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## The Mysteries of NFT Taxation and the Problem of Crypto Asset Tax Evasion

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# The Mysteries of NFT Taxation and the Problem of Crypto Asset Tax Evasion

Amy Q. Nguyen\*

## ABSTRACT

Cryptocurrencies have long captured the attention of the financial world, revolutionizing how the world does business by providing virtually costless transactions. More recently, however, a new digital token has taken its place on the world stage. Known as NFTs, non-fungible tokens have allowed for the reinvention of modern finance infrastructure consisting of sophisticated trading and loaning systems for different asset types. Despite cryptocurrencies' and NFTs' novelty and popularity, they are not immune to the U.S. Tax Code. The Internal Revenue Service (IRS) has provided guidance on the tax framework of cryptocurrencies, but the taxation of NFTs is still relatively unclear, leaving taxpayers to rely largely on the cryptocurrency tax framework to address NFT taxation. The cryptocurrency framework, however, does not fully address all issues that may arise in NFT taxation. Virtual currencies have drawn much excitement, sparking the popularity of cryptocurrencies and NFT investors but have also drawn the scrutiny and worry of tax regulators. The U.S. has been experiencing a significant tax gap between the money taxpayers make from the transactions of these crypto assets and the amount of taxes paid to the IRS. Specifically, to blame for this tax gap are the novelty of these crypto assets, their inherent anonymity, their cross-border nature, and their independence from governmental or financial institutions. This article discusses the taxation of cryptocurrencies, its influence on a potential NFT-specific tax framework, why crypto assets are the weapon of choice for tax evaders, and the possible solutions the U.S. can pursue to remedy crypto asset tax evasion.

## I. INTRODUCTION

The modern finance world has begun switching from traditional wallets to digital wallets using cryptocurrencies, a globally accepted virtual currency capable of facilitating virtually costless transactions.<sup>1</sup> Cryptocurrencies are

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1. 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=Mtlr> [https://perma.cc/8GTM-35C7].

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virtual, encoded, and decentralized mediums of exchange that operate without a central authority to manage and maintain their value.<sup>2</sup> They are resistant to being counterfeited and are almost impossible to double-spend.<sup>3</sup> Cryptocurrencies can be used to sell things ranging from daily common goods and services to assets such as stocks and precious materials.<sup>4</sup> No central authority issues cryptocurrencies, making them immune to governmental manipulation and regulation, and thanks to blockchain technology, cryptocurrencies are also decentralized.<sup>5</sup>

Recently, however, a new digital token has emerged and taken its place in the modern finance world. Non-fungible tokens (NFTs), as cryptographic assets, are immutable digital certificates in which ownership or other rights are stored on a blockchain. Creators can use cryptography to make limited edition certificates.<sup>6</sup> Fungible currencies, such as traditional currencies and cryptocurrencies, can be traded or exchanged.<sup>7</sup> NFTs, in contrast, are individually unique tokens.<sup>8</sup> Likened to digital passports, NFTs digitally represent assets, with each token having its own unique identity to differentiate it from other tokens.<sup>9</sup> Because NFTs are each unique, one NFT cannot be equal to another.<sup>10</sup> NFTs, however, can be combined to produce another unique NFT.<sup>11</sup>

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2. Kate Ashford & John Schmidt, *What is Cryptocurrency?*, FORBES ADVISOR, <https://www.forbes.com/advisor/investing/what-is-cryptocurrency/isor> [https://perma.cc/XPG9-K5BL] (last updated Jan. 25, 2022, 4:15 PM).
  3. Jake Frankenfield, *What is Cryptocurrency?*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/cryptocurrency.asp> [https://perma.cc/V7TB-QVQJ] (last updated May 28, 2022).
  4. Ashford & Schmidt, *supra* note 2.
  5. Frankenfield, *supra* note 3.
  6. Levi, MacKinzie Neal & Mana Ghaemmaghami, *Decoding the Fine Print on Nonfungible Token Licenses*, SKADDEN (Mar. 30, 2021), <https://www.skadden.com/insights/publications/2021/03/decoding-the-fine-print-on-nonfungible> [https://perma.cc/5Y9Q-63XY].
  7. Robyn Conti & John Schmidt, *What Is An NFT? Non Fungible Tokens Explained*, FORBES ADVISOR, <https://www.forbes.com/advisor/investing/nft-non-fungible-token/> [https://perma.cc/3YDD-E8GL] (last updated Apr. 8, 2022, 8:36 AM).
  8. Rakesh Sharma, *Non Fungible Token (NFT): What It Means and How It Works*, INVESTOPEDIA, [https://www.investopedia.com/non-fungible-tokens-nft-5115211#:~:text=Non%2Dfungible%20tokens%20\(NFTs\),traded%20or%20exchanged%20at%20equivalency](https://www.investopedia.com/non-fungible-tokens-nft-5115211#:~:text=Non%2Dfungible%20tokens%20(NFTs),traded%20or%20exchanged%20at%20equivalency) [https://perma.cc/6KGT-87Y4] (last updated Feb. 26, 2022).
  9. *Id.*
  10. *Id.*
  11. *Id.*

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NFTs are the next evolution of cryptocurrencies. NFTs are playing a critical role in changing the sophisticated trading and loaning systems for various assets, revolutionizing the modern finance infrastructure.<sup>12</sup> NFTs are the impetus of this change with their digital representation of physical assets and unique identification “with the benefits of a tamper-resistant blockchain of smart contracts.”<sup>13</sup>

Despite how popular cryptocurrencies and NFTs have become in the finance world, they are not resistant to the U.S. tax code.<sup>14</sup> The IRS clarified the tax treatment of cryptocurrencies through the issuance of Notice 2014-21 in 2014.<sup>15</sup> In general, the sale or exchange of cryptocurrencies and the usage of cryptocurrencies to pay for goods or services have real-world tax consequences.<sup>16</sup> However, the IRS has not issued any guidance on how to tax NFTs specifically.<sup>17</sup> NFTs create multiple taxable events for both their creators and their traders,<sup>18</sup> but the taxation of NFTs is based primarily on the tax treatment of cryptocurrencies.<sup>19</sup> To understand NFT taxation, thus, the tax treatment of cryptocurrencies must be examined. While the taxation of cryptocurrencies provides NFT taxation with a framework to work within, several issues have yet to be addressed concerning the taxation of NFTs specifically.<sup>20</sup> For example, many problems arise during the life cycle of NFTs—from their creation to the moment they become worthless.<sup>21</sup>

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12. *Id.*

13. *Id.*

14. Shehan Chandrasekera, *How Are Non-Fungible Tokens (NFTs) Taxed?*, BLOOMBERG TAX (May 26, 2021, 3:01 AM), <https://news.bloombergtax.com/daily-tax-report/how-are-non-fungible-tokens-nfts-taxed> [https://perma.cc/M9NU-A6G9].

15. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

16. *Id.* at 1.

17. Chandrasekera, *supra* note 14.

18. Amber Gray-Fenner, *NFTs: Why the Next Big Thing in the Digital Economy Is a Cash Cow for the IRS*, FORBES (Aug. 10, 2021, 10:51 AM), <https://www.forbes.com/sites/ambergray-fenner/2021/08/10/nfts-why-the-next-big-thing-in-the-digital-economy-is-a-cash-cow-for-the-irs/?sh=554d57ae4545> [https://perma.cc/NH3J-SE5N].

19. Lisa M. Blum, *The Taxation of Nonfungible Token Transactions*, THE CPA J. (Aug. 13, 2021), <https://www.cpajournal.com/2021/08/13/the-taxation-of-nonfungible-token-transactions/> [https://perma.cc/7BP4-CJCG].

