*Page 1523 - 1532* **DOI:** https://doij.org/10.10000/IJLMH.114194


# INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

## [ISSN 2581-5369]

**Volume 6 | Issue 1**

**2023**

# A Study on the United States Taxation Laws on NFT

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## ABSTRACT

*The objective of this paper is to provide an insight into the applicability of taxation regarding non-fungible tokens, known as NFTs and the issues regarding it from the United States perspective. Since the advent of Cryptocurrencies, they have attracted the interest of the financial world as they have revolutionised the economy with transactions that are virtually costless. However, NFTs have lately entered the global market, which has made it possible to redesign the modern financial infrastructure. Due to the continued ambiguity surrounding NFT taxation laws, taxpayers must depend primarily upon the existing cryptocurrency tax framework to resolve NFT taxation. However, the cryptocurrency framework does not completely address all problems pertaining to NFT taxation. Even though cryptocurrencies have generated a lot of interest and popularity among NFT investors, they have also caught the attention and concern of tax authorities. With the rapid growth of the digital era and its expanding influence on the financial world, it is vital to establish a solid set of legislation to regulate NFT. The qualitative nature of the study primarily relies on the I.R.C code, along with shedding light on various policies adopted by the I.R.S on the matter.*

***Keywords:*** *NFT, Cryptocurrencies, Taxation.*

## I. INTRODUCTION

Non-fungible tokens (NFTs) are a recent concept that has revolutionised the digital art market and captured the interest of internationally acclaimed art investors and collectors. It includes images, audio, and videos and can be collected, sold, or traded on various digital platforms basically.

Introduction, NFTs are just like any other physical collectible items, but only digital.[3] A non-Fungible Token is a unique digital asset that is non-interchangeable with an authenticated ownership and is stored in a database known as a blockchain.[4]

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[3] Megan L. Jones, Department: Tax Tips: Taxation Guidance For Non-Fungible Tokens, 44 L.A. L.A.W. 16 (Oct. 2021).
[4] Chevet, S.: Blockchain technology and non-fungible tokens: Reshaping value chains in creative industries.

NFTs are a legitimate method to transfer ownership of any physical item present on the record. They are solely used to signify ownership, which is recorded in a blockchain and cannot be tampered. Blockchain makes it possible to keep track of a token's past sales history and current owner. NFTs are limited to single ownership at a time.[5] However, due to the use of Blockchain Technology, ownership verification and transfer of tokens during the transactions are made easy. The blockchain technology that NFTs employ enables tracing back to the original artist of the artwork associated with the NFT, removing any ambiguity as to who created the artwork.[6] Because of blockchain technology, fraud has been considerably reduced, allowing art collectors and buyers to be more secure in the authenticity of their purchases and ensure that they possess the NFT exclusively.[7] NFT payments, in addition to their nonfungibility and authenticity, are extremely favorable for artists and content creators long after the original authors sell their NFTs. NFT royalties, gathered through automatic smart contracts, allow creators to optimize their earnings from their works, and the original inventor earns money each time the NFTs are sold in the marketplace. There is no need for intermediaries. The original creators of the NFT do not have to bother about maintaining the digital trail of their work because of these automatic NFT royalties agreements.[8] Furthermore, makers and artists of digital artworks and pieces can create as many NFTs as they like from the original, each with a unique code and set of intellectual property rights attached to ensure the artists receive any revenues the artists are entitled to from the work of art. The price that consumers are willing to pay for NFT determines its worth.[9]

## II. Taxation

Despite its growing popularity and recent innovations, there is still much to be explored about NFTs as society grows and adapts to incorporate them into the infrastructural ecosystem. One area of research for NFTs is how NFTs would be taxed and how taxpayers will participate in the NFT marketplace.[10] However, because NFTs are intangible assets, they generate a slew of tax difficulties because their intangibility introduces new complexity in terms of what is

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Available at SSRN 3212662 (2018)

[5] Robyn Conti & John Schmidt, What Is An NFT? Non-Fungible Tokens Explained, FORBES ADVISOR, available at https://www.forbes.com/advisor/investing/nft-nonfungible-token/.

[6] Rebecca M. Bratspies, Cryptocurrency and the Myth of the Trustless Transaction, 25 MICH. TELECOMM. & TECH. L. REV. 1 (2018), https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1242&context=Mttlr

[7] Shehan Chandrasekera, How Are Non-Fungible Tokens (NFTs) Taxed?, BLOOMBERG TAX, https://news.bloombergtax.com/daily-tax-report/how-are-non-fungible-tokens-nfts-taxed.

