Tax Considerations for Transactions of Non-Fungible Tokens

by Sonia K. Kothari and Louis Lehot

Sonia K. Kothari

Louis Lehot

Sonia K. Kothari is a senior counsel in the tax group and Louis Lehot is a partner in the business law group of Foley & Lardner LLP.

In this article, Lehot and Kothari examine the potential federal tax treatment of non-fungible tokens, and they emphasize that taxpayers would welcome even informal guidance on the topic.

I. Introduction

Creators, investors, users, and dealers of non-fungible tokens (NFTs) are at the forefront of the intersection of art, music, sports, entertainment, and technology — and they are simultaneously charting a new path when it comes to U.S. federal income tax considerations.

According to published estimates, 2021 saw more than $22 billion in global sales of NFTs, with an excess of 104 new NFT start-ups getting funded with more than $2 billion.

After discussing what NFTs are and how they are created, sold, and used, we will discuss some of the federal income tax issues for the various participants in the marketplace. Given the lack of specific guidance from the IRS and other government authorities, taxpayers must apply general tax principles to determine the tax treatment of NFT transactions.

II. What Is an NFT?

NFTs are powering the new iteration of the World Wide Web based on blockchain technology, which incorporates decentralization, privacy, and tokenization of digital assets and is commonly referred to as "Web3." Tokens can be either fungible or non-fungible assets, depending on whether the content is interchangeable. If they are interchangeable, or fungible, they are not uniquely identifiable — when you pay for a gallon of gas with a 20-dollar bill, no one cares which 20-dollar bill it is; it's fungible.

Typically, fungible tokens are referred to as "cryptocurrencies," like bitcoin, ether, or solana. Sometimes these cryptocurrencies represent a fractional interest in an enterprise or business, or the right to future profits. If so — or if the capital raised from the sale of the cryptocurrency is used to build a business — then it may be a security. In a Web3 ecosystem, fungible tokens provide a decentralized, secure, and private way for users to make payments to each other without any intermediary.

NFTs, on the other hand, are unique assets that are verifiable and distinct, and typically are representations of real-world objects like art, music, in-game items, and videos. NFTs provide a whole new way to monetize content by breaking it into parts and allowing for its digital realization and exchange.

NFTs are created or "minted" on marketplace platforms like OpenSea, Rarible, or Foundation and then listed for primary sale or secondary resale. Each has a digital signature that is unique and impossible to be exchanged for or equal to another.

A marketplace distributes payments and can therefore trip over "money transmitter" rules under federal, state, and local laws. Content creators can avoid money transmitter laws if they partner with a marketplace that is a licensed money transmitter. The market for NFTs has exploded with the proliferation of Web3 business models. NFTs had a market capitalization exceeding $7 billion in a mid-2021 report. OpenSea reported more than $6.5 billion in NFT trading volume in 2021 alone. There were more than 265,000 active wallets that traded NFTs on the ethereum blockchain in the third quarter of 2021 alone. Twitter co-founder and former CEO Jack Dorsey minted an NFT for his first tweet that sold for more than $2.6 million.

As more investors buy, sell, and hold NFTs, it's time to start thinking about how to report them on tax returns.

III. U.S. Federal Income Taxation of NFTs

A. IRS Guidance

IRS guidance on the taxation of digital assets is sparse. To date, the agency has issued one notice[1] on virtual currency transactions; FAQs[2] on virtual currency transactions for taxpayers who hold virtual currency as a capital asset; one revenue ruling[3] related to the taxation of hard forks and airdrops; and a few legal memoranda.[4] The notice defines virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value," and provides that virtual currency is treated as property and not as currency that could generate foreign currency gain or loss for U.S. federal income tax purposes.

The taxation of NFT transactions has yet to be addressed in any formal or informal IRS guidance. Thus, taxpayers must use the existing statutory, regulatory, judicial, and subregulatory framework to determine the tax treatment of NFT transactions. The following discussion uses general tax principles to consider the likely tax treatment of NFT creators, investors, non-dealers, and dealers.

B. Creation

The creation of an NFT generally shouldn't be a taxable event until the creator receives income from its sale.

1. Sale.

Income from the sale of an NFT generally will be treated as ordinary income. Under section 1221, a "capital asset" is "property held by the taxpayer" other than "a patent, invention, model or design (whether or not patented), 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." Thus, an NFT likely wouldn't be treated as a capital asset in the hands of the creator, and the income from the sale would be taxed at ordinary income rates, which now are a maximum rate of 37 percent for individuals and 21 percent for corporations.

2. Business vs. hobby.

If the creator is carrying on a trade or business of creating or minting and selling NFTs, she would be allowed to deduct some ordinary and necessary business expenses from the gross NFT sales proceeds to reduce her taxable business income. However, she would be subject to self-employment tax on the net earnings from the business.

If instead the creator is considered a hobbyist — that is, she isn't engaging in the activity of the creation and sale of NFTs for profit — expenses related to the creation of the NFT generally aren't deductible, and any losses are disallowed. The proceeds from the activities would be "other income" not subject to self-employment taxes.

[1] Notice 2014-21, 2014-16 IRB 938. The notice describes how existing general tax principles apply to virtual currency transactions in a question-and-answer format.

[2] IRS, "Frequently Asked Questions on Virtual Currency Transactions" (last updated Mar. 23, 2022). These FAQs are updated periodically and are intended to supplement the notice but, notably, are limited to virtual currency transactions and don't address other types of digital assets.

[3] Rev. Rul. 2019-24, 2019-44 IRB 1004.