20. Walter Effross, Leonard Goodman, Anthony Pochesci, & Jay A. Soled, *Tax consequences of nonfungible tokens (NFTs)*, J. OF ACCT. (June 24, 2021), <https://www.journalofaccountancy.com/news/2021/jun/tax-consequences-of-nfts-nonfungible-tokens.html> [https://perma.cc/SF4B-5WK9].

21. *Id.*

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Tax evasion is a problem worldwide. In the U.S., there is a significant tax gap between the amount of money taxpayers make from their crypto assets and the amount of taxes paid to the IRS.<sup>22</sup> This gap results from taxpayers using cryptocurrencies and NFTs as new tax havens and evasion methods.<sup>23</sup> Though the IRS has issued guidance on virtual currency taxation, the uncertainty of NFT taxation, the inherent anonymity of crypto assets, their innate cross-border nature, and their independence from governmental or financial institutions make crypto assets an easy new weapon of choice for tax evaders.<sup>24</sup> There are lax reporting and recordkeeping requirements due to these characteristics of crypto assets.<sup>25</sup>

The lack of guidance on NFT taxation potentially opens the doorway for taxpayers to evade taxes.<sup>26</sup> Specifically, an increasing number of investors and companies are finding tax havens in countries where cryptocurrencies and NFTs are tax exempt or have crypto-friendly tax policies.<sup>27</sup> For example, Singapore recently announced that the prevailing income tax rules, including making capital gains untaxable, apply to income derived from NFT transactions and trading; this means any capital gain that comes from NFT transactions will not be taxed.<sup>28</sup> The possible solution to this challenging problem is from not one source but from many examples of foreign tax regimes and efforts to address the issue of crypto tax havens and evasion. The U.S. should look at countries that have already established an NFT taxation framework in response to crypto and NFT tax havens and then adopt aspects of their remedial strategies.

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22. See Allyson Versprille, *NFT Investors Owe Billions in Taxes and IRS Sets Sights on Evaders*, BLOOMBERG WEALTH (Jan. 14, 2022, 12:00 PM), <https://www.bloomberg.com/news/articles/2022-01-14/nft-investors-owe-billions-in-taxes-as-u-s-officials-crack-down> [https://perma.cc/CCF2-4CYV].
  23. Scott Chipolina, *IRS Commissioner Concerned NFTs May Be Used for Tax Evasion*, DECRYPT (Apr. 15, 2021), <https://decrypt.co/66589/irs-commissioner-concerned-nfts-may-be-used-for-tax-evasion> [https://perma.cc/9D63-9AC2].
  24. See Omri Marian, *Are Cryptocurrencies Super Tax Havens?* 112 Mich. L. Rev. First Impressions 38 (2013), [https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1001&context=mlr\\_fi](https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1001&context=mlr_fi) [https://perma.cc/DN3R-UHG7].
  25. See *id.*
  26. Versprille, *supra* note 22.
  27. Vishal Chawla, *The Top 15 Crypto-Friendly Tax Havens*, CRYPTO BRIEFING (Feb. 11, 2021), <https://cryptobriefing.com/the-top-15-crypto-friendly-tax-havens/> [https://perma.cc/7TDK-W9QY].
  28. Chayanika Deka, *Singapore to Tax Income Generated From NFT Transactions*, CRYPTO POTATO, <https://cryptopotato.com/singapore-to-tax-income-generated-from-nft-transactions/> [https://perma.cc/2XDQ-4TGD] (last updated Mar. 12, 2022, 10:58 PM).

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## II. CRYPTOCURRENCIES & HOW THEY ARE TAXED

### A. What Are Cryptocurrencies?

There is no doubt that money has been a fundamental factor in many areas of development in the U.S. and worldwide. The division of labor and the transition from a subsistence economy to a market economy would not have been possible without money.<sup>29</sup> Modern monetary systems use fiat currencies that have no intrinsic value and are established, regulated, and backed by governments' full faith and credit.<sup>30</sup> However, transactions with fiat currencies rely on trust in the banking systems, and without trust, they become extremely risky.<sup>31</sup> Because of how important trust in the banking systems is, institutions, such as the U.S. Federal Reserve Banks, are responsible for maintaining this trust by stabilizing the money supply.<sup>32</sup>

In 2008, the world faced an economic crisis that resulted in the demise of several investment banking companies, including Lehman Brothers, Bear Stearns, and AIG.<sup>33</sup> The 2008 financial crisis inspired many to consider other ways to avoid facing the same issues again. Satoshi Nakamoto, one such individual or group of individuals, was inspired by the 2008 financial crisis and wrote the Bitcoin Whitepaper, credited with the invention of Bitcoin and cryptocurrency.<sup>34</sup> In the Bitcoin Whitepaper, Nakamoto pushed for a decentralized approach to transactions and the implementation of cryptocurrency's iconic blockchain technology, where timestamps for transactions are added to the previous timestamp to create a secured and unchangeable transactional record.<sup>35</sup> Nakamoto understood that trust is required for conventional currencies to function, but trust cannot be permanently guaranteed, as history has repeatedly demonstrated breaches of that trust.<sup>36</sup> Nakamoto also argued that governments could create more money at will and have their way with fiat currencies, while cryptocurrencies, such as Bitcoin, are finite in supply.<sup>37</sup>

Not long after the 2008 financial crisis, Satoshi Nakamoto created the first cryptocurrency, Bitcoin, to usher in a new era of blockchain technology; Nakamoto decentralized digital currencies to address many issues identified

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29. Bratspies, *supra* note 1, at 6.

30. *Id.*

31. *Id.* at 8.

32. *Id.*

33. *Id.*

34. Adam Hayes, *Who Is Satoshi Nakamoto*, INVESTOPEDIA, <https://www.investopedia.com/terms/s/satoshi-nakamoto.asp> [<https://perma.cc/P5QJ-CDF5>] (last updated May 27, 2022).

35. *Id.*

36. Bratspies, *supra* note 1, at 8.

37. *Id.* at 6.

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in fiat currencies.<sup>38</sup> Because of their autonomy and convenient characteristics, cryptocurrencies quickly became popular and a viable source of currency for many.<sup>39</sup> In 2020, it was estimated that there were over 2,000 cryptocurrencies in existence in the finance world.<sup>40</sup> They have incentivized and allowed entrepreneurs worldwide to expand into international markets easily and not be limited to only their local and national markets.<sup>41</sup> Encouraging entrepreneurs to reach out to global markets has allowed them to form relationships and develop a trust with markets never before available—a game-changer for developing nations.<sup>42</sup> Blockchain technology has undoubtedly revolutionized the cryptocurrency world.<sup>43</sup>

## B. How Are Cryptocurrencies Taxed?

Cryptocurrencies have been in the public eye for several years, and there are tax implications in their sale or exchange.<sup>44</sup> Taxable events occur when cryptocurrencies are used as a method of exchange in transactions, and how cryptocurrencies are taxed depends on how they are held and used.<sup>45</sup> According to the IRS in 2014, if cryptocurrencies are held as capital assets, they are considered “property” for tax purposes, meaning that crypto is taxed in the same way any other assets, such as stocks or gold, are taxed.<sup>46</sup> In addition to taxable events occurring every time an investment is sold or exchanged for another, taxable events also occur when different types of cryptocurrencies are traded.<sup>47</sup>

In 2014, the IRS released Notice 2014-21 discussing the tax treatment of virtual currencies.<sup>48</sup> Notice 2014-21 explains that when taxpayers receive

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38. Hayes, *supra* note 34.

