The Taxation of Nonfungible Token Transactions

Beware the Implications of Intangible Investments

By Lisa M. Blum and Benjamin P. Foster

Most CPAs are likely familiar with cryptocurrencies such as Bitcoin and Ethereum. These currencies are considered fungible, because they can be directly exchanged for other currencies or goods or services. The IRS has issued guidance on taxation related to transactions conducted with cryptocurrencies, including a recent requirement that any cryptocurrency transfers of $10,000 or more must be reported to the IRS (U.S. Department of the Treasury, *The American Families Plan Tax Compliance Agenda,* May 20, 2021, p. 21; https://bit.ly/3d49R4e). Recently, nonfungible token (NFT) trading has become a multimillion-dollar industry, but the IRS has yet to provide guidance on taxation of those transactions. CPAs are left to their own judgment regarding the taxation of these unique assets.

NFTs and Potential Tax Consequences

An NFT is a cryptographic asset authenticated and exchanged using blockchain technology. Each NFT is unique; unlike fungible tokens such as cryptocurrency, it cannot be directly exchanged. Unlike collectibles and other tangible items, the digital marketplace has recently seen investments rise in value tremendously in a short time. NFTs can be found in the fields of sports, music, art, and other sectors.

A downside to NFT transactions is the potential for significant income tax pitfalls. The IRS is working to make sure that gains from these new transactions are taxed. Clients who do not comply with recordkeeping requirements and plan transactions in accordance with the tax law may incur avoidable tax liabilities as well as civil underpayment penalties. Furthermore, some uninformed clients may even inadvertently subject themselves to criminal liability for unreported income.

The IRS addressed the taxation of cryptocurrency in Notice 2014-21 but has not yet provided any formal guidance for NFTs. Although Notice 2014-21 is relevant to NFTs purchased with virtual currency, it does not directly address the tax consequences of NFTs. Until additional guidance is issued, taxpayers will need to determine the tax consequences of their NFT transactions by applying general principles of existing tax law.

CPAs can guide individuals through the complex tax provisions as well as provide advice on how to both minimize taxes and ensure compliance with IRS reporting requirements. Due to the lack of guidance on NFTs, some individuals, particularly those already familiar with the tax consequences of cryptocurrency set forth in Notice 2014-21, may be under the erroneous impression that the same rules apply to NFTs. To avoid surprise tax liabilities, CPAs should explain to clients how NFTs differ from the fungible tokens addressed in Notice 2014-21, especially with respect to capital gains tax rates, loss disallowances, and market fluctuation issues. This article addresses these differences and explains the general tax rules for NFTs. In addition, NFT issues related to charitable gifting are discussed.

Capital Gain Tax Rates

Assets held for investment purposes are generally considered capital in nature and will generate capital gain or loss upon disposition (IRC section 1222). Short-term capital gains are taxed at the individual's marginal tax rate, which may be as high as 37% [IRC section 1(h)]. Although long-term capital gains are generally taxed at preferential rates of 0%, 15%, or 20%, capital gains resulting from the sale of "collectibles" are subject to a higher 28% maximum rate [IRC sections1(h)(1), 1(h)(F)(4)]. The IRS considers items such as works of art, antiques, metal or gems, alcoholic beverages, and stamps or tangible coins to be collectibles [IRC section 408(m)].

Fungible tokens like Bitcoins are indistinguishable from each other and could not be considered collectibles. The 28% rate for capital gains on sales of collectibles, however, may well extend to some or all NFTs, given their unique nature and similarity to physical collectibles. The resulting tax burden could be heavier than that anticipated under the cryptocurrency rules. Individuals with substantial NFT transactions should take this into account when calculating their estimated tax payments; they may also want to consider the possibility of generating capital losses to offset their gains.

Disallowance of Losses

Capital losses related to assets held for investment are deductible by taxpayers subject to capital loss limitations. Taxpayers are allowed to deduct capital losses to the extent of capital gains generated in the same period, plus an additional $3,000 deduction against other income. Any excess losses are carried forward indefinitely. Capital losses from the sale of personal use assets are disallowed [IRC section 165(c)].

Under Notice 2014-21, cryptocurrency is considered an investment asset unless held by a dealer. Accordingly, capital losses on cryptocurrency transactions are deductible, subject only to capital loss limitations. The classification of non-dealer NFTs is not as clear-cut. Similar to physical assets such as artwork or other collectibles, NFTs may be considered investment assets or personal use assets. This uncertainty creates the need for additional planning for NFT transactions to ensure that any capital losses generated will not be disallowed.

The treatment of losses under the tax code depends on the taxpayer's status as either an investor or collector. An art investor, for example, purchases artwork solely for the purpose of making a profit on its future sale, whereas a collector purchases the same artwork for personal use and enjoyment, without regard to whether the artwork will ever become a profitable investment. The burden of proof is on the taxpayer to establish an investment motive. Absent an investment or profit motive, NFT losses will be disallowed under the hobby loss rules (IRC section 183).

