Digital Assets: From Crypto to Compliance

Treatment of Nonfungible Tokens under the Final Broker Reporting Regulations

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This article provides an overview of nonfungible tokens (NFTs) that are within the definition of digital assets under the final U.S. broker digital asset reporting regulations published in the Federal Register on July 9, 2024 (the "final regulations"), the optional reporting method and de minimis reporting threshold for certain "specified nonfungible tokens," and a backup withholding exemption in certain transactions involving specified NFTs.

NFTs Generally

NFTs are digital tokens recorded on a blockchain that each represents a unique asset. The unique asset may be a piece of art or other digital content or media. In some cases, the NFT can represent ownership in an underlying physical asset.

These tokens differ from fungible tokens such as a cryptocurrency (e.g., Bitcoin), units in which can be exchanged equivalently for other units of the same cryptocurrency (e.g., they are fungible with one another). By contrast, an NFT may represent a particular artwork with unique characteristics (e.g., traits or rarity) that may not be exchangeable on a one-to-one basis with another NFT, even within the same "collection."

The final regulations consider NFTs to be within the definition of "digital assets." The preamble to the final regulations states that it is the Treasury's view that NFTs fall within the statutory definition of digital assets regardless of whether they "represent value" or whether they represent assets with value. NFTs are thus broadly in-scope for purposes of the broker digital asset reporting framework. However, because of the unique status of NFTs, the Treasury and the IRS also allow certain NFTs meeting specific criteria to be eligible for optional aggregate reporting and additional relief.

Optional Reporting Method for Specified NFTs

In particular, the final regulations provide that brokers can elect an optional aggregate reporting method to report NFTs that meet the definition of a “specified nonfungible token” (specified NFT). In addition, no reporting is required with respect to sales of specified NFTs for a customer unless the sales proceeds exceed $600 for the year.

A specified NFT for this purpose means a digital asset that:

- Is indivisible (cannot be subdivided into smaller units without losing its intrinsic value or function);
- Is unique (digital asset itself includes a unique digital identifier, other than a digital asset address, that distinguishes that digital asset from all other digital assets); and
- Is not and does not provide the holder any interest in certain “excluded property” (which include investment assets such as a security or commodity).

Under the optional method for reporting specified NFTs, a broker is required to report the following information with respect to specified NFT sales:

- The name, address, and taxpayer identification number of the customer
- The aggregate gross proceeds for the year from all sales of specified NFTs (after reduction for the allocable digital asset transaction costs)
- The total number of specified NFT sales
- To the extent ordinarily known by the broker, the aggregate gross proceeds that is attributable to the first sale by a creator or minter of the specified NFT
- Any other information required by the Form 1099-DA or instructions to the form.

Interestingly, there is no cost basis reporting noted in the final regulations for such specified NFT sales. The draft Form 1099-DA instructions released on September 9, 2024, indicates also that no cost basis information is required to be reported when the optional reporting method is utilized for reporting sales of specified NFTs.

Backup Withholding

Generally, under the final regulations, if a customer who does not fall into an exempt category fails to provide appropriate documentation (generally a Form W-9 or an appropriate Form W-8), the broker is required to withhold on proceeds of sale with respect to such customer at the rate of 24%. The amount withheld is deposited with the IRS and is available as a credit against taxes that may be owed by the customer. This withholding is referred to as backup withholding.

In the context of NFTs, industry participants had raised the concern that where an NFT is received in exchange for another digital asset (including another NFT), backup withholding would be impracticable since the NFT received would not be divisible into smaller units that could be liquidated for backup withholding purposes.

The IRS and Treasury provided relief to address this concern in a notice that was issued contemporaneously with the final regulations. Pursuant to Notice 2024-56, no backup withholding is required until further guidance is issued on sales of digital assets where the proceeds are in the form of specified NFTs. Thus, if a customer uses ETH to purchase an NFT that qualified as a specified NFT, the deemed sale of ETH would not be subject to backup withholding since the proceeds of sale are in the form of the specified NFT purchased. A sale of a specified NFT for ETH, however, would not fall under this exception.

Further Considerations

From a process perspective, reporting with respect to NFTs can be complicated. First, NFTs on an exchange or marketplace would need to be evaluated for qualification as a “specified NFT” under the final regulations. This process may be difficult as new NFTs may be created on a daily basis and smart contracts governing such NFTs can be highly customized. Custodial exchanges/marketplaces may need to implement a process such that only NFTs that have been reviewed for specified NFT qualification can be traded.

The importance of specified NFT qualification stems from several factors. There is the advantage of being able to conduct aggregate rather than transaction-by-transaction reporting for specified NFTs, including the advantage that for aggregate reporting, cost basis would not need to be reported. This is pursuant to the language of the final regulations and consistent with the draft instructions to Form 1099-DA. In addition, the exemption from backup withholding for sales of digital assets that result in the receipt of specified NFTs is also critical. Having to backup withhold on a purchased NFT by having to liquidate the NFT would defeat the whole purpose of such a purchase.

Second, whether an NFT is a specified NFT or not, valuation issues will often surface, especially where one NFT is exchanged for another NFT. If an NFT is exchanged for fiat or a publicly traded cryptocurrency, the proceeds may be determinable. However, where an NFT is traded for another NFT, valuation may be difficult if not impossible. A single trait variation in one NFT may cause significant variations in value in the hands of a collector. A reasonable methodology may need to be considered, or a determination will need to be made as to whether the proceeds amount is indeed undeterminable. The final regulations do provide an option for brokers to report certain proceeds as undeterminable.

Third, for NFTs that do not fall within the definition of a specified NFT, the mechanics of reporting and withholding on the sale and purchase of such assets would be challenging. There will be issues with transactional reporting, cost basis maintenance as well as potential backup withholding. In these cases, validation of customer tax documentation and having procedures in place to maintain the validity of such documentation will be key.

In the end, the mechanics reporting for sales of NFTs will be a challenge from the perspective of documentation, withholding and reporting. While the inclusion of specified NFT rules in the final regulations address some valid industry concerns, reporting on sales of NFTs under the optional reporting method or otherwise remains a complicated implementation process.

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