[8] AlexWGomezz, NFT Royalties: What Are They and How Do They Work?, CYBER SCRILLA, available at https://cyberscrilla.com/nft-royalties-what-are-they-and-howdo-they-work/

[9] Jones, supra note 2

[10] Bratspies; supra note 5.

transacted.[11] NFTs have a life cycle that encompasses activities such as creation, usage in transactions, charity gifts, and even loss of value, and their connections in these events have tax implications.[12] To understand the tax framework of NFTs throughout their life cycle, taxpayers must first determine whether the NFT's creator is selling the NFT; whether the seller is an investor, dealer, trader, collector, or personal user; the length of time the NFT was held; whether the value of the NFT appreciated while the seller held it; what type of property was used to purchase the NFT; and, whether the buyer used appreciated property to purchase the NFT.[13] NFTs can be used in a variety of ways. However, the tax implications will be determined by a few criteria, such as whether you are an investor or a creator and what you did with the NFTs you already own.

1. *For NFT Investment*

In general, if invested in NFTs, any income received from sales or trades is considered a capital gain and is subject to taxation similarly to income from more conventional capital assets. To exchange a cryptocurrency for an NFT, one must first sell their cryptocurrency and then use the proceeds to purchase the NFT. When the cryptocurrency is sold, one could receive or lose money on the transaction. In other words, when cryptocurrency is used to buy an NFT, the I.R.S. views the transaction as having two parts: first, the selling of cryptocurrency, which would be taxed as a capital gains transaction, and thereafter buying an NFT using the proceeds received from the sale. The annual income, the period of time having possession of the cryptocurrency, and the profit (or loss) from the sale all play a role in how much tax one has to pay. Additionally, if the income exceeds a specific amount, it can be subject to pay the Net Investment Income Tax (NIIT) on both short-term and long-term profits. Trading one NFT for another or selling an NFT in exchange for cryptocurrency is regarded as a sale and subject to capital gains tax. The tax burden will vary depending on a number of aspects, such as the type of NFT, period of time having possession, yearly income, and whether there was a profit or loss.

2. *For NFT Creators*

Any money from the sale of an NFT that is generated must be reported on the tax returns in order to be taxed at the regular income tax rate. If the NFT is generated as a part of a profession

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[11] Jones, supra note 2

[12] Walter Effross, Leonard Goodman, Anthony Pochesci, & Jay A. Soled, Tax consequences of non-fungible tokens (NFTs), J. OF ACCT. (June 24, 2021), available at https://www.journalofaccountancy.com/news/2021/jun/tax-consequences-ofnfts-nonfungible-tokens.html

[13] Andrea S. Kramer, Taxation of the Purchase and Sale Of NFTs, 12 THE NATIONAL L. REV. 1, 2 (Jan. 12, 2022), available at https://www.natlawreview.com/article/taxation-purchase-and-sale-nfts

or business, one may also be required to pay a self-employment tax. The creation of an NFT, also known as minting, will not result in tax liability.[14] Merely producing digital art or content on an NFT-compatible blockchain does not create a tax liability. Only when the purchaser of the NFT pays the full price for the NFT, which includes the price of the artwork and the price of the artwork's tokenization, is that entire sum taxed to the artist as gross income under Section 61 of the Internal Revenue Code.[15] When the creator sells or transfers the NFT, the NFT's creator will continue to earn taxable income from the NFT in addition to the new owner.[16] One must pay both ordinary income tax and self-employment tax on the valuation of royalties if the NFT was created as a part of a profession or business, and one is liable to regular income tax rates when an NFT made by the person is sold. This is the situation if someone produces an NFT and receives royalties in cryptocurrency whenever it is sold.[17]

## III. GENERAL TAX ISSUES

The tax treatment of NFTs, particularly as a crypto asset and their gain, loss, or income generation, has not yet been addressed by the I.R.S., despite the fact that it has provided some guidance regarding the tax consequences of transactions involving what it refers to as "virtual currency" or "cryptocurrency."[18]. However, like with other crypto assets, there is no doubt that normal tax principles would apply to some of the potential methods discussed below. NFTs have certain traditional characteristics of the property, even more so than "cryptocurrency," which the I.R.S. views as separate property from fiat, or "real," currency. Even while an NFT, is most likely to be regarded as an intangible asset similar to other forms of functional tangible personal property, one could argue that it has a life cycle. The production, usage, sale, exchange, a donation to a recognized charitable organization, and full loss of value are all possible stages in the life cycle of an NFT. The consequences of taxes on each of these occurrences are further explained in the study that follows.