To increase the likelihood of securing "investor status," taxpayers must keep careful records demonstrating that their NFT activities are being conducted in an investment-like manner. (See Treasury Regulations section 1.183-2 for more details.)

Examples of Tax Treatment of Cryptocurrency and NFT Transactions

The following examples illustrate the differences between cryptocurrency and NFT transactions with respect to capital gains and losses. In Examples 1 through 4, assume that Jennifer is a single taxpayer whose marginal federal rate of tax on ordinary income is 32%.

Example 1: Jennifer purchases $10,000 of Bitcoin, which she uses six months later to purchase a digital art NFT priced at $14,000. The transaction results in a $4,000 capital gain. Because Jennifer held the Bitcoin for less than one year, her $4,000 capital gain is considered short-term and will be taxed at her marginal tax rate of 32%. If Jennifer's holding period on the Bitcoin had been one year or longer, her gain would have been considered a long-term capital gain.

Example 2: Jennifer purchases $10,000 of Bitcoin which she uses 18 months later to purchase a digital art NFT priced at $6,000, resulting in a $4,000 capital loss. This was Jennifer's only capital asset transaction. Bitcoin is considered an investment asset. allowing Jennifer to deduct her capital loss subject to capital loss limitations. Because she does not have any capital gain transactions, Jennifer will only be able to deduct $3,000 of her capital loss this year, and the remaining $1,000 will carry forward to future years.

Example 3: At six months after purchasing an art NFT for $14,000, Jennifer sells it for $18,000, resulting in a $4,000 capital gain. Because Jennifer held the NFT for less than one year, her $4,000 capital gain is considered short-term and will be taxed at her marginal tax rate of 32%. If Jennifer's holding period on the NFT had been one year or longer, her gain would have been considered long-term capital gain. However, Jennifer's $4,000 of capital gain will be subject to a higher 28% rate instead of the 0%, 15%, or 20% if her art NFT is considered a collectible.

Example 4: At 18 months after purchasing the art NFT for $10,000, Jennifer sells it for $6,000, resulting in a $4,000 capital loss. Unless Jennifer qualifies as an investor, her NFT will

be considered a personal use asset and her $4,000 capital loss will be disallowed. If she qualifies as an investor and has no capital gain transactions, Jennifer will be able to deduct $3,000 of her capital loss this year, and the remaining $1,000 loss will carry forward to future years.

Market Fluctuation Issues

The potential risks and rewards of ownership are much greater with NFTs than with fungible tokens such as cryptocurrency. The value of an NFT depends on its desirability in the marketplace, which is affected by many factors, most very difficult to predict in the short term.

Anticipating the value of a given NFT months or years from now is impossible, but this has not stopped investors from paying exorbitant prices. To name just a few, artist Beeple sold a digital compilation for $69.3 million, Twitter founder Jack Dorsey sold his first "tweet" in NFT form for $2.9 million, and artist WhlsBe sold a 16-second video clip of a rotating gummy bear skeleton for $1 million (D. Phillips, "The 10 Most Expensive NFTs Ever Sold," *Decrypt,* April 3, 2021; https://bit.ly/2SYqgjV). While high-dollar purchases are rare, many investors have paid thousands of dollars to purchase NFTs, some which are already exhibiting significant volatility. By May 2021, the aggregate value of NFTs was less than half of their reported April 2021 values (S. Kiderlin, "NFT prices are worth less than half what they were in April," *Markets Insider,* May 18, 2021; https://bit.ly/3j36PRz). Investors holding assets susceptible to huge swings in value have a greater need for tax planning and vigilance.

Capital Loss Limitations

For Examples 5 and 6, assume Max is a single taxpayer who qualifies as an investor in NFTs and has no other capital gain transactions in the current tax year.

Example 5: Max purchased a video clip NFT of a song written and performed by a popular singer for $1 million. Sixteen months later, the value of the NFT plummeted after the singer was accused of plagiarizing the song. Max ends up selling his NFT for $50,000, resulting in a $950,000 capital loss. As an investor, Max may deduct $3,000 of his capital loss in the current year. The remaining $947,000 capital loss will carry forward for an indefinite time period. Even if a client could eventually deduct all of such a large capital loss carryforward, a current-year deduction would usually be more beneficial because of the time value of money.

Example 6: The year before selling the NFT at a loss, Max sold several stocks for a total gain of $950,000, paying $190,000 in capital gains tax. If Max had sold the NFT in Example 5 in the same year as the stock sales, he would have been able to fully offset his stock sale gains against his NFT loss, resulting in zero tax liability and no loss carryforward.

As these examples illustrate, CPAs should advise their clients with NFT transactions the same way they advise clients on all other capital asset transactions. NFT transactions should be timed and managed considering a taxpayer's overall portfolio of capital asset transactions in a given year. An investor unwittingly generating a huge capital gain in one year and a huge capital loss one year later could experience a severe and unnecessary income tax disadvantage. As mentioned previously, the worst-case scenario would result if Max does not qualify as an investor. In that case, his $950,000 loss would be completely disallowed; thus, proper record-keeping for NFT transactions is essential.

