

IRS Speaks—Sort of—on NFTs and “Collectibles”

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Introduction

Until Notice 2023-27,¹ the Internal Revenue Service (IRS) was silent about the tax treatment of nonfungible tokens (NFTs). When the IRS turned to NFTs, it focused on one aspect of NFTs: whether certain NFTs should be taxed as “collectibles.” This means that the government has sort of spoken about collectible NFTs, but it has remained silent on other aspects of taxing NFTs. Without comprehensive guidance, the door remains open for taxpayers to find creative ways to avoid taxes.² Without IRS guidance, taxpayers must analogize NFTs to other types of property, such as virtual currencies and other digital assets, to determine how to tax NFTs.³ As digital assets, NFTs have similarities to cryptocurrencies like bitcoin (BTC) and Ether (ETH), but they also have some unique, defining features we discuss in this article.

The government has provided limited guidance on digital assets generally. Starting with Notice 2014-21,⁴ the IRS addressed convertible virtual currencies and how they are property for federal income tax purposes. In 2019, the IRS issued Rev. Rul. 2019-24 addressing whether the receipt of cryptocurrencies from a hard fork or airdrop results in taxable income to the recipient. It also issued Frequently Asked Questions (FAQs) in 2019, which it has updated since then.⁵ The IRS Office of Chief Counsel has issued various advice memoranda addressing how specific federal income tax principles apply to cryptocurrencies (such as the like-kind exchange rules and when an asset is worthless).⁶

In Part I, we describe the technological qualities of NFTs, which is critical to understanding how to treat NFTs for tax purposes. In Part II, we introduce Notice 2023-27, while in Part III, we explain the interim guidance provided in the Notice. In Part IV, we look at what normally qualifies as a “collectible” for tax purposes, and in Part V, we discuss the tax consequences of classification as a collectible. We wrap up in Part VI by discussing the proposed “look-through” rule, raising some open questions.



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Part I: What Are NFTs?

An almost unknown product in 2020, NFTs skyrocketed to prominence in 2021, with a capitalization of only \$91 million at the beginning of 2021.⁷ In 2021, it was estimated that nearly \$30 billion of NFTs had been sold since inception⁸; market data from early 2023 reflects an increase in the average price of NFTs.⁹ One common prediction about NFTs is that “[t]he NFT market size is expected to grow by at least 33% year over year and is forecasted to reach approximately \$80 billion in net sales volume by 2025 and nearly \$350 billion by 2030.”¹⁰ For people unfamiliar with the impact of NFTs, an often-cited 2021 transaction has made its way into NFT folklore. It is the sale of artist Beeple’s NFT work “Everydays: The First 5000 Days,” which sold for a record high price of \$69.3 million.¹¹ This sales price obliterated the prior record high price for an NFT of \$6.6 million, set just a few weeks before.¹² In recognition of the impact the term NFT has had on our Lexicon, NFT was the Collins Dictionary’s 2021 word of the year.¹³

The Notice shows that the IRS has tipped its hand. It is likely to treat certain NFTs as collectibles. But what about other digital assets?

An NFT is a unique digital asset that is often—but not always—recorded and transferred on a blockchain, that is, a type of a digital ledger¹⁴ used to identify NFT ownership.¹⁵ NFTs can be a representation of something: a media file (such as a digital work of art or a digital trading card), a token in the metaverse, or proof of ownership.¹⁶ An NFT can be a single, one-of-a-kind item or it can be one of any number of replicas of the same content. Just about anything can be represented in an NFT. NFTs record ownership of digital media by programming the NFT with metadata that provides a link to a digital image, song, video, tweet, or other media that exists in digital form.¹⁷ Thus, the NFT can exist as a digital file, while the media can exist in a separate digital database.¹⁸ The location of the media file is programmed into the NFT to allow it to “point” to the location of the media file.¹⁹

