# WHEN IS A COLLECTIBLE NOT A "COLLECTIBLE"? NFTS AND INTERNAL REVENUE CODE SECTION 408(M)(2)

**KATHRYN S. WINDSOR** is an attorney with Adler Pollock & Sheehan PC, where she represents clients in a variety of tax law matters. Her practice areas include corporate tax, partnership tax, trusts and estates, federal and state tax resolution, self-directed IRAs, and tax-exempt entities. Kathryn's other practice areas include capital gains planning, tax credit and incentive programs, business succession planning, bankruptcy tax law, and various other types of tax planning and tax law. She also has experience in commercial lending, film financing, and general corporate matters, including corporate governance. Kathryn holds an advanced degree in tax law from Boston University School of Law.

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Over the past year, non-fungible tokens (NFTs) have been gaining popularity in the mainstream economy. NFTs are unique digital assets that are easily verifiable and transferable. On April 13, 2021, IRS Commissioner Charles Rettig testified before the Senate Finance Committee regarding cryptocurrencies and NFTs, stating that NFTs "are essentially collectibles in the crypto world."[1] His statement is consistent with the IRS treatment of cryptocurrencies as capital assets subject to capital gains tax rates. Arguably, an individual retirement account (IRA) can hold cryptocurrency but what about NFTs? Are NFTs collectibles for purposes of Internal Revenue Code (Code) section 408(m)(2), or are NFTs intellectual property that can be held by an IRA? This article will examine the unique tax characteristics of NFTs and whether an IRA is prohibited from investing in them.

## What are NFTs?

NFTs are blocks of data encoded on a blockchain. Each token is a unique digital asset that is transferable. Because the NFT is encoded on a blockchain, the authenticity and ownership of the NFT can be verified. Unlike forms of cryptocurrency, such as Bitcoin, that are interchangeable like traditional money, NFTs are not interchangeable. An NFT can represent ownership in a variety of assets including art, music, trading cards, sports moments, memes, or other types of digital files. However, the purchaser only acquires ownership of the token, rather than the original work or object. One commentator notes that although Dogecoin (a form of cryptocurrency) isn't an NFT, a GIF of Nyan Cat Dogecoin (a Dogecoin-inspired NFT) is.[2]

Some notable recent NFT sales include:

- "Everydays: The First 5,000 Days" by the digital artist known as Beeple for $69 million;[3]
- The sale of Jack Dorsey's first tweet for $2.9 million;[4]
- The sale of a CryptoPunk NFT "Covid Alien" at a Sotheby's auction for $11.7 million;[5] and
- Doge, the image of a Shiba Inu for which Dogecoin was branded, for $4 million.[6]

Mainstream companies such as Visa and Budweiser have also recently purchased NFTs.[7] In addition, professional sports organizations and others are minting NFTs. For example, the NBA offers officially licensed NFTs of NBA moment snapshots through the platform TopShot.[8]

## Code section 408(m)(2)

IRAs are prohibited from investing in "collectibles" pursuant to Code section 408(m). Section 408(m)(2) defines a collectible as any work of art,[9] any rug or antique,[10] any metal or gem,[11] any stamp or coin (with some exceptions),[12] any alcoholic beverage,[13] or any other tangible personal property specified by the Secretary.[14] Proposed Treasury Regulation section 1.408-10 added musical instruments and historical objects to the definition of collectibles.[15] The acquisition of a collectible by an IRA will trigger a deemed distribution from the account to the account holder in an amount equal to the fair market value of the collectible at the time of the purchase.[16] The deemed distribution is subject to the 10 percent early withdrawal penalty if the account owner is not 59 ½ years old at the time of the purchase.[17]

## IRS treatment of cryptocurrencies

The IRS treats cryptocurrencies, also known as "virtual currency," as property. The IRS issued a series of Frequently Asked Questions regarding the treatment of virtual currency in Notice 2014-21. In that notice, the IRS indicated that "[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency."[18] Accordingly, the exchange of virtual currency results in a capital gain or loss which will be taxed at ordinary or capital gains rates depending on the amount of time the asset is held.