39. Kaleb Davis, *The Economic Impact of Cryptocurrency*, GLOBALEDGE (Nov. 3, 2021, 10:00:24 AM), <https://globaledge.msu.edu/blog/post/57042/the-economic-impact-of-cryptocurrency> [https://perma.cc/KX9Z-X4AD].

40. *Id.*

41. *Id.*

42. *Id.*

43. Hayes, *supra* note 34.

44. *Tax Tips for Bitcoin and Virtual Currency*, TURBO TAX, <https://turbotax.intuit.com/tax-tips/tax-payments/tax-tips-for-bitcoin-and-virtual-currency/L1ZOgU00q> [https://perma.cc/L2JR-UGV7] (last updated Aug. 13, 2022, 12:14 PM).

45. *Id.*; Alex Gailey & Kendall Little, *Yes, Your Crypto is Taxable. Here's How to Report Cryptocurrency to the IRS in 2022*, TIME, <https://time.com/nextadvisor/investing/cryptocurrency/cryptocurrency-tax-guide/> [https://perma.cc/F33A-WF3K] (last updated May 23, 2022).

46. Tax, *supra* note 44.

47. Gailey & Little, *supra* note 45.

48. *Id.*

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virtual currency as payment for some good or service, the basis of that virtual currency is “the fair market value of the virtual currency in U.S. dollars as of the date of receipt.”<sup>49</sup> This also means that a cryptocurrency’s fair market value is how much it is worth if it is exchanged for U.S. dollars.<sup>50</sup> If the cryptocurrency is sold or exchanged at a profit or loss, it is considered a capital gain or capital loss.<sup>51</sup>

Like investors and owners of other capital assets, crypto investors and owners will be taxed for any gain or loss from the sale or exchange of the capital asset as a capital gain or loss.<sup>52</sup> Just like capital gains from stocks and other investments, capital gains from cryptocurrencies occur when the cryptocurrency is sold or traded for a profit.<sup>53</sup> That profit then triggers capital gains taxes.<sup>54</sup> If the cryptocurrency is sold or exchanged at a loss, no taxes are owed, but the losses must be reported on tax returns.<sup>55</sup>

The length of time a taxpayer owns the cryptocurrency also significantly determines which tax rate applies.<sup>56</sup> If the cryptocurrency is held for more than a year, it would generally qualify as a long-term capital gain or loss.<sup>57</sup> If the cryptocurrency is held and sold within a year, it would generally qualify as a short-term gain or loss.<sup>58</sup> As of 2021, short-term capital gains are taxed between 10% and 37%, while long-term capital gains are taxed between 0% and 20%.<sup>59</sup>

There are several taxable events concerning cryptocurrencies. For example, when someone sells cryptocurrency, they must report the gross income earned from that transaction based on the cryptocurrency’s fair market value when that transaction took place.<sup>60</sup> Another taxable event is selling cryptocurrency for fiat currencies such as the yen, U.S. dollar, or euro.<sup>61</sup>

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49. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

50. *Id.*

51. Joe Liebkind, *Cryptocurrency Taxes*, INVESTOPEDIA, <https://www.investopedia.com/tech/taxes-and-crypto/> [<https://perma.cc/Z46N-MTKS>] (last updated July 23, 2022).

52. Tax, *supra* note 44.

53. *Understanding the Cryptocurrency Tax Rate*, TAXBIT BLOG (May 14, 2022), <https://taxbit.com/blog/understanding-the-cryptocurrency-tax-rate> [<https://perma.cc/K2TP-NDGP>].

54. *Id.*

55. *Id.*

56. Gailey & Little, *supra* note 45.

57. *Id.*

58. *Id.*

59. *Understanding*, *supra* note 53.

60. Liebkind, *supra* note 51.

61. *Understanding*, *supra* note 53.



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When an exchange trades cryptocurrency for fiat money, the cost basis of the cryptocurrency is how much in money and fees the exchange paid, and then, to find out if there's a capital gain or loss from the transaction, the cost basis must be subtracted from the cryptocurrency's fair market value.<sup>62</sup> Cryptocurrency miners create a taxable event when they are compensated for verifying crypto transactions and adding them to the blockchain.<sup>63</sup> This compensation is taxed as ordinary income in the same way salaries are taxed, and if the mining takes place as part of a business enterprise, the tax code allows miners to report the crypto as business income and subtract the expenses they incurred in their mining operations as business expenses from their tax liability.<sup>64</sup> Using cryptocurrencies as payment for goods or services is another taxable event.<sup>65</sup> However, this taxable event is challenging because cryptocurrency users have to determine which currency was used to buy a specific good or service and then record the currency's price basis and value when used to purchase the good or service.<sup>66</sup> Such a case also only works when the coin is sold for a profit and not a loss.<sup>67</sup> A transaction cannot be classified as a loss if the trader buys a cryptocurrency for a certain amount and only uses a portion of the currency to buy a good or service when the currency is worth less than the original value.<sup>68</sup> Lastly, swapping or trading one cryptocurrency for another is another complicated taxable event.<sup>69</sup> When a trade or exchange of cryptocurrencies in a gain, the cryptocurrency owners must report that gain in U.S. dollars.<sup>70</sup> However, this is difficult for taxpayers because they must accurately track their gains or losses in U.S. dollars to report them.<sup>71</sup>

Tax treatment of cryptocurrencies is complex because of cryptocurrencies' price volatility.<sup>72</sup> Various transactional strategies have been developed to help taxpayers reduce or avoid paying taxes on the sale or exchange of their crypto assets; however, the IRS has taken a stance to limit such

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62. Liebkind, *supra* note 51.

63. *Id.*

64. *Id.*

65. *Understanding, supra* note 53.

66. Liebkind, *supra* note 51.

67. *Id.*

68. *Id.*

69. *Understanding, supra* note 53.

70. Lyle Daly, *How is Cryptocurrency Taxed (2021 and 2022 IRS Rules)*, THE MOTLEY FOOL, <https://www.fool.com/investing/stock-market/market-sectors/financials/cryptocurrency-stocks/crypto-taxes/#:~:text=A%20crypto%20trade%20is%20a,or%20lost%20in%20U.S.%20dollars> [https://perma.cc/AQS3-67WK] (last updated Mar. 1, 2022, 7:32 PM).

71. *Id.*

72. *Understanding, supra* note 53.

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situations in which such strategies can be used and reduce tax avoidance.<sup>73</sup> Despite this, the world of virtual currencies is growing ever more complicated to regulate, and tax policy and regulations must evolve to keep up.<sup>74</sup>

### III. NON-FUNGIBLE TOKENS (NFTS) & HOW THEY ARE TAXED

#### A. NFTs Take Center Stage

Non-fungible tokens (NFTs) have been one of the most recent innovations, revolutionizing the digital art world and catching the attention of international art investors and collectors.<sup>75</sup> NFTs are unique digital codes or tokens representing items such as “text, images, video, or music, along with the rights to and information about that content.”<sup>76</sup> Because of their uniqueness, NFTs create digital scarcity, according to Arry Yu, the Washington Technology Industry Association Cascadia Blockchain Council chair and managing director of Yellow Umbrella Ventures.<sup>77</sup> NFTs’ digital scarcity puts them in stark contrast with other cryptocurrencies, which are always in supply and are fungible.<sup>78</sup> When NFTs are created or transferred from one owner to another, they are registered online where the same blockchain technology that allows other cryptocurrencies to operate can universally verify the creation or transfer of such NFTs.<sup>79</sup>

NFTs are created from the digitalized representation of items, such as “art, GIFs, videos and sports highlights, collectibles, virtual avatars, video game skins, designer sneakers, and music.”<sup>80</sup> Once created, they exist on a blockchain.<sup>81</sup> Blockchain technology, designed to guarantee the privacy and security of a data record,<sup>82</sup> is used to make and preserve NFTs.<sup>83</sup> Blockchain technology records the NFTs, which are then authenticated and preserved by peer-to-peer networks to make a kind of ownership record.<sup>84</sup> However, the

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73. *Id.*

74. *See* Liebkind, *supra* note 51.

