, and therefore not a noncapital asset.
- As a Section 1231 asset, if the taxpayer sells or exchanges an NFT used in a business context and the taxpayer's overall Section 1231 gains exceed overall Section 1231 losses, Section 1231(a) would classify the Section 1231 gains and losses as long-term capital gains or losses.
- Alternatively, if the taxpayer sells or exchanges an NFT employed in a business context and overall Section 1231 losses equal or exceed Section 1231 gains, Section 1231(a)(2) classifies the Section 1231 gains and losses as ordinary gains and losses.
- Additionally, in the case of gains, the IRC Section 1245 recapture rules may also apply.



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# Collectible?

- A key issue is whether NFTs are “collectibles” for US tax purposes in the hands of collectors, with long term gains taxed at higher rates than other long term capital gains.
- Section 1(h)(4) of the Internal Revenue Code of 1986, as amended, provides that gains from the sale or exchange of collectibles are taxed at a rate of 28% rather than the usual maximum rate of 20%. Collectibles are defined under Section 408(m)(2) as follows:
    - Any work of art,
    - Any rug or antique,
    - Any metal or gem,
    - Any stamp or coin,
    - Any alcoholic beverage, or
    - Any other tangible personal property specified as a collectible by the IRS.
- There are no regulations or other guidance issued by the IRS which further define the term “collectibles



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# Collectible? *(cont.)*

- Whether an NFT is a collectible turns entirely on rules of statutory construction and how one interprets the phrasing in item (f).
- Item (f) contains a reference to "any other tangible personal property", so the issue is whether the reference to "any other tangible personal property" means that the property referred to in items (a) through (e) is also limited to "tangible" personal property.
- NFTs are clearly works of art, but they are also clearly intangible and not tangible personal property.
- If the reference in (f) limits the term collectibles to items that constitute tangible personal property, then NFTs would not constitute collectibles and would therefore be taxed at the lower, general long term capital gains rate. In order to qualify for this lower 20% capital gains rate, the collector must have held the NFT for at least 12 months.
- Regardless of whether NFTs are classified as collectibles, as with the gains from the sale of any capital asset, the gains from the sale of an NFT may additionally be subject to an additional 3.8% net investment tax and other state taxes.
- The determination of whether NFTs should be classified as collectibles may have other implications beyond the applicable tax rate.
- As above, NFTs would not constitute a capital asset in the hands of the originating artist either because they are self-created artistic compositions or they are inventory under Section 1221(a)(1),(3). Thus in the hands of the artist, any gains from the sale of NFTs would constitute ordinary income which would be taxed at rates of up to 37% federal plus any applicable state tax,



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# Other Types of Tax Treatment

Worthless Asset:

- What if an NFT becomes worthless after being purchased, whether by a collector or someone engaged in the trade or business of holding such assets?
- If an NFT becomes worthless in the hands of its owner who purchased it as an item of personal use, such as artwork used for decorative purposes, a deduction related to this loss would not be allowed.
- In contrast, within a trade or business context, if the taxpayer owned an NFT that became worthless, a deduction for the worthless asset should be allowable.

# Other Types of Tax Treatment *(cont.)*

Charitable Contributions:

- Regarding treatment of charitable contributions, subject to percentage limitations, taxpayers can deduct property contributions made to qualified organizations.
- Precluded are any deduction of the fair market value of services performed on a charity's behalf, including potentially the creation of the underlying artwork or NFT.
- Such determinations as to whether property or services have been contributed to a charitable organization is complex and the basis for much case law.
- The intricacies of that analysis, due to the possibly widely variable possible fact patterns, is beyond the scope of this discussion.
- Assuming that the amount contributed does qualify as a charitable deduction, determining the deductible amount is the next step.

# Other Types of Tax Treatment *(cont.)*

- Generally, in the case of intangibles, a taxpayer may deduct the fair market value of contributed property.
- However, the amount of any charitable contribution of property is reduced by “the amount of the gain that would not have been long-term capital gain” if the taxpayer had sold the property for its fair market value at contribution date.
- This limitation could impact the deductible amount of an NFT contributions made by creators.
- If a creator transformed the work into an NFT and then donated it, the NFT would likely constitute a noncapital asset in the creator’s hands, the deductible amount limited to the creator’s tax basis in the NFT—ordinarily minimal and limited to the raw materials and the tokenization process.
- However, others purchasing the asset and later donating it would not be so limited.
- One can imagine, in this scenario, a virtual art gallery of donated NFTs.



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# VI. Compliance and Reporting.



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# How Will IRS Know of Your Gain?

- Taxpayers are required to voluntarily and accurately report their gains on timely filed income tax return. Starting in the 2020 tax season, every taxpayer must answer certain questions on their tax returns relating to VC .
- VC exchange or payment processors must report a transaction to the IRS. A Form 1099-K or Form 1099-B statement from a crypto exchange is thus sent to the taxpayer. during any tax year, if a taxpayer has more than $20,000 proceeds and 200 transactions in a crypto exchange, the taxpayer will get a Form 1099-K indicating the resulting proceeds. The exchange is required to create these forms for the users who qualify and also to provide a copy to the IRS. A like process applies for Form 1099-B.
- A bank or exchange may file a Suspicious Activity Report ("SAR"). US banks and exchanges are required to file SARs for wire transfers that are "suspicious" and larger than $5,000 ($2,000 in the case of bitcoin exchanges).
  - The larger and/or more frequent your SAR filings, the more likely they will become a red flag and trigger an investigation.
- Whistleblower.