## IV. NFT CREATION AND ITS TRADE OR BUSINESS USE

A taxable event may not result from the development of an NFT. First off, if an artist "tokenizes" a work of art that they have produced into an NFT, the act of doing so creates wealth because the NFT can be much more valuable than the original work of art. However, the Code normally does not tax such imputed income, much like when an artist increases the value of a copy of

[14] Effross et al., supra note 11.
[15] Id.
[16] See Id.
[17] Jacquelyn Melinek, What's going on with NFT royalties? TechCrunch, available at https://techcrunch.com/2022/11/02/whats-going-on-with-nft-royalties/?
[18] Notice 2014-21 and Rev. Rul. 2019-24, Chief Counsel Advice 202114020

their work by signing it.[19] The final purchase price would be taxable to the artist under Sec. 61[20]. However, if a buyer had paid the artist not only for artwork but also for having it changed into an NFT, just as if the buyer had paid the regular price for a quantifiable artwork along with a premium because it had been autographed at their request. NFTs are treated as ordinary assets when they are owned by creators in accordance with I.R.C. Code 1221(a)(3)[21] because they are comparable to "a patent, music composition, artistic composition, or similar property created through the taxpayer's efforts or is a property that was prepared or produced for the taxpayer."

The NFT may continue to create taxable revenue for the artist after it has been sold or otherwise transferred, as well as taxable income for the new owner. For instance, in accordance with the conditions of the applicable NFT's intellectual property license, the NFT's owner may receive payments from viewers; "smart contracts" integrated into the underlying blockchain technology may automatically direct a certain portion of those fees to the NFT's inventor. Similarly, to this, the NFT and its rules might be set up so that the person who created it gets a share of the money paid for it on each sale after that.[22] Despite the word "token" being used, NFTs are intangible assets. As a result, Sec. 197(c)(2) normally prevents an NFT's adjusted basis from being amortized if it is generated by or for the taxpayer, but if an NFT is acquired, Sec. 197 regulations pertaining to the use of intangible assets may apply.[23]

Assuming Section 197 is applicable (i.e., the NFT is used in the taxpayer's trade or business to generate income and is not excluded as self-created), the taxpayer may amortize its adjusted basis in the NFT using the straight-line method over a 15-year period starting in the month in which the NFT was acquired[24]. As long as the taxpayer complies with all loss limitation requirements, such as the at-risk rules in Section 465, the passive activity loss requirements in Section 469, and the excess business loss ceiling requirements in Section 461[25], amortization deductions, and any potential losses they may generate would be permitted.

## V. SALE OR EXCHANGE OF AN NFT

The next stage in the life cycle of an NFT is its sale or exchange, which involves the third most prevalent form of NFT seller, the collector or investor, who can then transfer the NFT with the

[19] Effross et al, supra note 11.
[20] Code §§ 61(a)(3), 1001
[21] I.R.C. § 1221(a)(3) (2017).
[22] Kramer, supra note 12
[23] 26 U.S. Code § 197 - Amortization of goodwill and certain other intangibles, available at https://www.law.cornell.edu/uscode/text/26/197
[24] *Id*
[25] https://www.irs.gov/pub/irs-drop/rr-07-12.pdf

full or fewer rights.[26]

To tax an NFT at this time, it is essential to ascertain if it is a capital or noncapital asset and, if the latter, for how long it was held. NFTs held by taxpayers other than the taxpayers who created the NFTs, such as investors, dealers, and collectors, are likely to be classified by the I.R.S. as capital assets rather than noncapital assets. Therefore, the gain or loss would be regarded as an ordinary gain or ordinary loss if the NFT's inventor sold or exchanged the NFT for a gain or loss.[27] Another crucial factor to take into account is how long the NFTs will be retained as capital assets. Capital assets held for a year or less are known as short-term capital assets, and those held for more than a year are known as long-term capital assets. There are further factors that complicate their tax system and further influence how the second sort of NFT seller, the collector or investor, classifies the NFTs they have as a section 1221 asset.[28]

When NFTs are classified as 1221(a)(3) assets and are used for trade or business by someone other than their original authors, 1221(a)(2) would qualify the NFT as an asset.[29] Transactions may result in capital profits or ordinary losses because the asset is now a section 1231 asset and is no longer a noncapital asset.[30] If the taxpayers are using the NFT in a commercial transaction and there is an overall net gain under section 1231, section 1231(a) will define the gain and losses under section 1231 as well as any long-term capital gains or losses. On the other hand, if the opposite is true and the losses from the business transaction with the NFT are equal to or greater than the gains from the transaction, then Section 1231(a)(2) will classify the gains and losses from Section 1231 as ordinary gains and ordinary losses, respectively.[31]