75. Megan L. Jones, *Department: Tax Tips: Taxation Guidance For Non-Fungible Tokens*, 44 L.A. LAW. 16 (Oct. 2021).

76. *Id.*

77. Conti & Schmidt, *supra* note at 7.

78. *Id.*; Jones, *supra* note 75, at 16.

79. Effross et al., *supra* note 20.

80. Conti & Schmidt, *supra* note 7.

81. *Id.*

82. *See What is Blockchain?*, SPLUNK, [https://www.splunk.com/en\\_us/data-insider/what-is-blockchain.html](https://www.splunk.com/en_us/data-insider/what-is-blockchain.html) [<https://perma.cc/M468-6GPC>].

83. Jones, *supra* note 75.

84. *Id.*

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actual ownership of the original NFT stays with the creator of that specific NFT.<sup>85</sup> Like cryptocurrency transactions, the blockchain technology that NFTs use allows for tracing back to the artwork's original artist attached to the NFT, removing any doubt as to who created the artwork.<sup>86</sup> Due to blockchain technology, fraud has been greatly limited, allowing art collectors and buyers to be more confident of the authenticity of their purchases and guarantee that they exclusively hold the NFT.<sup>87</sup> Copies of digital artworks can no longer be distributed and passed off as original because NFTs have a special "signature" that demarks their uniqueness and authenticity when their original creators issue them.<sup>88</sup>

In addition to the nonfungibility and authenticity of NFTs, NFTs are also incredibly beneficial for artists and content creators even after the original creators sell their NFTs, thanks to NFT royalties.<sup>89</sup> NFT royalties, collected through automatic smart contracts, are a way for creators to maximize their earnings from their works, and each time the NFTs are sold in the marketplace, the original creator makes money.<sup>90</sup> No intermediaries are needed between the purchaser of the NFT and the original creators, and the original creators of the NFT do not have to worry about keeping track of their work and subsequent purchases thanks to these automatic NFT royalty agreements.<sup>91</sup> The optional inclusion of automatic NFT royalty agreements is a signature characteristic that has revolutionized the art world, differentiating modern digital art from traditional works of art.<sup>92</sup> NFT royalty agreements are made possible by blockchain technology and smart contracts, which work together to ensure that the original creators of these digital artworks are identified and paid accordingly for their work without worrying about fraudulent copies being circulated in the markets.<sup>93</sup> Additionally, creators and artists of digital artworks and pieces can produce as many NFTs as they wish from the original, each having a distinctive code and set of intellectual property rights affixed that ensure the artists receive whatever profits the artists are entitled to from the work of art.<sup>94</sup>

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85. *Id.* at 17.

86. *Id.*

87. *Id.*

88. *Id.* at 16.

89. AlexWGomez, *NFT Royalties: What Are They and How Do They Work?*, CYBER SCRILLA, <https://cyberscrilla.com/nft-royalties-what-are-they-and-how-do-they-work/> [https://perma.cc/7D9D-8CA7].

90. *Id.*

91. *Id.*

92. Jones, *supra* note 75, at 17.

93. AlexWGomez, *supra* note 89.

94. Jones, *supra* note 75, at 17.

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## B. NFTs and Their Taxation Framework

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.<sup>95</sup> One frontier of discovery for NFTs is how NFTs will be taxed and what participation in the NFT marketplace will look like for taxpayers.<sup>96</sup> Even with NFTs' growing prevalence, the IRS has yet to issue much specific guidance on how NFTs should be taxed.<sup>97</sup> The IRS has only issued Notice 2014-21 and Rev. Rul. 2019-24 to provide some guidance on the tax consequences of "virtual currency" or "cryptocurrency".<sup>98</sup> Therefore, taxpayers rely on broad tax principles that treat NFTs and cryptocurrencies as property transactions to report their taxes from NFTs.<sup>99</sup> However, as intangible assets, NFTs raise a host of tax issues because their intangible nature creates unique complexities regarding what is traded.<sup>100</sup> NFTs are never-before-seen assets, and the Internal Revenue Code has not considered all the different transactions that can occur at various points in an NFT's life cycle, so NFT taxation largely leans on broad cryptocurrency tax principles.<sup>101</sup>

NFTs have a life cycle that includes various events, including their creation, use in transactions, charitable contributions, and even loss of value, and their interactions in these various events create tax implications.<sup>102</sup> To understand the tax framework of NFTs throughout their life cycle, taxpayers must sort out several factors, including:

whether it is the NFT's creator who is selling the NFT; if the seller is an investor, dealer, trader, collector, or personal user; the duration of time for which the NFT was held; whether the value of the NFT appreciated while the seller had it; what type of property is used to purchase the NFT; and, if the buyer used appreciated property to buy the NFT, and how long the buyer held that property.<sup>103</sup>

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95. *See id.* at 16.

96. *See id.*

97. Chandrasekera, *supra* note 14.

98. Effross et al., *supra* note 20.

99. Jones, *supra* note 75, at 17.

100. *Id.*

101. *Id.*

102. Effross et al., *supra* note 20.

103. Andrea S. Kramer, *Taxation of the Purchase and Sale Of NFTs*, 12 THE NATIONAL L. REV. 1, 2 (Jan. 12, 2022), <https://www.natlawreview.com/article/taxation-purchase-and-sale-nfts> [<https://perma.cc/ZF4A-X79Y>].

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### 1. *Starting at Creation*

First in an NFT's life cycle is its creation. The creation of an NFT, also known as minting, is not a taxable event.<sup>104</sup> The initial creator of the NFT, one of the common types of NFT sellers,<sup>105</sup> tokenizes their art into an NFT.<sup>106</sup> Even though profit is generated from tokenization of the art as the NFT may be more valuable than the original art, the Internal Revenue Code does not tax imputed income on such profit.<sup>107</sup> This is similar to how the Code does not tax a copied artwork that an artist makes more valuable by autographing it.<sup>108</sup> Only when the buyer of the NFT pays the total price for the NFT, which includes the artwork's price and the price of the artwork's tokenization, is that entire price taxed under § 61 of the Internal Revenue Code to the artist as gross income.<sup>109</sup> Once the creator sells or transfers the NFT, the NFT's creator will continue to have taxable income from the NFT in addition to the new owner having taxable income from the NFT.<sup>110</sup>

At this stage, when the NFTs are held by their creators or dealers, they are characterized as ordinary assets, and NFT transactions at this stage will produce ordinary income and loss.<sup>111</sup> According to IRC Code § 1221(a)(3), NFTs are ordinary assets when held by creators because they are like "a patent, model, copyright, literary composition, 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."<sup>112</sup> In the hands of broker dealers, another common type of NFT sellers, they are also ordinary assets that produce ordinary income and loss in because the NFTs are held as inventory to be sold to customers "in the ordinary course of business."<sup>113</sup> However, this could change with how the NFT is used and who uses the NFT.

