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Introduction to Non-Fungible Tokens – Part 4

Taxation of Non-Fungible Tokens

IRS Guidance

1. Notice 2014-21

At the time of this publication, the U.S. government has only passed legislation addressing tax reporting requirements for "brokers" of "digital assets."[1] There is therefore no legislative guidance regarding the taxation of NFTs. Likewise, the IRS has not addressed NFTs in any of its limited cryptocurrency guidance. Notwithstanding, Notice 2014-21,[2] which is the IRS' first attempt to address the taxation of convertible cryptocurrencies, serves as a point of reference.

Notice 2014-21 applies to "virtual currencies," which are defined as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." It further provides that a convertible cryptocurrency is treated as property – not cash or currency – for tax purposes. Thus, general tax principles that apply to property apply to convertible cryptocurrency. While Notice 2014-21 does not specifically address nonconvertible cryptocurrencies or NFTs, it is most likely that NFTs are also treated as property for tax purposes.

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1 This legislation and its application to NFTs are discussed below.
2 2014-16 I.R.B. 938.

2. Purchasing NFTs with Cryptocurrency vs. US Dollars

An initial point of consideration regarding the taxation of an NFT is whether it was purchased with a cryptocurrency. The use of cryptocurrency to purchase an NFT results in taxable transactions for both the buyer and the seller. This is because the NFT buyer is buying property (i.e., the NFT) with other property (i.e., cryptocurrency). The buyer's gain would be taxable if the fair market value of the cryptocurrency used to buy the NFT is greater than the buyer's tax basis in the cryptocurrency. If, on the other hand, the NFT is sold for cash, the seller has a taxable transaction, but the buyer does not. The amount of taxable gain or loss for the seller is the difference between their adjusted tax basis in the NFT and the amount received for the NFT.

Capital vs. Ordinary Treatment

Gain or loss on an NFT transaction is treated as capital or ordinary, depending on whether the taxpayer is an investor or trader (capital) or a dealer or creator (ordinary). Whether the holder of an NFT is an investor, trader, dealer, or creator is a mixed question of fact and law.

1. Investors and Traders

Investors are typically taxpayers who profit solely from price fluctuations and income earned on the investments they hold. Investors are not engaged in a trade or business, so expenses attributable to their investments and losses arising from their investments may not be deductible for tax purposes.

Traders are professional "investors" who are considered to be engaged in a trade or business for tax purposes. Traders buy and sell capital assets to profit from favorable changes in market prices. Neither the Internal Revenue Code nor the Treasury regulations define the term "trader," and the court cases addressing traders turn on the frequency, extent, and regularity of the trading activity; the taxpayer's investment intent; and the nature of the income derived from the activity.[3] A trader is engaged in a trade or business, so ordinary and necessary expenses attributable to their investments may be deductible for tax purposes.

For an investor or trader, the holding period of the NFT will determine whether a preferential long-term capital gain rate applies (i.e., 0 percent, 15 percent or 20 percent) or a short-term capital gain rate applies (i.e., ordinary graduated income tax rates, with a current top rate of 37 percent).[4] In general, an NFT that is held for more than 12 months should result in a long-term capital gain or loss, while an NFT held for less than 12 months should result in a short-term capital gain or loss. If a taxpayer is also a collector, the NFT may be treated as a "collectible," which would result in a higher long-term capital gains rate of 28 percent.[5] A capital loss is subject to special limitation rules that apply to capital assets, which may result in a capital loss being nondeductible.[6]

2. Dealers

Dealers are distinguishable from investors and traders. A dealer earns income from a markup on items sold from their inventory, or stock-in-trade, to customers in the ordinary course of the dealer's trade or business.[7] Dealers often make markets by quoting the bid and ask prices at which they are willing to buy and sell an item. Because they buy and sell for their own account, they assume positions as part of their business activities and trade off of these positions. In theory, the dealers' profit is the markup based on their cost.

The courts and the IRS have found a combination of factors to be determinative of dealer status, including (a) having a large volume of sales and purchases,[8] (b) holding oneself out to the public as a dealer,9 (c) selling items out of inventory to customers,10 and (d) profiting from commissions rather than from appreciation in the

3 See *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983); see also *Endicott v. Comm'r*, T.C. Memo 2013-199 at 13.