The present tax code's specific capital gain tax rate for other collectible assets also applies to NFTs when investors or collectors hold them as collectibles. As with traditional works of art, NFTs are one-of-a-kind creations that can be collected. NFTs are regarded as long-term capital gains if they are categorized as collectibles, are held for a year or more, and result in a gain in a transaction. As a long-term capital gain, the NFTs will be taxed at a rate of 28%. Contrarily, if an NFT has short-term capital gains, even if it is classified as a collectible, those short-term capital gains will not be subject to any special tax treatment and will instead be taxed at the standard rates that are applicable to capital assets.[32]

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[26] Jones, supra note 2
[27] Chandrasekera, supra note 6.
[28] *Id*
[29] Effross et al, supra note 11.
[30] Kramer, supra note 12
[31] Effross et al, supra note 11
[32] Kramer, supra note 12

Another taxable event that affects how gains and losses for investors or collectors are classified is the use of bitcoin for the purchase of NFTs. NFTs must currently be purchased using cryptocurrencies, and because the I.R.S. considers cryptocurrencies to be property, purchasing NFT results in a taxable event when the cryptocurrency is changed into an NFT.[33]It is crucial to remember that buying NFTs using cryptocurrency is regarded as a barter transaction. Since the buyer retained the cryptocurrency used to purchase the NFT, the gain or loss resulting from that transaction is dependent on the growth or decline of the cryptocurrency. The buyer can skip paying taxes on the purchase of the NFT if the cryptocurrency has appreciated and was not used to do so. Instead, the buyer could buy fresh cryptocurrency to pay for the NFT, and the taxpayer would not feel any gain or loss from the purchase of the NFT thanks to the newly obtained, unappreciated coin.[34]

NFTs can be held by investors and collectors for personal use, such as a pastime or recreational activity, which will have an impact on how their earnings and losses are classified as personal-use assets. The taxpayer's intent, which establishes whether the NFT retained is for personal, or investment use, is crucial to this classification of the NFT.[35]

If the taxpayer uses the NFT rarely enough to not count as an investment activity or if the taxpayer fails to provide sufficient documentation of investment activity to demonstrate an intent to use the NFT for a purpose other than personal use, the NFT will likely be treated as a personal-use asset. Gains from the sale of NFTs held for personal use will be taxed as a capital gain. Losses from the sale of NFTs used for personal purposes, however, would not be deducted from the taxpayer's tax obligation. When NFTs lose all of their value, they are not eligible to be written off as a loss under Section 165(c). Last but not least, unless specifically permitted by 183 of the Code, no expenses related to the personal-use NFT may be subtracted from the taxpayer's tax obligation.[36]

## VI. Charitable contribution of an NFT

Taxpayers frequently use charitable contributions to lower their taxable income and deduct charitable contributions from their adjusted gross income. Throughout the NFT's lifetime,

[33] Amber Gray-Fenner, NFTs: Why the Next Big Thing in the Digital Economy Is a Cash Cow for the I.R.S., FORBES, https://www.forbes.com/sites/ambergray-fenner/2021/08/10/nfts-why-the-next-bigthing-in-the-digital-economy-is-a-cash-cow-for-the-irs/?sh=554d57ae4545 [https://perma.cc/NH3J-SE5N]
[34] Kramer, supra note 12
[35] Julian A. Fortuna, Eric Galen, & Gai Sher, How Should the Seller of an NFT Report It for Tax Purposes?, BLOOMBERG TAX (Mar. 4, 2022, 3:45 AM), https://news.bloomberglaw.com/tax-insights-and-commentary/how-should-theseller-of-an-nft-report-it-for-tax-purposes [https://perma.cc/Y4AU-AD6F].
[36] *Id*

taxpayers may donate NFTs as charitable gifts. Since NFTs cannot be quickly changed to fiat currencies as cryptocurrencies can, they are not the best form of donation to charities. Instead, most charities would like to accept an asset that can be quickly converted to cash. Despite these impracticalities, it is theoretically possible to directly contribute NFTs to charities.[37]

Treas. Reg. 1.170A-1(g), published by the Treasury, prohibits the use of any fair market value deduction for services rendered on behalf of charities.[38] This restriction creates issues since taxpayers must decide whether the NFT should be treated as a gift of property or as a service provided to the charity. However, many NFTs would be viewed as property rather than services under Notice 2014-21.[39] There are various case laws supporting this. Despite the case law confirming that NFTs are classified as property rather than services, there is still debate on the precise definition of NFTs due to the I.R.S.'s lack of NFT-specific tax guidance.[40]