### 2. *In Sales or Exchanges*

The next event in an NFT's life cycle is its sale or exchange, which involves the third common type of NFT seller, the collector or investor, who can subsequently assign the NFT with the original or lesser rights trans-

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104. Effross et al., *supra* note 20; Jones, *supra* note 75, at 17.

105. Jones, *supra* note 75.

106. Effross et al., *supra* note 20.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. Kramer, *supra* note 103, at 2.

112. *Id.*; I.R.C. § 1221(a)(3) (2017).

113. Kramer, *supra* note 103, at 2; I.R.C. § 1221(a)(1) (2017); Jones, *supra* note 75, at 17.

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ferred.<sup>114</sup> Most owners of NFTs are considered NFT investors.<sup>115</sup> To tax an NFT at this point, it is crucial to determine whether the NFT is a capital or noncapital asset and how long the NFT was held if it is determined to be a capital asset.<sup>116</sup> In the eyes of the IRS, NFTs held by their creators are likely characterized as noncapital assets, while those held by taxpayers other than the NFTs' creators, such as investors, traders, and collectors, are likely characterized as capital assets.<sup>117</sup> Thus, if the creator of the NFT sells or exchanges the NFT for a gain or loss, the gain or loss would be considered ordinary gain or ordinary loss.<sup>118</sup> However, when a taxpayer other than the creator sells or exchanges the NFT they held for gain or loss, the gain or loss would be considered capital gain or loss.<sup>119</sup> How long the NFTs are held as capital assets is another important consideration as capital assets held for a year or less are characterized as short-term capital assets, and those held for longer than a year are characterized as long-term capital assets.<sup>120</sup> There are other considerations that further affect the characterization of NFTs held by the second type of NFT seller, the collector or investor, that add more complexities to their tax framework.

When NFTs are treated as § 1221(a)(3) assets, and someone other than the NFTs' original creators use the NFTs in trade or business, §1221 (a)(2) would classify the NFT as a § 1231 asset.<sup>121</sup> As a § 1231 asset and no longer a noncapital asset, transactions may produce capital gains or ordinary losses.<sup>122</sup> If the taxpayers use the NFT in a business transaction, and there is a net overall § 1231 gain, § 1231(a) will characterize the § 1231 gain and losses and long-term capital gains or long-term capital losses.<sup>123</sup> On the other hand, § 1231(a)(2) will characterize the § 1231 gains and losses as ordinary gains and ordinary losses if the converse is true, and the § 1231 losses are not less than the § 1231 gains that result from the business transaction with the NFT.<sup>124</sup>

When collectors or investors hold NFTs as collectibles, the current tax framework special capital gain tax rate for other collectible assets also ap-

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114. Jones, *supra* note 75, at 17.

115. Chandrasekera, *supra* note 14.

116. See Effross et al., *supra* note 20.

117. *Id.*

118. *Id.*; Jones, *supra* note 75, at 18.

119. Jones, *supra* note 75, at 18.

120. Kramer, *supra* note 103, at 2.

121. Effross et al., *supra* note 20.

122. Kramer, *supra* note 103, at 2.

123. Effross et al., *supra* note 20.

124. *Id.*

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plies to those NFTs.<sup>125</sup> NFTs are unique works of art and can be considered collectibles like traditional art pieces.<sup>126</sup> When NFTs are classified as collectibles, held for a year or more, and produce a gain in a transaction, they are considered long-term capital gains.<sup>127</sup> The NFTs will be taxed at a 28% capital gain rate as a long-term capital gain.<sup>128</sup> In contrast, even if an NFT is characterized as a collectible, if it has short-term capital gains, those short-term capital gains will receive no special tax treatment and will be taxed at the usual rates that apply to capital assets.<sup>129</sup> Only losses from the sale or exchange of collectibles are subject to a limitation.<sup>130</sup>

The conversation of cryptocurrency for the purchasing of NFTs creates another taxable event that affects the classification of gains and losses for collectors or investors.<sup>131</sup> Currently, NFTs must be bought with cryptocurrencies, and since the IRS classifies cryptocurrency as property, buying an NFT creates a taxable event in which the cryptocurrency is converted into an NFT.<sup>132</sup> It is important to note that when purchasing NFTs with cryptocurrencies, the transaction is considered a barter transaction.<sup>133</sup> Therefore, the gain or loss that arises from that transaction depends on the appreciation or depreciation of the cryptocurrency used to buy the NFT as the buyer held the cryptocurrency.<sup>134</sup> If the buyer has appreciated cryptocurrency and does not use it to purchase the NFT, the buyer can avoid paying taxes for the NFT purchase.<sup>135</sup> Instead, the buyer could purchase new cryptocurrency to pay for the NFT, and the newly acquired, unappreciated cryptocurrency will allow the taxpayer to not experience any gain or loss from the purchasing of the NFT.<sup>136</sup> The characteristic of the gain or loss from the barter transaction of cryptocurrency for NFTs also depends on whether the cryptocurrency used to buy the NFT is a capital or an ordinary asset in the buyer's hand.<sup>137</sup>

Investors and collectors can hold NFTs for personal use, such as a hobby or recreational activity, and as a result, the characterization of their

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125. Kramer, *supra* note 103, at 3.

126. *See id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. Gray-Fenner, *supra* note 18.

132. *Id.*

133. Kramer, *supra* note 103, at 5.

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.*

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gains and losses as personal-use assets will be affected.<sup>138</sup> Critical to this classification of the NFT is the taxpayer's intent, which determines whether the NFT held is for personal or investment use.<sup>139</sup> NFTs are likely to be treated as personal-use assets if the taxpayer does not use the NFT frequently enough to qualify as investment activity or if the taxpayer does not document enough evidence of investment activity to show an intent of using the NFT for something other than personal use.<sup>140</sup> When NFTs held for personal use produce gains in a sale, the gain will be taxed as capital gains.<sup>141</sup> However, if there are losses from the sale of NFTs held for personal use, the losses would not be deductible from the taxpayer's tax liability.<sup>142</sup> NFTs held for personal use cannot benefit from being deductible as a loss under § 165(c) when NFTs become worthless in value.<sup>143</sup> Lastly, any expenses that arise from the personal-use NFT cannot be deducted from the taxpayer's tax liability unless it is specifically allowed in § 183 of the Code.<sup>144</sup>

### 3. As Charitable Contributions

Charitable contributions are a popular way for taxpayers to deduct their adjusted gross income and reduce their tax liability.<sup>145</sup> Taxpayers can also donate NFTs as charitable contributions during the NFT's life cycle.<sup>146</sup> NFTs are not the most suitable form of contribution to charities as NFTs cannot easily be converted to fiat currencies in the same way cryptocurrencies are, and most charities would rather take an asset that can be readily converted to cash.<sup>147</sup> In theory, it is possible to donate NFTs to charities directly despite these impracticalities.<sup>148</sup>

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138. 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-the-seller-of-an-nft-report-it-for-tax-purposes> [https://perma.cc/Y4AU-AD6F].

139. *Id.*

140. Kramer, *supra* note 103, at 4.

141. *See id.*

142. Fortuna et al., *supra* note 138.

143. *Id.*; Kramer, *supra* note 103, at 4.

144. Kramer, *supra* note 103, at 4.

145. *See 7 charitable tax deduction questions answered*, FIDELITY CHARITABLE, <https://www.fidelitycharitable.org/guidance/charitable-tax-strategies/charitable-tax-deductions.html> [https://perma.cc/84F7-B7EK].

146. *See Effross et al., supra* note 20.

