Proliferation of NFT Transactions Raises Numerous US Tax Questions

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Nathan W. Giesselman
Partner / Palo Alto
650.470.3182
nathan.giesselman@skadden.com

Carl R. Erdmann
Counsel / Washington, D.C.
202.371.7127
carl.erdmann@skadden.com

David Berke
Associate / Washington, D.C.
202.371.7569
david.berke@skadden.com

Martin de Jong
Associate / Palo Alto
650.470.3151
martin.dejong@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

Background on NFTs

With the market for nonfungible tokens (NFTs) exploding, NFTs attached to art, music, video clips, tweets and other digital collectibles have sold for significant sums: An NFT of an animated flying Pop-Tart cat sold for $600,000, and an NFT from the artist Beeple was auctioned for $69 million. Demand for such tokens does not appear to be slowing, and the Internal Revenue Service (IRS) and state tax authorities undoubtedly have (or will) take notice.

An NFT is a digital certificate of certain rights associated with an asset. NFTs are usually associated with digital assets, but NFTs representing rights to physical assets or experiences have also been minted. For example, the band Kings of Leon minted an NFT giving the holder the right to front-row concert tickets, and tennis professional Oleksandra Oliynykova auctioned an NFT for the right to determine what tattoo to put on her arm.

As other authors have described, for example, in a March 30, 2021, *Bloomberg Law* article, "NFTs Raise Novel and Traditional IP and Contract Issues," NFTs raise a multitude of intellectual property (IP) and contract law issues. As for tax considerations, while each NFT transaction may differ, two points are generally applicable. First, given the novel nature of the transactions, NFT minters, purchasers and platforms that allow users to buy and sell NFTs must consider a host of U.S. tax issues. Second, no direct guidance is currently available to resolve those issues, so open questions about the tax treatment of NFTs abound. The discussion below outlines a few of the more salient tax questions relevant to NFTs and considers how existing guidance could be applied to analyze them.

Background on Taxation of Digital Assets

Little guidance addresses the taxation of digital assets. The U.S. Internal Revenue Code has generally been written to apply to transactions involving physical assets and more traditional IP (*e.g.*, patents), and the IRS has struggled to issue timely guidance clarifying how the tax law applies to rapidly evolving technologies. For example, taxpayers are still awaiting final regulations addressing the taxation of cloud-based transactions.

The IRS has advised taxpayers that virtual currency (*e.g.*, bitcoin, Ether or other cryptocurrency) "is treated as property" for U.S. income tax purposes,[1] but has yet to issue guidance specifically addressing other digital assets that leverage blockchain technology, such as NFTs. However, the IRS virtual currency guidance is clearly relevant to many NFT transactions because NFTs are generally acquired in exchange for virtual currency. For example, taxpayers acquiring NFTs with virtual currency should be aware that such acquisition results in the recognition of gain or loss on the taxpayer's virtual currency.[2]

Therefore, unless and until guidance directly addressing NFTs is issued, taxpayers will have to analyze NFT transactions by applying general tax law principles, possibly through the prism of the existing (if sparse) IRS guidance on virtual currency.

[1] Notice 2014-21, 2014-16 I.R.B. 938.

[2] *Id.* at A-6.

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How To Characterize NFTs and NFT Transactions

As noted above, an NFT is essentially a digital certificate that entitles the holder to certain rights associated with an asset. Similar to the protocol with any other such certificate (*e.g.*, a deed of ownership or a stock certificate), the underlying rights and asset should dictate how to tax transfers and ownership of the certificate.

NFTs are generally associated with digital assets, which are treated as IP or intangible property, for tax purposes. Under U.S. law, any article of IP includes a "bundle of rights," and the holder of such rights can transfer some or all of them. For example, the copyright holder of a work generally has the exclusive right to reproduce, prepare derivative works of, publicly perform and publicly display that work for a certain period of time. The holder could choose to transfer all of these rights to a single transferee or to transfer certain limited rights (*e.g.*, the right to publicly display the work on certain platforms) to one or more transferees. Such rights can be transferred for the entire term or for a limited period, and can be transferred on either a nonexclusive or an exclusive basis. The scope of IP rights conveyed with an NFT can similarly vary widely.