NFTs are often purchased with cryptocurrencies which can result in capital gains tax. For example, a taxpayer purchases an NFT for $5,000 with virtual currency that has a basis of $1,000. If the virtual currency was held for over one year, then the result would be long-term capital gains tax on the gain on the virtual currency of $4,000 at the time of the exchange for the NFT. Assuming NFTs are also "property," any gain upon the sale of the NFT would also be taxed at capital gains rates.

Aside from IRA considerations, if NFTs are considered "collectibles" for the purposes of Code section 408(m), then the maximum 28 percent capital gains rate will apply. Congress chose to keep the maximum capital gains rate at 28 percent for collectibles under the Taxpayer Relief Act of 1997. Congress reduced the maximum capital gains rate from 28 percent to 20 percent except for on the disposition of collectibles as defined under Code section 408(m). The purpose of the reduction was to stimulate economic growth.[19] Ostensibly, Congress did not think that investments in collectibles stimulated economic growth.

## IRS enforcement

Over the past few years, the IRS has made cryptocurrency one of its top enforcement priorities. In July of 2018, the IRS announced a Virtual Currency Compliance campaign to address "noncompliance related to the use of virtual currency through multiple treatment streams including outreach and examinations."[20] The IRS also noted in the announcement that it is not contemplating a voluntary disclosure program for virtual currency transactions, leaving it up to the taxpayer to correct any underreporting as soon as practical to avoid additional penalties and interest.[21] For tax year 2020, the IRS added a new question to the US Individual Income Tax Return (Form 1040), asking if the taxpayer at any time during the year received, sold, sent, exchanged, or otherwise acquired any financial interest in any virtual currency. The taxpayer is required to check "yes" or "no" to this question.[22] In addition, the IRS sent letters to taxpayers in 2019 and 2020 who may have failed to report income from cryptocurrency, helping to "educate" the taxpayers on their tax and filing obligations and how to correct mistakes in reporting. Failure by the taxpayer to respond to the Letter 6173 by the given response date may result in the IRS sending the taxpayer's account to exam.[23]

As noted above, IRS Commissioner Charles Rettig, in testimony before the Senate Finance Committee, took aim at NFTs when discussing how to close the gap on the estimated $1 trillion in overall federal tax that is owed but not collected each year. He indicated that increased reporting of cryptocurrency and NFT transactions would be very important in closing the tax gap.[24] Increased reporting is important, according to Commissioner Rettig, because "[NFTs] are not visible items by design. The crypto world is not visible."[25]

However, the IRS has issued no formal guidance on NFTs at this time. One can assume that the IRS will treat NFTs similar to cryptocurrency for tax purposes, but are NFTs "collectibles" or just "property"?

## Intangible assets and Code section 408(m)(2)

Code section 408(m)(2)(F) includes in the definition of collectible "any other tangible personal property specified by the Secretary." The plain language of the statute would seem to exclude intangible property.

Cryptocurrency, such as Bitcoin, is treated for accounting purposes as an intangible asset pursuant to non-binding guidance issued by the Association of International Certified Professional Accountants (AICPA) in the form of the Practice Aid "Accounting for and Auditing of Digital Assets."[26] The Financial Accounting Standards Board (FASB) ASC Master Glossary defines an intangible asset as an asset that lacks physical substance. After determining crypto assets meet the definition of intangible assets, the Practice Aid indicates that crypto assets should generally be accounted for under FASB ASC 350, Intangibles–Goodwill and Other. FASB has not yet issued official guidance on accounting for cryptocurrency but recently included accounting for exchange-traded digital assets and commodities on its research agenda for 2022.[27]

Presumably, NFTs fall within the FASB definition of an intangible asset, and therefore are excluded from the plain language definition of a collectible under Code section 408(m)(2). However, the analysis should not end there.

