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Taxation of The Purchase and Sale Of NFTs

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Given a lack of guidance on the tax treatment of non-fungible tokens (NFTs), taxpayers can be forgiven for experiencing a certain level of uncertainty with respect to how the Internal Revenue Service (IRS) will apply its tax rules to purchases and sales of these assets. IRS reasoning on other asset classes, however, sheds some light on this otherwise uncharted territory. This article reviews the various factors that are likely to play a role in determining the classification and treatment of NFT transactions for tax purposes.

IN-DEPTH

The taxation of NFTs has not been addressed in any of the pronouncements on cryptocurrency, digital tokens and other cryptocurrency-related digital assets from the IRS. As a result, general tax principles must be applied to identify the likely tax treatment of purchases, sales and other transactions involving NFTs, which are a form of digital tokens. (For a discussion of NFTs generally, see "Introduction to NFTs.") This means that the tax treatment of a purchase or sale of an NFT depends on a number of factors, including whether the seller created the NFT; whether the seller is a dealer, trader, investor, collector or personal user; how long the seller has held the NFT; whether the NFT has appreciated in the seller's hands; what type of property is used to purchase the NFT; and, if the buyer used appreciated property to buy the NFT, how long the buyer held the property.

CLASSIFICATION OF NFTs FOR TAX PURPOSES

The first question to be answered is whether NFTs are currency or property for tax purposes. In Notice 2014-21 (2014-16 I.R.B. 938) and the 2019 Frequently Asked Questions (FAQs, most recently updated March 2021), the IRS addressed the taxation of *convertible* cryptocurrency, which is cryptocurrency with an equivalent value in fiat currency (such as the US dollar) that can be purchased for or exchanged into such currency or used to buy goods and services. Under this definition, bitcoin (BTC) and ether (ETH) are convertible cryptocurrencies. According to the IRS, convertible cryptocurrency is property, not currency. As a result, the general tax principles that apply to property transactions apply to convertible cryptocurrency transactions.

Although Notice 2014-21 does not address the tax character of non-convertible cryptocurrencies or NFTs, given the IRS's reasoning, it is likely that other cryptocurrencies and digital tokens (including NFTs) are property for tax purposes. It stands to reason that if convertible cryptocurrency is not

treated as currency for tax purposes, other digital assets including NFTs will not be treated as currency.

CAPITAL OR ORDINARY ASSETS

Ordinary Assets

In the hands of creators of and dealers in NFTs, NFTs are ordinary assets. Such taxpayers have ordinary income and loss on their NFT transactions. (For a discussion of NFT creators, see "Taxation of NFT Creators.") For creators, an NFT is an ordinary asset because it is in the nature of a patent, model, copyright, literary composition, musical composition, artistic composition or similar property *created* through the taxpayer's personal efforts or is property that was prepared or produced for the taxpayer (Code § 1221(a)(3)). An NFT is also an ordinary asset in the hands of a dealer because the taxpayer is holding it as inventory or for sale to customers in the ordinary course of business (Code § 1221(a)(1)). An NFT dealer receives ordinary income and loss on sales of NFTs (Code § 61 and 1221(a)(1)).

For a taxpayer who is not a creator or dealer but, instead, uses the NFT in its trade or business, there are many tax issues that need to be addressed, including rules under Code § 1231 for property used in the taxpayers trade or business, so that gains might be capital and losses ordinary (In addition to Code § 1231, other relevant rules include possible recapture under Code § 1245, as well as the impact of Code § 1245(b)(8) on Code § 197 intangibles.)

Because an NFT is an intangible asset, creators cannot amortize their tax basis in an NFT. This is because Code § 197(c)(2) allows certain taxpayers—other than creators—to amortize tax basis on an intangible asset that was (1) acquired by the taxpayer and which is used in the taxpayer's trade or business or (2) is an investment activity described in Code § 212 (Code §§ 197(c)(1), (2)). If an amortizable NFT becomes worthless, a deduction might be available (Code §§ 197(f) and Treas. Reg. § 1.197-2(g)(1)(i)).

Capital Assets

NFTs held by traders, investors, collectors and personal users are treated as capital assets. Short-term capital assets are those that are held for one year or less, while long-term capital assets are held for more than one year. This statement of black-letter law, however, does not take into account all of the additional issues that need to be consider in addressing the taxation of NFTs held by these taxpayers. Some of these rules are mentioned in the remainder of this section.

Because NFTs are intangible assets, taxpayers holding NFTs for investment can amortize their adjusted basis in their NFTs (Code § 197).

A taxpayer's intent in acquiring an NFT must be established to determine if the NFT is a collectible or a personal asset not held for investment.

Collectibles

Collectibles are a unique category of items subject to a special capital gain tax rate. While the Taxpayer Relief Act of 1997 reduced the maximum capital gain rate to 20%, it left the maximum rate at 28% for collectibles. Collectibles include alcoholic beverages, works of art, rugs, antiques, stamps, certain coins, gems and precious metals (Code §408(m)). Because each NFT is unique, those that

are similar to works of art and other collectibles might be treated as collectibles. Those that are held for the long-term holding period are subject to the higher 28% capital gain rate. Taxpayers need to be aware of this higher rate so they properly report and pay estimated taxes. Short-term capital gains are subject to the same tax rates that generally apply to capital assets, without regard to whether they would be treated as collectibles. Losses on the sale of collectibles are subject to the limitations on losses that generally apply to capital assets.