For U.S. tax purposes, an important threshold question for a transfer of IP rights is whether the transfer constitutes a sale or a license. If the transfer is a sale, then the transferor can offset its amount realized on the sale by its basis in the IP rights. In other words, the taxable income on the transaction is limited to the transferor's gain in the property. If the IP rights were a capital asset to the transferor, then that gain on the sale is presumably eligible for long-term capital gains rates (in the case of individuals) if the rights were held for more than a year. If, instead, the transfer is treated as a license, then the transferor: (i) will generally recognize ordinary income (*i.e.*, royalties on the license); and (ii) will not be able to directly offset its income from the license with its basis in the IP rights, though such basis will continue to be amortized over future years.

Whether a transfer of IP rights is treated as a sale or license for tax purposes generally depends on whether the transferor transfers all "substantial rights" it holds in the IP. Whether all substantial rights are transferred depends on the overall facts and circumstances; whether the transfer is formally labeled a "sale" or "license" is not controlling. The more rights that are transferred, the more likely that the transfer is properly treated as a sale. For example, where a transferor holds all rights to a copyright, an exclusive license of all those rights for the term of the copyright would generally be a sale for tax purposes. By contrast, a nonexclusive license of certain rights to that copyright (*e.g.*, the right to publicly display the work) by that same transferor would generally be a license for tax purposes. However, if the transferor only holds certain rights to the copyright in the first instance (*e.g.*, the transferor only owns the right to publicly display the work), a subsequent transfer of all of those limited rights would likely be a sale for tax purposes, regardless of whether the transferred rights constitute a license for IP law purposes.[3]

As outlined in the March 30, 2021, *Bloomberg Law* article referenced above, the IP rights associated with an NFT can vary from one NFT to another. In general, however, purchasing an NFT does not provide the purchaser with exclusive ownership of all IP rights in the associated work, and instead conveys a very limited license, often limited to display of the associated work for personal purposes. This can result in differing tax treatment for the "primary" and "secondary" transferors of the NFT.

- In the primary transfer of an NFT — where the creator of/copyright holder for the work associated with the NFT transfers the NFT to an initial transferee — the transferor will need to determine whether it has sold the work associated with the NFT or merely granted a license. Because, as noted above, an NFT usually does not provide exclusive ownership of all IP rights in the associated work, most primary NFT transfers are likely to be treated as licenses for tax purposes.
- The secondary transfer of an NFT — where the NFT trades in the secondary market after that primary transfer — is likely to be treated as a sale. This is because in a secondary transfer, the transferor presumably transfers all of its limited rights in the associated work.

Put another way, because the secondary holder's rights associated with the NFT are likely to be limited in the first instance, that secondary holder is more likely to be transferring "substantially all" of its rights associated with the NFT. This is true regardless of whether the primary transfer is properly treated as a sale or license.

As described above, if the transfer of an NFT is treated as a sale, the transferor can generally offset its amount realized with its basis in the NFT. For such a sale, the tax consequences of any gain or loss will depend on several factors, including, in addition to the quantum and character considerations described above: (i) whether the transferor amortized any basis in the NFT and the underlying work (which would generally be subject to recapture at ordinary income rates); (ii) whether the transferor trades in NFTs as a mere hobby (which would limit the transferor's ability to deduct losses incurred in connection with NFT transfers);

[3] *Mylan Inc. v. Commissioner*, 111 T.C.M. (CCH) 1199 (2016); *MacDonald v. Commissioner*, 55 T.C. 840 (1971).

and (iii) whether the NFT is properly treated as a collectible (for which gains are generally subject to higher rates than they are in normal capital asset transactions).