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Charitable Gift Tax Planning

Individuals facing hefty tax bills from NFTs or other transactions may want to consider making charitable contributions to reduce their tax burden. In certain circumstances, donating an intangible NFT artwork may be more tax-advantageous and provide more flexibility than donating a comparable tangible work of art. Donations of intangible property are not currently subject to the same limitations as donations of tangible property. CPAs can help individuals choose which assets to donate and structure donations to optimize choices and tax benefits.

Example 7: Donna owns a painting originally purchased as an investment three years ago for $50,000 that is now worth $300,000. Donna would like to donate the painting to a cherished children's charity. Donna's adjusted gross income (AGI) for the year, without regard to the charitable contribution deduction, is $750,000.

The first step in calculating a deduction for donated property contributions of tangible assets is whether the asset, if sold, would give rise to income taxed as long-term capital gain or ordinary income. If treated as long-term capital gain, the donor is entitled to deduct the fair market value of the asset as a charitable contribution, subject to a 30% AGI limitation. If ordinary income results, the deduction is limited to the donor's cost basis in the asset, subject to a 50% AGI limitation [IRC sections 170(e)(1)(A), 170(b)(1)(B)].

Donna tentatively qualifies for a fair market value deduction because a sale of the painting would generate long-term capital gain. Personal tangible property is subject to a second threshold, however; a fair market value deduction is only allowed if the charity uses the donated property in a way related to its charitable purpose [section 170(e)(1)(B)]. Because the donee's mission is to reduce childhood poverty, as opposed to an art appreciation or education purpose, Donna will not be entitled to a fair market value deduction. Based on these facts, Donna's charitable deduction will be $50,000, her basis in the painting.

Example 8: Assume the same facts as in Example 7, except that instead of owning a physical painting, Donna owns an artwork NFT.

Donna is entitled to a fair market value deduction, subject to a 30% AGI limitation, or $225,000 ($750,000 × 30%). Because the donor use limitation does not apply to intangible or real property, the charity's use of the donated property or its relation to the charity's primary mission is irrelevant. Her excess contribution of $75,000 will carry over for a five-year period.

Example 9: Sam wishes to donate an NFT originally purchased two years ago for $200,000 and now worth $300,000. Sam's AGI without regard to the donation is $500,000.

Although a fair market value deduction is normally more advantageous for an appreciated asset, the optimal choice depends on the particulars of the taxpayer's situation, due to the differing AGI limitations. Although Sam is entitled to a fair market value deduction of $300,000 for the NFT, that option will only provide a deduction of $150,000 for the current tax year, after applying the 30% AGI limitation ($500,000 × 30% = $150,000). Sam could carry forward the excess $150,000 for five years. Or Sam could elect to take an adjusted basis charitable contribution deduction of $200,000 in the current year because that amount would not be further reduced by the applicable 50% AGI limitation ($500,000 × 50% = $250,000) [IRC section 170(b)(1)(C)(iii)].

Example 10: Sam wishes to donate an NFT originally purchased two years ago for $400,000 and now worth $200,000. Sam's AGI without regard to the donation is $500,000.

Sam should consider selling the asset and subsequently donating the proceeds to the charity. When loss property is donated, the donor's deduction is limited to the property's lower fair market value regardless of holding period (Revenue Ruling 79-419, 1979-2 CB 107). Thus, Sam's deduction would be limited to $200,000 and the loss potential in the property would disappear, because the charity's basis in loss property will be the property's fair market value of $200,000 rather than the donor's carryover basis of $400,000 under the split basis rules applicable to gifted loss property.

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Reporting Requirements

The 2020 federal income tax forms ask taxpayers specific questions regarding interests in cryptocurrency; taxpayers should be prepared to see similar questions about NFTs in the future. The IRS has now indicated that virtual currency transactions will need to be reported similarly to what is required on Form 1099 for securities dealers. However, the IRS has not required similar reporting for NFT transactions. In the event of an IRS audit, taxpayers may not have information from other parties to help substantiate how the transaction is reported. The IRS provides the following answer to Frequently Asked Questions regarding the maintenance of records for virtual currency transactions:

> *A46*. The Internal Revenue Code and regulations require taxpayers to maintain records that are sufficient to establish the positions taken on tax returns. You should therefore maintain, for example, records documenting receipts, sales, exchanges, or other dispositions of virtual currency and the fair market value of the virtual currency. (https://bit.ly/3voD943)

The burden is on the taxpayer to keep detailed records of all cryptocurrency and NFT transactions to comply with IRS requirements for establishing investor status, basis, and subsequent gain or loss calculations.

Prepare for Complexity

This article illustrates some of the complex potential income tax issues related to NFT transactions. CPAs need to be prepared to advise clients on the tax implications of virtual currency and NFT transactions. Taxpayers considering engaging in NFT investments should seek out a skilled tax advisor to help with reporting requirements and planning for the potentially significant income tax ramifications of such transactions. ■

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