It seems likely that those NFTs that qualify as works of art will be subject to the 28% maximum rate. Other types of NFTs, however, such as NFTs that represent ownership of actual assets or provide for experiences, might not be classified as collectibles, and would instead be subject to regular capital gain tax rates.

Personal-Use NFTs

Personal-use assets are assets that are neither held in a trade or business nor held for investment. Such assets include assets used by taxpayers in hobbies and for recreational use.

A taxpayer's intent is determinative as to whether an NFT is taxed as a personal-use asset. A taxpayer's NFTs would probably be treated as personal-use assets if the activities are too infrequent to rise to the level of investment activities, or the taxpayer does not maintain adequate books and records to support an investment intent.

If a taxpayer wants its NFTs to be considered as investments, the taxpayer has the burden of proving investment intent. Whether an activity is an investment turns on whether the activity is engaged in for profit, after considering all applicable facts and circumstances (Treas. Reg. § 1.183-2(a)). Treas. Reg. § 1.183-2(b) sets out nine factors for determining whether an asset is held for investment, without any one factor being determinative (Code § 183(d); Treas. Reg § 1.183-2(b)):

1. The manner in which the taxpayer carries out the activity
2. The taxpayer's expertise or that of the taxpayer's advisors
3. The time and effort expended to carry on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. Success in carrying on other activities
6. History of income and losses with respect to the activity
7. Amount of occasional profits, if any
8. Financial status of the taxpayer
9. Elements of personal pleasure or recreation

If an activity produces a profit during three or more years out of a five-year period, the taxpayer is presumed to be in the activity for profit, unless the IRS proves otherwise (Code § 183(d)).

Under Code § 212, a taxpayer with a personal-use NFT cannot deduct investment expenses because the taxpayer's expenses are not incurred for the production or collection of income. A taxpayer can, however, deduct certain expenses to the extent that gross income from these personal activities exceeds the tax deductions otherwise allowable to the taxpayer without regard to whether the activities were engaged in for profit (Code § 183(b)).

Personal-use assets are treated the same as other capital assets, with a few important differences:

- Gains are taxable as capital gains at the same rates as other capital assets.
- Expenses attributable to personal-use NFTs cannot be deducted except for those allowed under Code 183.
- Losses are not deductible (since tax changes in 2017).
- If a personal-asset NFT becomes worthless, losses are not deductible under Code § 165(c).

Sale or Exchange of an NFT

Because NFTs are recorded and generally transferred on a blockchain, NFTs are typically purchased using cryptocurrency, not fiat currency (although some NFTs can be purchased with fiat currency or with a credit card). When a taxpayer purchases an NFT using cryptocurrency to make the purchase, both the seller and the buyer have engaged in a taxable barter transaction. The NFT (property) is acquired using other property (cryptocurrency).

Sellers have ordinary or capital gain or loss, depending on whether the NFT is an ordinary or capital asset in the taxpayer's hands, as is discussed above. If the NFT is a capital asset, the taxpayer has capital gain or loss. If it is held for the long-term holding period (more than one year), the gain is taxable at the long-term capital gain rate, unless it is a collectible held for the long-term. Collectibles are subject to a 28% maximum rate. If an NFT is held for one year or less, gain is taxed at the taxpayer's short-term capital gain rate. Losses are subject to the limitations on capital losses, with losses prohibited on personal transactions.

A buyer paying for an NFT in fiat currency would not have a barter transaction and, as a result, would not have a taxable event on the purchase. (The tax laws do not treat US currency as appreciated or depreciated property in the hands of US taxpayers.) If an NFT is purchased with cryptocurrency, however, the transaction is treated as a barter transaction. Gain or loss is based on whether the cryptocurrency used to buy the NFT is appreciated or depreciated in the hands of the buyer. Gain or loss on the barter transaction is capital or ordinary, depending on whether the cryptocurrency used to make the purchase is a capital or ordinary asset in the buyer's hands.

For a buyer using cryptocurrency that is a capital asset in the buyer's hands to buy an NFT, the buyer has long-term capital gains or loss if the cryptocurrency was held for the long-term holding period. Gain or loss would be short-term if the buyer held the cryptocurrency for one year or less.

A buyer who holds appreciated cryptocurrency can avoid paying tax on the purchase of an NFT if the buyer does not use the appreciated cryptocurrency to make the purchase. Rather, the buyer can acquire the required amount of cryptocurrency in the market and deliver the newly acquired cryptocurrency in payment for the NFT. There would not be any appreciation in the newly acquired

cryptocurrency so the taxpayer would not have any gain or loss on the NFT purchase.

State Tax

Buyers and sellers of NFTs need to consider possible state taxation on their NFT transactions. Purchases and sales might trigger state income tax, sales tax and use tax. As a result, taxpayers need to be aware that different tax rules might apply to capital transactions and those generating ordinary income and loss. Some states, for example, tax capital gains as ordinary income, while others do not.

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