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# Records Requirements

- A taxpayer is required to maintain records sufficient for determining the amount of any gain or loss, as well as the holding period of VC owned.
- The IRS can generally go back and audit tax returns for a period of 3 years. That period is extended to 6 years if the tax return omitted more than 25% of income.
- There is no time limit if the civil fraud penalty applies, or the taxpayer never filed their tax returns.



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# Passage of Infrastructure Act

- The US Internal Revenue Service and Treasury Department will be able to set tax reporting rules for cryptocurrency transactions starting in 2023, with the now final approval of the massive US infrastructure bill.
- The provision entitled "Information Reporting for Brokers and Digital Assets" in the Infrastructure Investment and Jobs Act is designed to support tax-enforcement efforts and help fund the estimated $1.2 trillion in spending authorized by the bill.
- The bill mandates that a broker will have to report any digital-asset transfer moved to the account of an unknown person or address.
- The new rules will increase emphasis on a broker's Know Your Customer (KYC) and tax information reporting systems.
- A particularly contentious element of the relevant provision in the Act is the definition of a "digital-asset broker."
- The provision states that a digital-asset broker will constitute, "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."
- An ongoing cryptocurrency lobbying effort has sought to amend the provision to explicitly exempt miners, validators, and software developers.



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# Passage of Infrastructure Act *(cont.)*

- While these efforts and public outcry did produce compromise language (endorsed by Treasury Secretary Janet Yellen), the amendment did not make it into the bill prior to passage in the Senate.
- The bill recently passed the US House of Representatives without including this compromise language.
- The rules in the infrastructure bill mandate that brokers must report all digital-asset transactions "from an account maintained by such broker to an account which is not maintained by, or an address not associated with, a person that such broker knows or has reason to know is also a broker."
- This reporting is meant to be accomplished through a yearly tax form, such as one in the Form 1099 series or another form the IRS may create to meet the new reporting objective.
- The reporting requirements would be effective January 1, 2023 and will be required for all tax returns filed for the taxable year.
- Regulations will further define how these new rules will be defined and applied.
- Note that there is also a risk the IRS could expand the information reporting to transfers by non-US clients in the final regulations.

# VII. Conclusion.



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# Conclusion

- At this time, it is unknown whether further guidance for NFTs, or, more broadly, digital tokens, will be forthcoming, at least in the near future.
- Given that this broader “nascent” digital currency, or token, industry has existed for over 10 years, the guidance received from IRS and the Treasury Department is sorely lacking.
- Again, technology continues to outpace the government’s ability to keep up.
- Yet, it is possible to rely on existing tax principles and contort them to provide answers, if only suboptimal ones.
- Given that NFTs are proving popular as a way for artists and other creators to protect the value of the resulting digital asset, more specific guidance is needed.
- Meanwhile, tax professionals will have to puzzle over the tax code and apparently construe the best answers possible for clients who need real answers today.
- In solving an intellectual property issue for digital artwork, and other assets more generally, NFTs have added tax complexity.

# Biography

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Megan Jones focuses her practice on advising companies, investors, family offices and individuals on sophisticated domestic and international tax planning. Megan guides clients on tax and corporate planning arising from the acquisition, disposition and restructuring of businesses, corporations and partnerships both domestically and internationally. Megan frequently advises foreign individuals moving to the U.S. on pre-immigration, income, gift and estate tax planning opportunities, along with helping those leaving California or the United States.

Megan also focuses her practice in the technology arena, including crypto assets and block chain technology. Megan's expertise includes advising startup companies and their founders, from the foundational stages to a recognition event. Megan understands how to plan in the context of intangible assets or innovative technology. Her grasp of complex financial statements adds a level of sophistication to her practice.

Previous experience includes working for a globally focused investment bank, doing mergers and acquisitions and public offering work. Megan is an adjunct professor at USC Gould School of Law and Loyola Law School. She frequently speaks and writes on tax-and other topics and has written three books. An active member in the legal community, she serves in leadership roles including on the planning committee of the Society of Trust and Estate Practitioners' (STEP) Los Angeles Branch. Megan is on the prestigious USC Tax Institute planning committee. She is Chair of the tax executive committee at the Los Angeles County Bar Association and is a member of both CalCPA's estate planning state and Los Angeles planning committees.

An education advocate, Megan is on the board of directors of the Mr. Holland's Opus Foundation and advises schools on a pro bono and regularly retained basis.

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# Biography

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Charles is a partner in the private client, tax and corporate teams.

He focuses his practice on international tax, corporate, and partnership matters. He assists clients in tax and corporate planning relating to the acquisition, disposition and restructuring of businesses, corporations and partnerships both domestically and internationally. Charles frequently advises foreign individuals moving to the U.S. on pre-immigration, income, gift and estate tax planning opportunities. Charles also focuses his practice on the cannabis industry/cannabusiness, crypto assets and block chain technology, and tax issues related to initial coin offerings (ICOs).

In addition, he advises DJs, actors and actresses, musicians, songwriters, producers, directors and 1nancers, both domestic and foreign, on a wide range of individual and corporate tax issues, speci1c to the entertainment industry. Charles has written several articles and given many presentations on entertainment tax issues.

He has advised over 200 clients with unreported foreign 1nancial accounts, foreign trusts, and other foreign investments, on the 1ling of FBARs and other information returns, and whether participating in the IRS's various offshore voluntary disclosure programs is appropriate. Charles has written and lectured on the extensive information reporting requirements for U.S. taxpayers with international business operations.

Charles has extensive experience in representing clients during audits by the IRS or the California Franchise Tax Board, as well as in front of the IRS Appeals Of1ce or IRS Collection.

Charles is recognized as a "key lawyer" by The Legal 500 US in 2021 and 2020 in the area of international tax.



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