As the technology has evolved, the use cases for NFTs have expanded to include access to experiences, events, concerts, physical goods, and services.²⁰ Take, for instance, the apparel retailer GAP. In 2022, GAP launched a collection of 100 NFTs with artist Brandon in an effort to promote scarcity and, unlock physical clothing for \$415.²¹ Similarly, in April 2023 apparel retailer Ralph Lauren sold NFTs that can be used to register for tickets to a private party at an estate in Miami, Florida.²² NFTs can also have practical business uses, such as enhancing record-keeping obligations, such as in a production supply chain or property title registries.²³

Each NFT, regardless of what it represents, has its own unique metadata, making it nonfungible, so it is not interchangeable with another NFT or any other digital or non-digital property.²⁴ This is true even when the NFT is a replica of other content.²⁵ When an NFT is created or “minted,” it is often listed on an NFT marketplace like OpenSea, Rarible, or SuperRare.²⁶ As “smart contracts,” NFT metadata includes the contractual terms and conditions that govern their use.²⁷ For example, NFT creators embed terms and conditions that apply to NFT use and resale, merchandise that is available in connection with the NFTs, and royalties and other property rights.²⁸

NFTs are generally sold for an agreed-upon amount of cryptocurrency or the digital token that is native to the blockchain on which the NFTs are recorded.²⁹ In some jurisdictions, some NFTs can also be purchased using actual currency or with a credit card.³⁰ As nonfungible items, the value, if any, of an NFT is only what a willing buyer will pay a willing seller.

Part II: IRS Notice 2023-27

In Notice 2023-27, the IRS defines an NFT as a “unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset.”³¹ It views NFTs as having two parts: the digital file itself and the property or rights to which the file provides access.³² According to the IRS, NFTs involve a look-through aspect—whatever it is that the digital file “looks through to—whether it is a physical object, digitized assets, or rights.”³³ The Notice is unique in several respects.

- First, it was drafted by the Employee Benefits, Organizations, and Employment Taxes Division of the IRS, which tells us that a key focus is on retirement plans and other exempt organizations.

- Second, the IRS said it intends *in the future* to issue guidance as to the treatment of certain NFTs that should be classified as “collectibles.” This signals a more cautious government approach to issuing guidance about digital assets. Instead of issuing a Notice or publishing FAQs—without providing an opportunity for public comments before stating the IRS’ positions—the IRS is asking for comments.
- Third, the Notice appears to acknowledge that certain types of IRS sub-regulatory guidance must follow the notice and comment provisions of the Administrative Procedure Act.³⁴

In seeking public comments, the Treasury and the IRS ask if the Notice provides an accurate definition of an NFT, or whether other NFT definitions should be used in future guidance.³⁵ This comment request signals that the IRS is attempting to work with the industry to best address this emerging technology.

Part III: Interim Guidance

Whether an NFT is a “collectible” is important for at least two reasons. First, under Code Sec. 408(m)(1), an acquisition of a collectible by an individual retirement account (IRA) or by an individually directed account is taxed as a distribution from the account in an amount equal to the cost of the collectible. Second, collectibles that are capital assets are taxed at a maximum long-term rate of 28 percent, which is higher than the highest long-term capital gain rate of 20 percent that applies to other capital assets.³⁶

According to the IRS, whatever the rights or assets that the digitized file “looks through” to is a Code Sec. 408(m) collectible, the IRS is proposing to treat the NFT, itself, as a collectible.³⁷ By way of example, if an NFT certifies the ownership of a certain gem, which is a collectible under Code Sec. 408(m), the NFT itself is a collectible.³⁸ On the other hand, if the NFT provides “a right to use or develop a ‘plot of land’ in a virtual environment,” such as in the metaverse,³⁹ it is not a collectible.⁴⁰ In Notice 2023-27, the Treasury and the IRS make it clear that they are seeking comments as to whether an alternative analysis might be more appropriate than this look-through analysis. They ask questions such as, what burdens does the analysis impose? How might the analysis be applied to an NFT with more than one associated right or asset where one is a collectible, but another is not? How might the potential for an NFT owner to receive additional rights or assets (such as receiving additional NFTs) be treated?⁴¹

Part IV: What Are Collectibles?