If the transfer of an NFT is treated as a license, the transferor generally recognizes ordinary income, as noted above, but must consider a number of other tax consequences. In particular, any payment for the NFT would generally be treated as a royalty for tax purposes, which may raise sourcing questions and may require a U.S. transferee to withhold on the payment if the transferor does not certify itself as a U.S. taxpayer.

Holders of NFTs will have to carefully consider the terms of their NFT transactions to properly determine and report the resulting tax consequences.

How To Treat Costs Incurred in Creating an NFT

Creators of NFTs will need to determine how to treat costs incurred in developing and marketing their NFTs. If a creator makes NFTs as part of a trade or business, it can generally deduct or capitalize costs for tax purposes. A taxpayer usually prefers to deduct rather than capitalize costs, as a deduction reduces the taxpayer's tax liability for the current year while a capitalized cost is recouped over time. Subject to certain exceptions, the tax law generally requires that costs incurred in creating or enhancing a separate and distinct asset with a useful life beyond the current taxable year must be capitalized. Capitalized costs are part of an asset's basis, and can be recovered upon a sale of the asset or, in circumstances where the asset has an identifiable useful life, by amortizing the costs over the asset's useful life.

When considering the tax consequences of creating NFTs, creators will thus need to consider whether they are in a trade or business of creating NFTs (a factually intensive question), and if so, whether to deduct or capitalize costs incurred in creating NFTs.

Large-scale enterprises that seek to monetize existing IP via NFTs (*e.g.*, professional sports leagues or entertainment enterprises) will need to assess how to best structure their NFT arrangements for tax purposes. For example, such enterprises must consider how to contractually integrate their existing IP into their NFT business and how to draft the terms of their NFT agreements to ensure an efficient tax result. Additionally, such enterprises must determine how to account for an array of costs that were incurred in acquiring, developing and marketing the relevant IP long before the enterprise contemplated monetizing such IP via NFTs. In many cases, potentially all of the underlying costs will have previously been claimed as deductions, while, going forward, a portion of such costs might more properly be capitalized or deferred to offset potential NFT income streams. Smaller-scale creators of NFTs will have to quickly familiarize themselves with the tax rules applicable to creators and marketers of IP.

How To Report NFT Transactions

The IRS has demonstrated that it is highly focused on tax compliance and reporting for digital asset transactions. The agency's efforts have included a wide-reaching campaign in which the IRS issued letters to thousands of taxpayers for potential failures to report virtual currency transactions, as well as broad demands for virtual currency exchanges to provide user information.

Most recently, the IRS added the following question to the first page of the Form 1040 (U.S. Individual Income Tax Return) for 2020: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" As noted above, most NFT transactions to date have been effected in virtual currency. Individual taxpayers that exchange NFTs for virtual currency should be prepared to check "yes" to this question and report the tax consequences of such transfers on their 1040s.[4] Individual taxpayers that exchange NFTs for fiat currency will have to consider whether an NFT could itself be considered "virtual currency" for purposes of the 1040 question. Also, the IRS may expand the scope of this question in future filings to specifically encompass other digital asset transactions, such as NFTs.

In April 2021 testimony to the Senate Finance Committee, IRS Commissioner Charles Rettig stated that the IRS is prioritizing new rules for information reporting on virtual currency transactions. To date, marketplaces that effect transfers of virtual currency have operated without clear guidance. Any marketplace that effects transfers of NFTs must consider whether it is obligated to report NFT transactions to the IRS and what documentation it will need from users to satisfy such reporting obligations (*e.g.*, an IRS Form W-8 or W-9).

State and Local Tax Considerations

State and local tax authorities have issued even less guidance than the IRS has regarding the taxation of digital assets. Additionally, tax laws differ across states and localities. NFT stakeholders will therefore have to navigate a maze of questions in determining how to characterize and report NFT transactions for state and local tax purposes.