147. Andrea S. Kramer, *NFTs and Charitable Fundraising: Navigating Tax Hurdles*, 12 THE NATIONAL L. REV. 1, 2 (Jan. 12, 2022), <https://www.natlawreview.com/article/nfts-and-charitable-fundraising-navigating-tax-hurdles> [https://perma.cc/6PMA-VM4X].

148. *Id.* at 3.



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The Treasury released Treas. Reg. § 1.170A-1(g) which disallows any fair market value deduction of services performed on a charity's behalf.<sup>149</sup> This limitation raises complications as taxpayers must consider whether the NFT may be regarded as providing the charity a service or as a donated property.<sup>150</sup> However, with Notice 2014-21, many NFTs would be seen as property, not services.<sup>151</sup> There is case law supporting this.<sup>152</sup> In *Holmes*, the Tax Court allowed the taxpayer to take charitable deductions for two films that the taxpayer produced for two charitable organizations, finding them not the taxpayer's services.<sup>153</sup> In the case of *Cupler*, the taxpayer developed an eye cataract removal device and a heart-lung machine to donate to a qualified charity.<sup>154</sup> The Tax Court, in this case, stated that the taxpayer is allowed to deduct the value of the two devices donated on the basis that the services performed were "coalesced in the resultant property interest."<sup>155</sup> Despite the case law supporting the finding of NFTs as property and not services, the lack of NFT-specific tax guidance from the IRS leaves room for argument about what NFTs are exactly.<sup>156</sup>

The valuation of NFTs depends on how much a buyer and seller are willing to pay and sell the NFT for.<sup>157</sup> Because of this, an NFT that has not been sold or bought does not have a market value and is not fit for direct charitable donation unless the NFT fits a charity's mission.<sup>158</sup> However, when someone other than the creator of the NFT donates the NFT to a qualified charitable organization, that taxpaying donor can reduce their tax liability the donated NFT's fair market value plus the contributed amount minus the short-term capital gain that the donor would have originally reported if the donor had sold the NFT under § 170(e)(1)(A).<sup>159</sup>

Two hurdles with charitable contributions of NFTs are recordkeeping requirements and identification. NFTs require rigorous documentation of their usage as charitable contributions because they are noncash donations.<sup>160</sup> The problem with identifying NFTs is that as unique digital assets with distinct characteristics that differentiate them from cryptocurrencies, NFTs must

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149. *Id.*; Effross et al., *supra* note 20.

150. Kramer, *supra* note 147, at 3.

151. *Id.*

152. *See id.*

153. *Holmes v. Comm'r*, 57 T.C. 430, 437 (1971); Effross et al., *supra* note 20.

154. *Cupler v. Comm'r*, 64 T.C. 946, 953 (1975); Effross et al., *supra* note 20.

155. *Cupler*, 64 T.C. at 954; Effross et al., *supra* note 20.

156. Kramer, *supra* note 147, at 3–4.

157. *See id.* at 4–5.

158. *Id.* at 5.

159. *Id.*; I.R.C. § 170(e)(1)(A).

160. Kramer, *supra* note 147, at 5.

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be individually identified when they are used, whether purchased or sold.<sup>161</sup> Recordkeeping and reporting requirements of NFT charitable donations lack any specific guidance from the IRS, leaving most NFTs and cryptocurrencies to be considered property for taxation purposes that need donors to carefully keep track of how much and what type of donation they are making.<sup>162</sup>

#### 4. *Ending with Death – When NFTs Become Worthless*

The final stage in an NFT's life cycle is when it becomes worthless, which also has tax implications.<sup>163</sup> How the NFT will be taxed depends on in whose hands did the NFT become worthless.<sup>164</sup> § 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.<sup>165</sup> 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.<sup>166</sup> 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).<sup>167</sup>

### C. **Current Problems with NFT Taxations**

Except for a few tax treatments, tax guidance on NFTs remains unclear on many topics.<sup>168</sup> Addressing the taxation of NFTs by analogizing to the taxation of cryptocurrencies and other intangible properties is progress but is ultimately not perfect as NFTs are unique assets that differentiate them from cryptocurrencies and other intangible properties.<sup>169</sup> For there to be proper taxation of NFTs, the IRS must issue NFT-specific tax guidance.<sup>170</sup> Several complications with the taxation of NFTs have to be resolved.

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161. *Id.*

162. *Id.*

163. Effross et al., *supra* note 20.

164. *Id.*

165. *Id.*

166. *Id.*; I.R.C. § 165(c).

167. Effross et al., *supra* note 20; Treas. Regs. § 1.197-2(g)(1)(i)(B)(2020).

168. Michael Cohn, *Tax Guidance on NFTs remains a murky area*, ACCT. TODAY (Aug. 6, 2021, 4:31 PM), <https://www.accountingtoday.com/news/tax-guidance-on-nfts-remains-a-murky-area> [<https://perma.cc/6UZT-UMCT>].

169. *As non-fungible tokens (NFTs) gain momentum, taxpayers should be aware of related tax obligations*, WOLTERS KLUWER (Dec. 2, 2021), <https://www.wolterskluwer.com/en/news/as-non-fungible-tokens-gain-momentum-taxpayers-should-be-aware-of-related-tax-obligations> [<https://perma.cc/L6UY-6U23>].

170. Effross et al., *supra* note 20.

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A core problem that arises with the taxation of NFTs that must be solved before any tax of NFTs can be fully understood is the valuation of NFTs.<sup>171</sup> The volatility of NFTs also makes their valuations a concern.<sup>172</sup> To determine if there are gains or losses with the sale or exchange of NFTs, taxpayers must know their fair market value, the price at which the NFT would change hands between a buyer and seller.<sup>173</sup> The valuation of NFTs largely depends on their value in the marketplace in the same way traditional art is valued in an auction house.<sup>174</sup> It is how much people are willing to pay for the artwork, which is affected by various factors. For example, age affects the value of the NFT as older NFTs may be considered a “digital artifact” with a greater value.<sup>175</sup> The marketability of the NFT and the creator’s fame also affect the value of the NFT, increasing the value of the NFT if the NFT has high marketability and if a famous artist made the NFT.<sup>176</sup> One of the most recent trends to increase the value of NFTs is destroying the original artwork.<sup>177</sup> When the original artwork is destroyed, leaving the NFT as the “only remaining form,” the NFT becomes a more valuable, rare digital asset.<sup>178</sup> A less drastic method of increasing the value of an NFT is using contractual restrictions to limit the display of the original work.<sup>179</sup> That way, the creator cannot publicly display, use the original work, or even license the original artwork to someone else.<sup>180</sup> If the creator violates the contractual restrictions, the buyer has a potential breach of contract and a potential copyright infringement claim.<sup>181</sup>

Finally, calculating NFT gains and losses is also difficult. NFT marketplaces are relatively new and do not provide any tax documents or transac-

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171. Matthew Erskine, *Uncertainty In the Valuation of Non-Fungible Tokens*, FORBES (Feb. 2, 2022, 2:52 PM EST), <https://www.forbes.com/sites/matthewerskine/2022/02/02/uncertainty-in-the-valuation-of-non-fungible-tokens/> [https://perma.cc/XQ6K-JEKY].

172. *As non-fungible tokens (NFTs) gain momentum, taxpayers should be aware of related tax obligations*, *supra* note 169.