[4] ILM 202035011 (convertible virtual currency received in exchange for performing a microtask through a crowdsourcing platform is taxable as ordinary income); ILM 202114020 (taxpayer who received bitcoin cash as a result of a bitcoin hard fork had gross income because the taxpayer had accession to wealth under section 61); and ILM 202124008 (exchanges of bitcoin, ether, and litecoin weren't eligible for tax-free exchange treatment under section 1031 even if completed before 2018, when the Tax Cuts and Jobs Act limited like-kind exchange treatment to real property).

3. Royalties.

Another possibility is that the creator has ongoing royalty income through a "smart contract" that automatically provides a payment when the NFT is used or resold. A creator can use a smart contract to build into the marketplace the desired economics of secondary sales, royalties, transaction costs, and other terms of use following the primary sale. As with royalty payments on patents, copyrights, and other intellectual property assets, these payments may continue for years after the NFT is initially created and sold. Royalty income generally is taxable as ordinary income and may also be subject to the 3.8 percent net investment income tax.

4. Virtual currency.

NFT sales generally are transacted in cryptocurrency and not fiat currency. If the purchase price is paid in cryptocurrency, gross proceeds from the sale equal the fair market value of the cryptocurrency on the date of the transaction. This amount would also be the tax basis of the cryptocurrency in the hands of the creator, which would be used to determine whether there is gain or loss on the ultimate disposition of the cryptocurrency. Any gain on the disposition of the cryptocurrency would be treated as capital gain and would be eligible for long-term capital gain treatment if the cryptocurrency is held for more than one year from the date of acquisition of the cryptocurrency.

C. Secondary Purchase

Regardless of whether it is being purchased as an investment, for personal use, for use in a business, or to be sold by a dealer, the purchase of an NFT on a marketplace could be a taxable event if cryptocurrency is used to purchase it.

A buyer may be subject to tax on the disposition of cryptocurrency used to purchase an NFT because the cryptocurrency is treated as property under the notice. The amount of taxable gain would be the difference between the basis (generally, the cost) in the cryptocurrency used to make the purchase and the FMV of the cryptocurrency on the date of the NFT purchase.

For example, if a buyer purchased an NFT for 3 ethereum (ETH) at a time when the FMV of 3 ETH was $9,000, and the buyer's cost basis in the 3 ETH was $6,000, the buyer would have taxable income of $3,000, even though she received no U.S. dollars in the exchange. The rate of tax would be determined by the amount of time that the buyer held the ETH — if it was more than one year, the gain would be characterized as long-term capital gain and generally would be taxed at preferential rates for individuals and other noncorporate taxpayers, currently a maximum rate of 20 percent, plus an additional 3.8 percent NII tax. The buyer's holding period in the NFT would begin on the date that she purchased the NFT, not on the date that she purchased the ETH that she exchanged for the NFT. Interestingly, CCA 202124008 indicates that even if section 1031 was in pre-Tax Cuts and Jobs Act form, the exchange of ETH for an NFT likely would not be eligible for tax-free like-kind exchange treatment.

1. NFT held for investment.

If a buyer — which could be an individual or a business — holds an NFT for investment for more than one year, the profits on the sale likely would be characterized as long-term capital gain and could be subject to preferential rates. If the NFT is held for one year or less, the profits would be characterized as short-term capital gain and would be taxed at ordinary income tax rates.

An NFT could be classified as a collectible, so that the gain on disposition would be subject to a higher 28 percent rate of tax under section 1(h)(4). Section 408(m)(2) defines a "collectible" as: 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 by the IRS for this purpose. Because each NFT is unique, some NFTs that are similar to works of art or other listed collectibles could be subject to this higher rate of tax.

The gain on disposition of an NFT held for investment may also be subject to the 3.8 percent NII tax.

2. Nonbusiness use.

Personal use property is generally defined as property that is neither held for investment nor used in a trade or business. The taxpayer's intent determines whether an asset is considered held for investment or for personal use. An example is an NFT purchased on a marketplace by an individual for use in a video game. When the buyer later sells the NFT, she would be taxed on any capital gain, but losses generally wouldn't be deductible.

3. Dealers.

For a buyer who holds NFTs primarily for sale to customers in the ordinary course of her business (that is, a dealer), an NFT wouldn't be a capital asset. Dealers may deduct ordinary and necessary expenses associated with the business and will recognize ordinary income on the net proceeds from the sale of an NFT. If an NFT is considered a "security" for income tax purposes, a dealer may be required to account for gains and losses on a mark-to-market basis. This classification is unlikely for most types of NFTs.

4. Business use.

A business may purchase an NFT to use in its business rather than for resale to its customers. For example, a business might commission a creator to create a business logo for use in marketing materials. The business may be permitted to depreciate the purchase price of the NFT over the course of the years that the NFT is in use. If the NFT is later sold for a profit, some of the depreciation deductions could be subject to recapture and treatment as ordinary income. Any remaining gain could be treated as long-term capital gain.

IV. Conclusion

Although the IRS hasn't provided specific guidance on the classification of NFTs, existing rules, regulations, case law, and informal guidance provide an adequate framework for determining the proper tax treatment of the creation, purchase, use, and sale of NFTs.

In addition to the federal income tax issues discussed here, NFT transactions and uses implicate many other local and international tax issues such as state and local income tax; sales or use taxes; installment sales; valuation issues surrounding gifts, bequests, and charitable donations; and identification of counterparties for information reporting to the IRS. Recent statements by members of Congress and the Biden administration suggest that more guidance is coming. In the meantime, any informal guidance from the IRS would be welcomed by taxpayers engaged in this increasingly popular new asset class. ■