**Take-Away:** Investing in a non-fungible token (NFT) may provide an exciting investment opportunity, but its tax and administrative complications could easily outweigh the benefits of such a speculative investment.

**Background:** There is an interest in the investment in digital asset, particularly in the form of non-fungible tokens, or NFTs, although that interest has subsided some from the pandemic years. Congress has codified a *digital asset* as any digital representation of value which is recorded on a cryptographically secured digital ledger or any similar technology as specified by the Secretary of the Treasury. [IRC 6045(g)(3)(D).] As a more practical generalization, a *digital asset* is convertible currencies, cryptocurrencies, stable coins, and NFTs. Recently the IRS replaced *digital assets* with its new terminology, *virtual currencies.* As has been reported in these missives in the past, the IRS considers digital assets as **property.** Regarding NFTs, they are the ownership of truly unique digital artifacts {which, frankly, is the total extent of my knowledge of NFTs and how they work.} How NFTs are taxed is when the aspect of this new type of investment gets technical.

**NFT is *Property*:** In Notice 2014-21 the IRS stated that for federal tax purposes, *virtual currency* is treated as property and general tax principles applicable to property transactions apply to transactions that use or apply to *virtual currency.* Thus, while the term *virtual currency* is used in the Notice, this definition is extended to NFTs.

> **NFT Valuation:** Determining an NFT's value is challenging at best; complicating this challenge is that the IRS had issued no guidance on how to go about valuing NFTs. The valuation of an NFT depends almost entirely on the market. Yet NFTs have no intrinsic value, unlike other collectibles. Consequently, the characteristics of an NFT that makes it an

attractive, albeit aggressive, investment also makes it extremely difficult to value. An NFT's value is derived from being the sole verifiable owner of the NFT. Thus, its uniqueness leads to its value, without any comparable available to use in the appraisal process required to determine fair market value. Nor can there be a 'like-kind-exchange' of one NFT for another NFT. The burden is placed on the individual NFT owner to prove its value. And as for proving the fair market value of an NFT, there is a lack of qualified appraisers who meet the IRS's definition of a *qualified appraiser*. Then, as noted, there is no guidance from the IRS on how that appraiser is to value the NFT. Nor is there any existing history of the sales of NFTs that an appraiser can refer to for comparable sales, which are almost always private. Finally, the accuracy of any NFT's valuation is easier for the IRS to challenge, since in the absence of market data, the NFT appraisal will be highly subjective.

**U.S. Dollars:** NFTs are usually bought and sold using cryptocurrency. The Notice requires that transactions using *virtual currency* must be reported in U.S. dollars. Therefore, for income tax purposes, an individual is required to determine fair market value of the *virtual currency* used, in U.S., as of the date of payment or receipt. Considering the price volatility of cryptocurrencies, this can pose a challenging task. Accordingly, the currency used to purchase the NFT also must be valued, with corresponding capital gain exposure when the appreciated *property* is used to purchase the NFT.

**NFT is a *Collectible*:** The IRS announced in Notice 2023-27 that it is soliciting public comments on whether an NFT is a *collectible*, as defined in IRC 408(m). IRC 408(m)(2) defines a *collectible* as: (i) any work of art; (ii) any rug or antique; (iii) any metal or gem; (iv) any stamp or coin; (v) any alcoholic beverage; (vi) any other *tangible* personal property specified by the Secretary of Treasury. [This definition of *collectible* has been covered in the past; IRAs cannot hold *collectibles* as investments. Accordingly, the implication is that an IRA cannot hold an NFT.] The upshot of this Notice is that the IRS takes the position that an NFT falls within the definition of *collectible*. More on this tentative classification as a *collectible* below.

**IRAs:** Note: If an IRA acquires a *collectible,* such as an NFT, the acquisition of the *collectible* in the IRA account is treated as a **taxable distribution** from the IRA in an amount that is equal to the purchase price of such *collectible;* income taxes will be incurred by the IRA owner, and perhaps a 25% penalty if the IRA owner is younger than age 59 ½.

**Income Tax Consequences:** If the NFT falls within the definition of a *collectible,* then the sale of the NFT will be subject to a higher capital gain tax. *Collectibles* are subject to a higher maximum capital gain rate of **28%.** IRC 1(h)(5)(A) provides with respect to an IRC 408(m) *collectible:*

> *The terms 'collectible gain' and 'collectible loss' mean gain or loss (respectively) from the sale or exchange of a collectible….which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.*

**A Tax on the Way In, a Tax on the Way Out:** The sale of an NFT will likely be viewed as a taxable recognition event. Using cash to acquire an NFT will not be a taxable event. However, the use of cryptocurrency that is often used to purchase an NFT will be a taxable event. If cryptocurrency is used to purchase an NFT, the use of that cryptocurrency will be treated as a disposition/sale of appreciated *property,* i.e., the cryptocurrency, that is used to acquire an NFT. Then, when the NFT is later sold, it will again be taxed as the sale of appreciated *property.* In short, a capital gain may be incurred to acquire an NFT at a 28% capital gain rate, and another capital gain tax at the 28% rate may be incurred when the NFT is later sold by its holder.