173. Erskine, *supra* note 171.

174. *Id.*

175. *Id.*

176. *Id.*

177. Ben Natter & Audrey Sparschu, *Valuation of NFTS: Factors to Consider and an Alternative to Destroying the Original Work*, HAUG PARTNERS (July 28, 2021), <https://haugpartners.com/article/valuation-of-nfts-factors-to-consider-and-an-alternative-to-destroying-the-original-work/> [https://perma.cc/C6AH-9C2J]

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

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tion history reports that would be helpful to taxpayers in calculating their NFT capital gains and losses.<sup>182</sup> In dealing with cryptocurrency, however, many tax software can help taxpayers automatically calculate their capital gains and losses, though the software for NFTs is still relatively new and is not as reliable.<sup>183</sup>

#### IV. CRYPTOCURRENCY AND NFT TAX HAVENS AND TAX EVASION

Virtual currencies have drawn much excitement, sparking the popularity of cryptocurrencies and NFT investors but have also drawn the scrutiny and worry of tax regulators.<sup>184</sup> In May 2013, the Government Accountability Office (GAO) more closely examined the regulation of virtual currencies, publishing a public report detailing the potential tax-compliance risks that can arise with the increasingly prevalent use of virtual currencies and economies.<sup>185</sup> In 2014, the IRS released its taxation framework for virtual currencies.<sup>186</sup> IRS Commissioner Charles Rettig also addressed the serious concern with NFT and cryptocurrency tax evasion,<sup>187</sup> telling the Senate Finance Committee that the IRS fails to collect about \$1 trillion in taxes every year, partly because of the explosive popularity of cryptocurrency usage, which is designed to be difficult to regulate and tax.<sup>188</sup> A Treasury Department Tax Compliance Agenda issued in late May 2021 identified cryptocurrencies as the main concern when it comes to illicit activities, including tax evasion because tax evaders who once relied on using offshore bank accounts or fiat currencies to avoid their tax obligations are now taking advantage of the unregulated NFTs and other crypto assets to avoid detection from tax authorities.<sup>189</sup> What regulatory bodies need to consider, however, is that cryptocurrencies and NFTs possess the traditional characteristics of tax havens that make reporting requirements lax and thus, attractive to tax evaders.<sup>190</sup> In par-

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182. Shehan Chandrasekera, *How to Avoid Common NFT Tax Pitfalls*, Forbes (Oct. 28, 2021), <https://www.forbes.com/sites/shehanchandrasekera/2021/10/28/how-to-avoid-common-nft-tax-pitfalls/?sh=7d01b3a3176a> [<https://perma.cc/LU62-932J>].

183. *Id.*

184. Marian, *supra* note 24.

185. *Id.*

186. I.R.S. Notice 2014-21, *supra* note 15.

187. Joyce Beebe, *The Uncharted Territory of Taxing Non-fungible Tokens (NFTs)*, Baker Institute Blog (June 8, 2021), <https://blog.bakerinstitute.org/2021/06/08/the-uncharted-territory-of-taxing-non-fungible-tokens-nfts/> [<https://perma.cc/GDW6-7E8X>].

188. Chipolina, *supra* note 23.

189. Beebe, *supra* note 187.

190. *Id.*; Marian, *supra* note 24, at 39.

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ticular, the taxpayer who uses the crypto assets in transactions remains anonymous, and the crypto asset transaction does not take place in any one specific jurisdiction that exposes it to taxation at its source.<sup>191</sup> Cryptocurrencies and NFTs also have independence from governmental and financial institutions, making them more profitable than offshore tax evasion operations that the IRS has largely cracked down on.<sup>192</sup>

Tax havens are other jurisdictions with “no or only nominal taxation” that attract taxpayers seeking to evade paying taxes in their home jurisdictions.<sup>193</sup> Crypto asset-rich taxpayers in countries with a taxation framework for imposing capital gain taxes on cryptocurrencies and NFTs are drawn to countries with these lax capital gain taxes.<sup>194</sup> Many tax havens have adopted blockchain technology, making it more profitable for cryptocurrency and NFT users to relocate there.<sup>195</sup> Places like Singapore and Puerto Rico are popular locations for an increasing number of investors looking to move to places where their cryptocurrency and NFTs are tax-exempt or treated with crypto-friendly policies.<sup>196</sup> Businesses even sell passports to taxpayers looking to avoid paying taxes on their cryptocurrency profits.<sup>197</sup> Individuals also take advantage of international jurisdictions to avoid paying taxes by not reporting the passive income, such as interest and dividends, they earn in those jurisdictions.<sup>198</sup> Addressing tax evasion and avoidance through tax havens has been the subject of many congressional and presidential proposals.<sup>199</sup>

Cryptocurrencies and NFTs are most favorable for unlawful transactions and activities.<sup>200</sup> Cryptocurrencies and NFTs are anonymous as users can

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191. Marian, *supra* note 24, at 39, 42.

192. *Id.* at 39.

193. *Id.* at 40.

194. *See* Chawla, *supra* note 27.

195. *Id.*

196. *Top 10 Crypto Tax Free Countries 2022*, KOINLY, <https://koinly.io/blog/crypto-tax-free-countries/> [<https://perma.cc/7AEZ-D2KP>] (last updated Jan. 5, 2022).

197. MacKenzie Sigalos, *This company sells passports to Americans looking for a tax break on their bitcoin profits*, CRYPTO DECODED (July 11, 2021, 11:19 AM EDT), <https://www.cnbc.com/2021/07/11/plan-b-passport-tax-break-bitcoin-profits.html#:~:text=Crypto%20Decoded-,This%20company%20sells%20passports%20to%20Americans%20looking%20for,break%20on%20their%20bitcoin%20profits&text=Plan%20B%20Passport%20offers%20crypto,gains%20taxes%20on%20crypto%20holdings> [<https://perma.cc/JKY8-K7ES>].

198. Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CONGRESSIONAL RESEARCH SERVICE (Jan. 6, 2022), <https://sgp.fas.org/crs/misc/R40623.pdf> [<https://perma.cc/ZU8B-8JEC>].

199. *Id.*

200. Marian, *supra* note 24, at 42.

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purchase or mine cryptocurrencies and trade them without disclosing their true identity.<sup>201</sup> Secondly, NFTs and cryptocurrencies are cross-border in nature and thus, do not operate in any specific jurisdiction that would expose them to taxation at that source.<sup>202</sup> This makes them easily exchanged and sold in countries with lax or no capital gain taxation policies.<sup>203</sup> Cryptocurrencies and NFTs operate autonomously, are decentralized, and are independent of any governmental or financial institution and control.<sup>204</sup> They are exchangeable peer-to-peer and are held in cyberspace accounts known as “online wallets” without anyone to regulate them.<sup>205</sup> Cryptocurrencies and NFTs are intangible property, operating in a not visible world.<sup>206</sup> Because of these crypto assets’ anonymity, cross-border nature, and removal from regulatory institutions, there are incredibly lax reporting requirements for earning from transactions of these crypto assets, leaving the federal government blind to many of these transactions occurring daily.<sup>207</sup> Crypto assets are becoming a major concern that requires governmental attention.

With the evolution of the financial market around the developments of crypto assets, offshore tax havens have also evolved to include crypto assets in their tax frameworks. For example, Singapore is one of the world’s economic hubs, even dominating as one of Asia’s most sophisticated and fastest-developing economies.<sup>208</sup> Singapore is classified as a tax haven because non-resident offshore companies benefit from Singapore’s favorable tax advantages and its ability to attract foreign investors with massive tax breaks, lax immigration policies, and a favorable business environment.<sup>209</sup> Singapore’s tax system only taxes domestically-sourced income and attracts foreign investors with its “many tax breaks for certain industries,” including the crypto asset market.<sup>210</sup> In 2022, Singapore announced that NFT-derived income is no longer immune from tax implications, but this does not mean Singapore

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201. *Id.*

202. *Id.*

203. *See Top 10, supra* note 196.