## Are NFTs collectibles?

Although IRAs are prohibited from direct investments in collectibles, the IRS does allow IRA investments in *funds* that are invested in collectibles. In a series of Private Letter Rulings,[28] the IRS determined that acquisitions by an IRA of shares of registered investment trusts that hold gold and silver bullion are not acquisitions of collectibles by the IRA.[29] The IRS focused on whether or not the IRA had a possessory interest in the collectible. "Apart from a right to obtain an in-kind redemption of shares under the conditions described above, ownership of shares will not give their holder any immediate possessory interest in the bullion represented by the shares. A holder of shares will not have any right or ability to obtain possession of the bullion represented by the shares it owns, unless and until those shares are surrendered for redemption."[30]

However, rather than a share or interest in a collectible, an NFT seems to be the collectible itself. Collectibles have intrinsic value because of many factors, including scarcity, uniqueness, or popularity. For example, one early application of NFTs was CryptoKitties by Dapper Labs, the same company responsible for minting NBA NFTs. CryptoKitties allowed its users to breed and trade digital cats so that each cat has individual traits.[31] The NFTs acted like ID collars for the digital cats. Some of the original generation of CryptoKitties NFTs saw a resurgence in value in September 2021 with about $7.27 million worth of CryptoKitties NFTs being traded over a 24-hour period.[32] NFTs are appealing to investors as collectibles themselves rather than as interests in a collectible such as the precious metal interests discussed in the Private Letter Rulings.

In the case of NFTs, the IRS most likely will take the position that this type of intangible asset is a collectible for the purposes of Code section 408(m) especially when the NFT represents artwork, trading cards, memes, or similar assets. However, there still may be a way for an IRA to invest in NFTs. Similar to an IRA investment in gold exchange funds, an IRA may be able to invest in NFTs through an exchange traded fund (ETF). For example, Defiance ETFs recently launched an exchange traded fund focused on NFTs which is traded on the New York Stock Exchange.[33]

## CONCLUSION

While there is an argument that NFTs are not tangible personal property and thus excluded from the definition of a collectible under Code section 408(m)(2)(F), IRS guidance on cryptocurrency and enforcement priorities both point to the IRS treating NFTs as collectibles. As such, IRAs should avoid investing in NFTs at least until the IRS issues formal guidance. Congress will also need to take action to amend the definition of Code section 408(m) to include these types of intangible assets as collectibles. Both cryptocurrencies and NFTs are moving firmly into the mainstream economy, and Congress and the IRS will need to act quickly to keep up with these changing times.

## Notes

1 Robert Frank, IRS is probing the dark web to look for cryptocurrency and NFT tax evasion, says IRS commissioner, CNBC.com, Apr. 14, 2021, available at https://www.cnbc.com/2021/04/14/irs-is-probing-the-dark-web-to-look-for-cryptocurrency-nft-tax-evasion.html.

2 Mitchell Clark, NFTs, Explained, The Verge, Aug. 18, 2021, available at https://www.theverge.com/22310188/nft-explainer-what-is-blockchain-crypto-art-faq.

3 Christie's, Online Lot 20447, March 11, 2021, available at https://onlineonly.christies.com/s/beeple-first-5000-days/beeple-b-1981-1/112924.

4 Elizabeth Howcroft, Twitter boss Jack Dorsey's first tweet sold for 2.9 million as an NFT, Reuters, Mar. 22, 2021 (tweet March 21, 2006, "just setting up my twttr"), available at https://www.bbc.com/news/business-56492358.

5 Sotheby's, CryptoPunk 7523/Lot 1, June 10, 2021, available at https://www.sothebys.com/en/buy/auction/2021/natively-digital-cryptopunk-7523/cryptopunk-7523.

6 Kalhan Rosenblatt, Iconic "Doge" meme NFT breaks record, selling for $4 million, NBCNews.com, June 11, 2021, available at https://www.nbcnews.com/pop-culture/pop-culture-news/iconic-doge-meme-nft-breaks-records-selling-roughly-4-million-n1270161.

7 Ryan Browne, Visa jumps into the NFT craze, buying a 'CryptoPunk' for $150,000, CNBC.com, Aug. 23, 2021, available at https://www.cnbc.com/2021/08/23/visa-buys-cryptopunk-nft-for-150000.html; Sebastian Sinclair, Budweiser Buys Beer.eth Domain Name for 30 ETH, Rocket NFT for 8 ETH, CoinDesk.com, Aug. 25, 2021, available at https://www.coindesk.com/markets/2021/08/25/budweiser-buys-beereth-domain-name-for-30-eth-rocket-nft-for-8-eth/.