**Gift Tax Consequences:** Considering the potential for substantial growth in value of an NFT, it may make an excellent asset to be gifted by its holder. Yet, seemingly as always, there are complications with such a gift, since there must be a completed gift to remove the asset from the donor's taxable estate.

**Value:** The value of a gift is its fair market value at the time of the complete transfer of the property to the donee. [IRC 2512(a).] Noted above is the challenge when it comes to valuing an NFT, as the Tax Code uses the 'willing buyer, willing seller' test to determine the NFT's fair market value when arguably, there is no actual 'market' for NFTs.

**Delivery:** The Tax Code requires that the transfer or delivery of the property must be complete and irrevocable. [Treasury Regulation 25.2511-1(a).] There must be a transfer that is complete and recognized as a completed gift when the donor has so parted with dominion and control as to leave the donor with no power to change its disposition, whether for his/her own benefit or for the benefit of another. State law controls when there is a relinquishment of dominion and control of the asset subject to the gift. Normally this is satisfied with the act of delivery to the donee.

**Intangible Personal Property:** However, an NFT is intangible personal property, and thus it is impossible for it to be manually delivered it to the donee. However, delivery can be 'constructive or symbolic.' Delivery is 'constructive' if the donor gives the donee the means to obtain possession or control of the subject of the gift, e.g., a gift of a key to the place where the subject property is located. A 'symbolic' gift is one in which the donor gives the donee an object or item that symbolizes the subject of the gift, like the delivery of an instrument that evidences the claim to that intangible personal property, e.g., stock certificates to gain control of shares of stock.

**NFT Wallets:** With these delivery rules as background, consider an NFT which may be held in either a unique 'cold wallet' (stored offline using a private key like a USB stick or smart card) or 'hot wallet' (a web-based or mobile application that is accessible via an internet connection), which are the most common NFT storage methods. With a 'cold wallet' that holds the NFT, probably the physical delivery of the USB stick will document the donor's actual delivery of the non-tangible NFT to the donee. With a 'hot wallet' storage of the donor's NFT, a transfer from the

donor's 'hot wallet' directly to the donee's 'hot wallet' will work to achieve delivery of the NFT. Less certain would be the situation where the donor provides login credentials to his/her 'hot wallet' to the donee, since the gift must be irrevocable, and the NFT donor still has it within his/her power the ability to exercise control over the login credentials to alter its disposition, i.e., an *incomplete* gift.

**Estate Taxes:** The biggest estate tax hurdle dealing with NFTs is the valuation of the NFT, again using the 'willing buyer, willing seller' test to determine fair market value, determined as of the date of the decedent owner's death.

**Alternate Valuation Election?** In light of the high volatility of NFTs, a potential decline in value of the decedent's NFT after his/her death between the date of death and the alternate valuation date may make it a good candidate to use the alternate valuation date election by the estate within 6 months of the date of the decedent's death, if the election will reduce the amount of the estate taxes payable. [IRC 2032.]

**Income Tax Basis:** As with any other asset received from the decedent's estate, a beneficiary can take a stepped-up (or stepped-down) tax basis equal to the NFT's fair market value at the time of death. [IRC 1014(a).] Like any other appreciating asset, the NFT's owner must balance a lifetime gift of the NFT, with carryover basis subjecting the donee to a 28% capital gain tax on the donee's later sale of the NFT, or the owner holding onto the NFT until his/her death, obtaining a new income tax basis for the NFT, but exposing the NFT's volatile value to estate taxation in the owner's estate.

**Estate Administration:** Considering all the complications posed by an NFT owned by a decedent, it would not be surprising to see a nominated fiduciary decline to serve if the decedent's estate is comprised of substantial digital assets. The presence of NFT's in a decedent's estate creates a significant burden on the fiduciary who must access, manage, and possibly dispose of the NFT, along with its unusual tax consequences.

**Use a Trust Director:** It might be wise for the NFT owner's estate planning documents to authorize the named fiduciary to hire a digital asset manager with the expertise in NFTs or appoint a trust director with sole authority to deal with the decedent's digital assets.

**Prudent Investor Rule:** Estate fiduciaries are governed by the Prudent Investor Rule, which carries a duty of prudence as an objective standard of care when the fiduciary administers either the decedent's estate or the decedent's Trust. That Rule provides that the fiduciary must invest and manage property as a prudent investor would by considering all the circumstances of the Trust. Under the Prudent Investor Rule, NFTs are probably too risky for estate and Trust assets to be invested. With that in mind, if the NFT owner intends for his/her Trust to retain NFTs, then the Trust instrument should expressly authorize the trustee's authority to retain NFTs, along with the written consent of the trust beneficiaries. In the absence of this specific authorization, the fiduciary will probably feel obligated to sell the NFT and reinvest the sales proceeds.

**Conclusion:** The arrival of NFTs as a relatively new class of digital asset presents unique tax and administration challenges for both owners and their fiduciaries. These challenges will need to be expressly addressed in the owner's estate planning documents, along with close attention to their unique (and expensive) tax attributes. Consequently, having a basic understanding of digital assets,  NFTs, and their underlying technology will be important for all advisors as we move swiftly into the digital age.

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