Code Sec. 408(m) collectibles include art, rugs, antiques, metals, gems, stamps, coins (with certain exceptions for gold, silver, and platinum coins), alcoholic beverages, musical instruments, historical objects, and other “tangible personal property” as defined by the Treasury.⁴² In addition to tangibility, collectibles also are scarce, unique, and sought after. With that said, NFTs are likely to be intangibles.

Once again, with so many unresolved questions, taxpayers should consult their tax advisors.

The Financial Accounting Standards Board (FASB) defines an “intangible asset” as an asset that lacks physical substance.⁴³ Based on its definition, FASB has determined that crypto assets should generally be accounted for as intangibles.⁴⁴ Thus, we know that at least for financial accounting purposes, NFTs are intangible assets. Under such an analysis, NFTs in and of themselves would not be considered Code Sec. 408(m) collectibles.

In the context of an NFT, however, the definitions of “collectibles” and “tangible” are not likely as straightforward as the FASB’s analysis. Thus, the Treasury and the IRS ask in Notice 2023-27:

- Can a digital file itself constitute a “work of art” and thus a collectible under Code Sec. 408(m)(2)(A)?
- Can a digital asset be “tangible personal property” under Code Sec. 408(m)(2)(F)?
- What factors might be relevant if the NFT’s associated right is less than full ownership of an asset (for example, if the associated right is simply personal use of a digital file)?⁴⁵

Part V: Tax Consequences of an NFT Being a “Collectible”

Should the IRS proceed forward with its logic of Notice 2023-27, it is likely that it will ultimately issue guidance that designates certain NFTs as a type of asset that can be a collectible. Under Code Secs. 1(h)(4) and (5), the sale or exchange of a collectible that is a capital asset held for more than one year is taxed at a maximum of 28 percent

capital gains tax. Other long-term capital assets are taxed at a maximum of 20 percent rate.

Beyond the higher tax rate, qualified retirement plans and IRAs are explicitly prohibited from holding collectibles.⁴⁶ Generally, an IRA that purchases a collectible is treated as having made a distribution in an amount equal to the cost of the collectible to the IRA account holder.⁴⁷ Thus, if a retirement plan or an IRA fiduciary invests in an NFT taxed as a collectible, the contribution is automatically treated as a taxable distribution to the participant or IRA owner. This deemed tax distribution is triggered without regard to whether there is an actual distribution to the plan participant or to the IRA owner.

The trustee of a retirement plan or an IRA custodian is required to issue a Form 1099-R to the participant/owner to report the fair market value of the collectible as taxable income in the year it was acquired.⁴⁸ This would be true for NFTs that are designated as collectibles under the “look-through” rule.

Notice 2023-27 may have a significant impact on the self-directed IRA market. In 2022, the Department of Labor issued guidance cautioning 401(k) plan fiduciaries to exercise extreme caution before allowing a participant to invest plan assets in cryptocurrencies. This guidance was prompted by the risks and challenges that cryptocurrencies present, but the guidance, however, does not appear to extend to IRAs because it was specifically addressed to 401(k) plan fiduciaries.⁴⁹ In fact, self-directed IRA products that allow investments in BTC and other cryptocurrencies are becoming more popular. We have seen a large increase in digital assets being offered to IRAs as investment options. Such investments will likely require analysis under Code Sec. 408(m) and Notice 2023-27.

Part VI: Look-Through Rule

If an NFT’s digital file reflects ownership (license rights) to something else (digital assets), the look-through rule might make sense on its face. At the same time, it raises several unanswered and important questions.