8 Jonathan Shieber, CryptoKitties developer launches NBA TopShot, a new blockchain based collectible collab with the NBA, TechCrunch.com, May 27, 2020, available at https://techcrunch.com/2020/05/27/cryptokitties-developer-launches-nba-top-shot-a-new-blockchain-based-collectible-collab-with-the-nba/.

9 IRC § 408(m)(2)(A).

10 IRC § 408(m)(2)(B).

11 IRC § 408(m)(2)(C).

12 IRC § 408(m)(2)(D). Certain coins are excluded from the definition of collectibles pursuant to section 408(m)(3)(A) (generally American Eagle Coins) as are certain bullion if such bullion is in the physical possession of a trustee pursuant to section 408(m)(3)(B).

13 IRC § 408(m)(2)(E).

14 IRC § 408(m)(2)(F).

15 Prop. Treas. Reg. § 1.408-10(b)(6) & (7).

16 IRC § 408(m)(1). The individual retirement account's tax qualification under section 401(a) does not terminate upon the investment of collectible as it would if a section 4975 prohibited transaction occurred.

17 Prop. Treas. Reg. § 1.408-10(f).

18 IRS 2014-21–Answer 1.

19 Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), 48-49 (Dec. 17, 1997). See also, Troy K. Lewis, Brian C. Spilker, and Kamri S. Call, The Taxation of Collectibles, The Tax Advisor, Nov. 1, 2019.

20 IRS, Large Business and International Active Campaigns, Virtual Currency, available at https://www.irs.gov/businesses/corporations/lbi-active-campaigns#virtual-currency.

21 Id.

22 This question was included on the Schedule 1 of the 2019 Form 1040, but in 2020 was added to the Form 1040 itself making it less easy for taxpayers to ignore.

23 IRS News Release, IR-2019-132, Jul. 26, 2019, available at https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts.

24 Frank, supra note 1.

25 Id.

26 Issued December 16, 2019.

27 FASB Media Advisory dated December 15, 2021.

28 Private Letter Rulings (PLR) may not be relied on as precedent by other taxpayers or by IRS personnel. A PLR is issued in response to a written request by a specific taxpayer.

29 Priv. Ltr. Rul. 200446032 (August 19, 2004), Priv. Ltr. Rul. 200732026 (May 17, 2007); Priv. Ltr. Rul. 200732027 (May 17, 2007) (IRA's acquisition of shares of registered investment trusts that hold gold and silver bullion will not constitute acquisition of collectible under Code section 408(m), but if a redemption results in a distribution of shares or the bullion to the IRA owner, the value of the shares or bullion will be treated as a taxable distribution).

30 Priv. Ltr. Rul. 200446032 (Aug. 19, 2004).

31 Caitlin Ostroff, The NFT Origin Story, Starring Digital Cats, Wall St. J., May 8, 2021, available at https://www.wsj.com/articles/the-nft-origin-story-starring-digital-cats-11620446425.

32 Andrew Hayward, Remember CryptoKitties? Classic Ethereum NFTs Are Soaring in Value, Decrypt.co, Sept. 3, 2021.

33 Non-IRA investors should be careful when investing in ETFs that own collectibles as they may be subject to the 28 percent capital gains rate on collectibles upon disposition of their ETF interest. In a Chief Counsel Memorandum dated May 2, 2008, the IRS advised that if an ETF is treated as a trust under 26 CFR § 301.7701-4(c), then the investor is treated as owning an undivided beneficial interest in the collectible held in the trust. The ETF cited in the Chief Counsel Memorandum directly invested in metal ("physically backed metal ETF"). If the investor sells his interest in the ETF or the ETF sells a portion of the collectible, then any gain from either sale is treated as a gain from the sale of a collectible and subject to maximum capital gain rate of 28 percent.