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A Magical Action for Naught: Nonfungible Tokens

By Russell A. Willis III

You can pick up a used paperback copy of Jack Kerouac's 1957 ''beat'' novel, *On the Road*, for less than $4. A hardcover copy from the first print run of the first edition, of which there were only 7,500 copies, will set you back something closer to $4,000. Signed by the author, something north of $25,000.

The 120-foot scroll on which Kerouac typed the original manuscript was bought by a private collector 20 years ago for a couple or three million.

Apart from the scroll, which includes material that did not make the final edits, the text is essentially identical in all these copies. What you are buying if you pay a few thousand for a signed first edition is scarcity. What you are buying if you pay a few million for the scroll is uniqueness.

In either case you will want some evidence of authenticity, which can usually be provided only by third party experts and/or records of provenance. And in any case you do not acquire rights in the intellectual property itself. The copyright is still held by the Kerouac estate.

Enter the NFT Something like this is what seems to be going on with the so-called ''nonfungible token,'' or NFT, except that in most cases there is no ''scroll.'' What you are buying when you buy an NFT is a string of code, signifying ''ownership,'' whatever that means, typically of an electronic image anyone can freely access. The token is your evidence of authenticity or provenance, but what it authenticates is only itself, not an ''original'' or any particular copy of the image to which it is ''attached.''

Russell A. Willis III, J.D., LL.M., is a tax lawyer and a consultant to other lawyers—an advisor to the advisor—on issues arising in connection with wealth transfers.

Of course, these are early days. Over time, the NFT will find appropriate uses in authenticating ownership and facilitating transfers of ''real world'' assets. But it will still be the case that while the NFT, as such, is a certificate of authenticity or evidence of title, possibly with additional rights established by contract with the seller, it is not itself the property whose ownership it authenticates.

Meanwhile, we are in this weird moment where the token itself is in many instances the object to which ''value'' is being ascribed. What the purchaser is acquiring is literally the verifiable uniqueness of the string of code, nothing else. And for the moment, at least, there is a sharply rising speculative market in these tokens.

As the Subject of a Charitable Gift The day will inevitably come, if it has not already, when someone will want to make a gift of an NFT to a public charity, probably a donor advised fund, in order to avail herself of an income tax deduction at fair market value, while avoiding recognition of gain on the disposition.

Typically, the recipient organization will want to sell immediately in order to maintain diversification of its investment portfolio. Its primary concern concern will be whether there is a ready market into which it will be able to sell. This will depend on demand for the particular NFT, which may be difficult to measure outside established markets like cryptokitties. Also, most platforms for buying and selling NFTs are closing these transactions in cryptocurrencies, so the charity would need to have one or more ''wallets'' set up for that purpose.

We will not digress into the question of a prearranged sale, except to note that in its briefing on cross motions for summary judgment in *Dickinson v. Commissioner*,

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IRS appears to have signaled a renewed interest in advancing what might be called the ''second prong'' of its Revenue Ruling 78-197, which focuses on whether the organization received the contribution subject to an existing obligation to sell to an identified purchaser.

Although the revenue ruling is framed as an acquiescence in *Palmer v. Commissioner*, the U.S. Tax Court has more than once, and again in *Dickinson*, said it does not accept the second prong analysis, and will instead continue to view these cases through an assignment of income lens.

What Exactly Is This Thing? There are difficulties on the donor's side as well, not the least of which is finding an appraiser who is qualified by education and experience to render a valuation opinion the IRS will respect. Regulations finalized in 2018 are rather stringent on this point, requiring certification from ''a generally recognized professional appraiser organization,'' specifically as to the particular ''type'' of property.

Then there is the question whether the NFT is a capital asset, a necessary condition of the advantageous tax treatment sketched above. If the donor is a dealer in NFTs, the token might be treated as ''inventory,'' and her deduction would be limited to the lesser of fair market value or her adjusted basis—unless the recipient organization is maybe a museum of electronic artifacts and intends to put the NFT to a ''related use.'' If the donor herself created the token, her unrealized gain would have been ordinary income, and her deduction will be limited to her cost basis.

There has been some chatter on the Internet to the effect that even in the hands of an investor an NFT might be treated as a ''collectible,'' specifically as a ''work of art,'' on which the unrealized gain would have been so-called ''28% gain″—in which case the deduction would again be limited to basis. This writer is skeptical.

The tax code definition of ''collectible'' at tax code Section 408(m)(2) lists several specific categories, of which ''work of art'' is certainly one, but then concludes with the catch-all ''any other tangible personal property'' IRS might identify in formal guidance, which it has not done. The legislative history is to the same effect, and a proposed Treasury Regulation, published in January 1984 but never finalized, also used the ''other, tangible'' phrasing.

The word ''other'' here would seem to imply that the preceding categories, including ''work of art,'' are understood to be ''tangible.'' Clearly an NFT is not tangible, and as we were just discussing, and the token is not itself the ''work of art,'' but merely a mechanism for authenticating ''ownership'' and provenance. This writer would argue the NFT itself is not a ''collectible.''

IRS might adopt a different view, but it may be constrained by the statutory text and legislative history.

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Author Information *Russell A. Willis III, J.D., LL.M., is a tax lawyer and a consultant to other lawyers—an adviser to the adviser—on issues arising in connection with wealth transfers. Much of his practice is focused on structuring charitable contributions of closely held business and real property interests.*

Among his other engagements, Russ is a manager of noncash research for Charitable Solutions, LLC , a planned gift risk management consulting firm headed by Bryan Clontz. About three years ago, he launched a newsletter, the Jack Straw Fortnightly , analyzing current developments in the law—both tax and nontax—concerning the transfer of private wealth in the U.S..

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