In *Holmes,* the Tax Court permitted the taxpayer to claim charitable deductions for two movies the taxpayer made for two nonprofit organizations, judging them not to be the services of the taxpayer.[41] *In the case of Cupler*, the taxpayer created a heart-lung machine and an eye cataract removal gadget to donate to a recognized charity. According to the Tax Court's ruling, in this case, the taxpayer is entitled to a tax deduction for the value of the two donated devices because the services provided "coalesced in the ensuing property interest."[42]

The price at which a buyer and seller are willing to buy and sell an NFT determines the NFT's value. Due to this, an NFT that has not been sold or purchased lacks a market value and cannot be donated directly to a charity unless it is in line with its objective.[43] However, when someone other than the NFT's creator donates the NFT to a qualified charitable organization, that taxpaying donor can lower their tax liability by deducting the short-term capital gain that they would have initially reported if they had sold the NFT in accordance with Section 170(e)(1)(A) from the fair market value of the donated NFT plus the contributed sum.[44]

Identification restrictions and recordkeeping standards are two barriers to NFTs making philanthropic contributions. Because NFTs are non-cash donations, careful documentation of their use as charitable contributions is required. The issue with recognizing NFTs is that each

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[37] 7 charitable tax deduction questions answered, FIDELITY CHARITABLE, https://www.fidelitycharitable.org/guidance/charitable-tax-strategies/charitabletax-deductions.html [https://perma.cc/84F7-B7EK].
[38] Effross et al, supra note 11.
[39] Kramer, supra note 12
[40] *Id*.
[41] Holmes v. Comm'r, 57 T.C. 430, 437 (1971)
[42] Cupler v. Comm'r, 64 T.C. 946, 953 (1975)
[43] Kramer, supra note 12
[44] Id.; I.R.C. § 170(e)(1)(A)

 [ISSN 2581-5369]

one needs to be identified when utilized, whether bought or sold because they are separate digital assets that distinguish them apart from cryptocurrencies. Since the I.R.S. has not provided any specific guidance on the recordkeeping and reporting requirements for NFT charitable donations, the majority of NFTs and cryptocurrencies are treated as property for taxation purposes, necessitating the careful tracking of donors' donation amounts and types by donors.[45]

## VII. NFTs that become worthless

The final stage in an NFT's life cycle is when it becomes worthless, which also has tax implications. How the NFT will be taxed depends on in whose hands did the NFT become worthless.164 § 165(c) of the Code applies if the NFT loses all its value in the hands of the buyer who purchased the NFT as a personal-use asset.165 Under § 165, the taxpayer would not be able to include a deduction related to the loss that the buyer experienced when the NFT loses all its value.[46] However, if a taxpayer owns the NFT as a part of their trade or business and the NFT becomes worthless, the taxpayer will be allowed to take deductions under § 197 and Treas. Regs. § 1.197- 2(g)(1)(i)(B).[47]

## VIII. Conclusion

Cryptocurrencies and NFTs have gained considerable attention in recent decades since they have transformed the financial sector. Cryptocurrencies are digital, encrypted, and decentralized mediums of exchange, allowing transactions and usage to be unregulated by any government or financial organization. NFTs, unlike cryptocurrencies, are non-fungible but are regarded as intangible property rather than money. NFTs have become a new form of investment and profit-making in the digital art world, solving many of the challenges experienced by the traditional art sector by utilizing the blockchain technology that is the core and distinguishing characteristic of cryptocurrencies.[48]

The NFT tax framework examined in this paper provides a comprehensive overview of how NFTs can be taxed relying on how other crypto assets are taxed, but many challenges and questions remain. More tax guidance will be helpful in the future in assisting taxpayers in reporting their gains or losses from NFT transactions. Even with additional tax guidance on how to tax crypto assets, simply identifying what is a taxable event or determining the

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[45] See *Id*.
[46] Effross et al, supra note 11.
[47] Id.; I.R.C. § 165(c).
[48] Amy Q. Nguyen, The Mysteries of NFT Taxation and the Problem of Crypto Asset Tax Evasion, 25 S.M.U. Sci. & Tech. L. Rev. 323 (2022) https://scholar.smu.edu/scitech/vol25/iss2/

categorization of tax profits or losses from crypto asset transactions is insufficient to tackle the growing problem of crypto asset safe havens and crypto tax evasion.[49]

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[49] *Id*.