- How far can the look-through approach go?
- How many layers of digital files might need to be peeled back to get to a digital asset that could be treated as a work of art?
- Can digital files ever be tangible personal property under Code Sec. 408(m)(2)(F)? If not, does the look-through analysis need to be limited to NFTs

that ultimately reflect ownership of a tangible asset such as art and gems?

- What approach should taxpayers take if an NFT contains both a digital file and a non-digital file (*i.e.*, a concert ticket that is combined with a unique digital image)?
- What about NFTs that provide for more than one associated right or asset where one is a collectible and others are not?
- What if the owner of the NFT has received additional rights or assets, such as additional NFTs?

The IRS sets out two simple examples of whether an NFT’s digital files reflect a collectible. First, if an NFT certifies ownership of a gem, it constitutes a collectible under Code Sec. 408(m)(2)(C).⁵⁰ Second, the NFT is not a collectible if its associated right or asset is a right to develop a plot of land in the metaverse.⁵¹ As a result, not all NFTs fit cleanly into these two simple categories.

The IRS acknowledges that NFT digital files do not fit the statutory categories of collectibles except, perhaps, the category for “art.” But can a digital asset (reflected in an NFT’s digital file) ever be art? This is a threshold question that many are asking, while NFTs are being sold by reputable auction houses and traditional art dealers.⁵²

- If NFTs can be art, who decides what is a “work of art”?
- Not every visual representation of something is art. When does a digital asset go from merely being a digital representation of something to being a work of art?
- Must the NFT owner be granted ownership in a tangible asset?
- Is ownership in a tangible asset the test of when an NFT represents a work of art?

Conclusion

Notice 2023-27 has a limited focus and we are glad that the IRS is requesting comments on the definition of an NFT, the look-through analysis, and other key issues. However, the Notice does not address other important questions about how NFTs are or should be taxed. It says nothing about the federal income tax treatment of NFTs held by dealers or creators of NFTs remains unclear. When held by this type of owner, an NFT may be considered ordinary property as inventory or a creative intangible, not a collectible. The Notice also does not signal if an NFT will be subject to the recently enacted broker reporting rules for digital assets. This is a critical shortcoming of Notice 2023-27. We can only speculate as we write this as to whether the IRS and the Treasury might be considering

the possibility of extending this NFT look-through to other areas of the tax law. For example, might they apply it to digital tokens that grant ownership right in stock or securities to investors?⁵³

The Notice shows that the IRS has tipped its hand. It is likely to treat certain NFTs as collectibles. But what about other digital assets? Once again, with so many unresolved questions, taxpayers should consult their tax advisors.

ENDNOTES

* The material in this article expresses the individual views of the authors, is for general information only, and is not intended to serve as a source of legal advice for any purpose. No readers of this material should act or refrain from acting on the basis of this material without seeking legal advice from counsel.

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¹⁹ *Id.*

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²⁹ Benedict George, *Can You Buy NFTs Without Owning Crypto?*, CoinDesk (May 11, 2023), www.coindesk.com/learn/can-you-buy-nfts-without-owning-crypto/.

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³¹ Notice 2023-27, IRB 2023-15, 634.

³² *Id.*

³³ A digital file is different from a digital asset, as defined in Code Sec. 6045(g). For purposes of reporting by brokers under Code Sec. 6045(g), a digital asset is defined as any digital representation of value that is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Treasury Secretary.

³⁴ See *Mann Constr., Inc.*, CA-6, 2022-1 USTC ¶50,122, 27 F4th 1138 (2022).

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³⁶ Code Sec. 1(h).

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⁴² Code Sec. 408(m)(2). The definition of collectible is also relevant to Code Sec. 45D (new markets tax credit); Code Sec. 1397C (enterprise zone business defined); Reg. §301.6111-1T; Q&As-24 and -57E (tax shelter registration); and Notice 2004-50, 2004-2 CB 196, Q&A-65 (regarding permissible investments for health savings accounts).

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