[4] Under current IRS guidance, the original acquisition of that virtual currency may not have been reportable if that virtual currency was acquired for fiat currency. *See Frequently Asked Questions on Virtual Currency Transactions*, A-5, IRS.gov (visited April 11, 2021).

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Most states impose an income tax. Generally, these states follow federal tax principles for purposes of computing taxable income.[5] A state then usually taxes resident individuals on all taxable income, and nonresident individuals and corporations on taxable income "sourced" to the state. For corporations, and in some states other types of entities, doing business in multiple jurisdictions, such sourcing is generally determined based on an apportionment formula.[6]

Whether the transfer of an NFT is treated as a sale or license for federal tax purposes will thus generally determine how the transfer is treated for state income tax purposes. However, certain transferors still must determine the source of any income resulting from such transfer. For an individual that transfers an NFT, as a hobby, where the associated asset is digital, the sourcing question is probably not imperative, as income from the transfer would likely only be taxed by the individual's resident state. However, individuals that transfer NFTs as a trade or business, corporations and other business entities will likely need to determine the source of any income from their NFT transfers in order to properly apportion such income among different states. For personal income tax purposes, states usually source income from the transfer of a tangible asset based on where the asset is located, but income from transfers of intangible assets is generally sourced only to the state of the transferor's domicile unless the transferor is transferring that intangible asset as part of a trade or business. Corporations or other entities conducting a trade or business would generally source such income by reference to the state of domicile or principal place of business of the transferee. Because NFTs associated with digital assets can easily be transferred without any information regarding the transferee's location, transferors may have difficulty sourcing income from NFT transfers.

[5] For example, in California, corporations and individuals generally calculate their income tax liability by starting with their federal taxable or adjusted gross income respectively and then make state-specific adjustments. *See* 2020 California Form 100 (California Corporation Franchise or Income Tax Return); 2020 California Form 540 (California Resident Income Tax Return).

[6] California, for example, requires most corporations to pay state income tax based on a "single sales factor apportionment" method (Cal. Rev. & Tax. Cd. § 25128.7). This generally requires that a corporation pay California income tax based on the portion of its total sales that are made in or to California.

In addition to income tax, states and localities often impose sales and use taxes. Most states impose such tax on sales of tangible personal property and certain services. Some jurisdictions also impose such tax on transfers of certain types of digital property. For example, Texas imposes sales tax on the transfer of a digital product if the product would be taxable if delivered in physical form.[7]

Sales tax, if applicable, is generally imposed by the jurisdiction where the transfer of possession occurs. Use tax is generally imposed by the jurisdiction where the good or service is used or consumed. Where a physical asset is sold, where the good is transferred or used, and thus which jurisdiction could impose tax, is usually easy to determine. For the sale of a digital asset, however, this determination can be significantly more difficult. The location of the sale is likely to be determined based on the state of residence of the transferee, or the state where the digital asset is stored, used or viewed. Taxpayers will need to collect this information even though NFT transfers often occur without noting any information regarding the location of the transferee. In addition, since NFTs are stored on blockchains, which are computer networks distributed over multiple geographic locations, determining where an NFT is "stored" is not readily apparent. The same might also be true of the underlying digital asset, which may be stored on a form of distributed network. Further complicating matters is that states have different standards regarding whether remote sellers (*i.e.*, sellers based outside the state or making only casual or isolated sales) are obligated to collect and remit any applicable sales and use tax.

Given the above, NFT transferors and marketplaces will have to carefully consider what information they need from transferees in order to comply with state and local tax obligations. States may issue direct guidance regarding the taxation of digital asset transfers, but until then, NFT stakeholders will have to answer their state and local tax questions by reference to law enacted long before anyone contemplated paying $600,000 for certain rights to a flying Pop-Tart cat image.

[7] *See* Texas Policy Letter Ruling No. 200101966L (Jan. 3, 2001).