4 In addition to this capital gains tax, a high-income earner may also be subject to a net investment income tax of 3.8 percent.

5 See I.R.C. § 408(m)(2). Collectibles include alcoholic beverages, works of art, rugs, antiques, stamps, certain coins, gems and precious metals. NFTs that are similar to works of art and other collectibles might be treated as collectibles.

6 See generally I.R.C. §§ 183 and 1211.

7 For tax purposes, the definition of a dealer also includes "noninventory" dealers. A noninventory dealer is a taxpayer who regularly offers to enter into, assume, offset, assign or terminate financial product positions with customers in the ordinary course of their trade or business. Noninventory dealers are not discussed herein.

8 *Reinach v. Comm'r*, 373 F.2d 900, 901-02 (2d Cir. 1967), *aff'g* 24 T.C.M. (CCH) 1605 (1965), *cert. denied*, 389 U.S. 841 (1967).

9 *Verito v. Comm'r*, 43 T.C. 429, 441-42 (1965), acq. 1965-2 C.B. 7.

10 *United States v. Chinook Inv. Co.*, 136 F.2d 984, 984-85 (9th Cir. 1943), *aff'g* 42-2 U.S.T.C. (CCH) ¶9575 (D.C. Or. 1942).

value of an item.11 Infrequent and isolated transactions do not qualify as dealer transactions.12 Dealers earn ordinary income and loss (i.e., not capital) on the transactions that are part of their trade or business activities, and are accordingly subject to tax on their income at graduated rates (with a current top rate of 37 percent). A dealer may deduct ordinary and necessary business expenses.

3. Creators

A creator is commonly understood to be the artist who created an NFT and offers it for sale in marketplaces. A creator of NFTs who is engaged in a trade or business of creating NFTs recognizes ordinary income or loss upon the disposition of an NFT[13] and may additionally be subject to self-employment tax on any income earned on the disposition. In addition, a creator of NFTs who is engaged in a trade or business of creating NFTs may deduct ordinary and necessary business expenses.

Current Trends

1. Broker Definition

Prior to 2022, there was no direct legislative guidance regarding tax and information reporting for NFTs. Nevertheless, an exchange or platform for NFTs is still required to consider whether it is a broker that is required to file information returns (e.g., IRS Forms 1099, 1099-B) showing the name and address of the account holder and details regarding any sales.[14] For tax purposes, the term "broker" includes any person with members or clients that contract with each other to trade or barter property (i.e., a barter exchange), which may extend to an exchange or platform for NFTs.[15]

11 *Kemon v. Comm'r*, 16 T.C. at 1026, 1032-33 (1951); *accord. Brown v. United States*, 426 F.2d 355, 364 (Ct. Cl. 1970).

12 *Pan-American Bank & Trust Co. v. Comm'r*, 5 B.T.A. 839, 844 (1926).

13 I.R.C. § 1221(a)(3).

14 I.R.C. § 6045(a).

15 I.R.C. § 6045(c)(3).

2. Infrastructure Investment and Jobs Act

The enactment of the Infrastructure Investment and Jobs Act on Nov. 15, 2021, may affect the obligations of NFT trading platforms.[16] Starting in 2023, the legislation requires brokers of digital assets to comply with tax information reporting requirements that historically only applied to securities, regulated futures contracts and commodities. Under these requirements, a broker of digital assets must file with the IRS information returns (i.e., IRS Form 1099-B) containing a brief description of the digital asset sold, the date it was bought and sold, the cost paid to acquire it, the amount received upon a sale, and whether the broker withheld tax upon a sale. A digital asset is defined as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by [the IRS]."[17] The term "broker" is defined to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person."[18]

3. Potential Forthcoming Guidance

The Infrastructure Investment and Jobs Act provides the IRS and the Treasury Department with clear direction to write rules interpreting and implementing the definitions of a digital asset and a broker, and the related tax information reporting rules applicable to brokers. But as of the date of this publication, the limits and definitions of the terms "digital asset" and "broker" are not known, including whether an NFT constitutes a "digital asset." It is anticipated that the IRS and the Treasury Department will issue clarifying guidance in 2022 regarding this new legislation.

16 P.L. 117-58.

17 I.R.C. § 6045(g)(3)(D).

18 I.R.C. § 6045(c)(1)(D).

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