204. Hayes, *supra* note 34.

205. Marian, *supra* note 24, at 42.

206. Chipolina, *supra* note 23.

207. Greg Iacurci, *Cryptocurrency poses a significant risk of tax evasion*, CNBC (May 31, 2021, 8:30 AM), <https://www.cnbc.com/2021/05/31/cryptocurrency-poses-a-significant-risk-of-tax-evasion.html> [<https://perma.cc/QWZ4-RXBQ>].

208. Offshore Protection, *International Offshore Jurisdiction Spotlight – Singapore as a Tax Haven*, OFFSHORE PROTECTION, <https://www.offshore-protection.com/singapore-offshore-tax-haven#:~:text=The%20country%20has%20attracted%20international,to%20offshore%20on%2Dresident%20companies> [<https://perma.cc/NWX7-7B94>] (last updated Feb. 26, 2022).

209. *Id.*

210. *Id.*

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will become less attractive to taxpayers.<sup>211</sup> Singapore's Finance Minister, Lawrence Wong, assured taxpayers that since Singapore does not have a capital gains tax regime, the country will not tax capital gains from NFT and cryptocurrency transactions.<sup>212</sup> As a low-tax jurisdiction,<sup>213</sup> Singapore prides itself on having one of the world's most taxpayer-friendly cryptocurrency legislation, making it the ideal place for crypto asset investors to relocate to.<sup>214</sup> Even the 2022 budget proposal for raising taxes on high-income earners does not dim Singapore's attractiveness to high-value individuals, including crypto asset investors, because of Singapore's lack of a capital gains tax.<sup>215</sup>

Puerto Rico, a U.S. territory that creates its own tax laws, is a popular tax haven of choice for American crypto asset investors.<sup>216</sup> Puerto Rico is immensely attractive to U.S. crypto and NFT holders because they can benefit from the tax haven without giving up their U.S. citizenship.<sup>217</sup> Once the crypto or NFT owners move to Puerto Rico and stay on the island for at least 183 days a year, there are no taxes on capital gains from the digital asset transaction, and if a business exports services from Puerto Rico elsewhere, there is only a 4% corporate tax rate.<sup>218</sup> Compared to the current tax framework implemented in the U.S. for cryptocurrencies and NFTs, which taxes short-term capital gains up to 37% and long-term capital gains up to 20%,

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211. Reethu Ravi, *Singapore to Introduce An Income Tax On NFT Transactions*, NFT EVENING (Mar. 14, 2022), <https://nftevening.com/singapore-to-introduce-an-income-tax-on-nft-transactions/> [https://perma.cc/59LJ-7D57].

212. *Id.*

213. Selva Ozelli, *Why Singapore is one of the most crypto-friendly countries*, COINTELEGRAPH (Feb. 12, 2022), <https://cointelegraph.com/news/why-singapore-is-one-of-the-most-crypto-friendly-countries> [https://perma.cc/HZP4-6J6X].

214. *Singapore to Charge Income Tax On NFTs*, COINCU (Mar. 11, 2022), <https://news.coincu.com/71856-singapore-to-charge-income-tax-on-nfts/> [https://perma.cc/3UTC-UBSE].

215. Arnold Kirimi, *Singapore Finance Minister Confirms Income Tax Will Apply to NFTs*, FX EMPIRE (last updated Mar. 11, 2022, 4:22 CST), <https://www.fxempire.com/news/article/singapore-finance-minister-confirms-income-tax-will-apply-to-nfts-931530> [https://perma.cc/PJL4-AAWB].

216. *Could Puerto Rico Be Your Crypto Tax Haven?*, GORDON LAW GROUP (Aug. 12, 2021), <https://gordonlawltd.com/puerto-rico-crypto-tax-haven/> [https://perma.cc/2629-GXWU].

217. *Id.*

218. Mark Ellwood, *How Puerto Rico became a tax haven for high-flying crypto millionaires*, NY POST (Dec. 27, 2021, 3:32 PM), <https://nypost.com/2021/12/27/how-puerto-rico-became-a-tax-haven-for-crypto-millionaires/> [https://perma.cc/VAH4-DZK9].

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Puerto Rico's tax laws are more beneficial to taxpayers.<sup>219</sup> This is all thanks to Puerto Rico's Act 60, which encourages financial investments in Puerto Rico through generous tax breaks and incentives.<sup>220</sup> In Puerto Rico, dubbed "Crypto Rico," cryptocurrencies and other blockchain technology are welcomed and enjoy the same benefits.<sup>221</sup> Therefore, once crypto asset investors have established residence in Puerto Rico to qualify for tax exemptions, they immediately begin building up their portfolios with NFTs, crypto games, and token-swapping, which they can manage from anywhere in the world.<sup>222</sup>

With the tax evasion potential of cryptocurrencies and NFTs, the 2013 GAO Report's primary recommendation to the IRS has been to devise "low-cost ways to provide information to taxpayers . . . on the basic tax reporting requirements for transactions using virtual currencies developed and used outside virtual economics," like posting the relevant reporting requirements on the IRS's website.<sup>223</sup> However, even with the IRS Notice 2014-21, which lays out the taxation framework for cryptocurrencies and also suggests how NFTs should be taxed, the real difficulties that crypto assets pose to tax collection remains.<sup>224</sup> Simply educating taxpayers on calculating their tax liabilities from their cryptocurrencies and NFTs does little to remedy the tax-evasion problem because tax evaders who use offshore tax havens, crypto assets, or other means to avoid taxes are already well aware of their obligation to report their earnings.<sup>225</sup> They are decisively choosing to evade taxes.<sup>226</sup> To solve the problem of tax evasion through crypto assets, the IRS must develop enforcement mechanisms that will allow tax authorities to keep track of the hidden earnings made from crypto transactions.<sup>227</sup> The IRS might need to look across borders at foreign tax regulatory regimes to develop a method of addressing crypto asset tax evasion.

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219. Rafael Matos, *Practical Techie: Crypto boom in Puerto Rico shaken by ups and downs*, NEWS IS MY BUSINESS (Feb. 2, 2022), <https://newsismybusiness.com/practical-techie-crypto-boom-in-puerto-rico-shaken-by-ups-and-downs/> [<https://perma.cc/Y22J-GYMS>].

220. *Could Puerto Rico Be Your Crypto Tax Haven?*, *supra* note 216.

221. *See* Ellwood, *supra* note 218.

222. Matos, *supra* note 219.

223. Marian, *supra* note 24, at 45; *see* Gov't Accountability Office, GAO-13-516, VIRTUAL ECONOMIES AND CURRENCIES: ADDITIONAL IRS GUIDANCE COULD REDUCE TAX COMPLIANCE RISKS, 16 (2013), <https://www.gao.gov/assets/gao-13-516.pdf> [<https://perma.cc/S3RY-Z8W3>].

224. *See generally* Effross, *supra* note 20.

225. Marian, *supra* note 24, at 45.

226. *Id.*

227. *Id.*



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### A. Solutions to the Problem

The first aspect of crypto assets that allows taxpayers to evade taxes is anonymity.<sup>228</sup> To properly tax cryptocurrencies and NFTs, the anonymity around crypto asset owners must be uncovered because it prevents regulatory authorities from sufficiently monitoring crypto assets and allows suspicious transactions to go undetected.<sup>229</sup> With crypto assets transactions, tax evasion can easily occur because tax authorities do not know what parties were involved in the transaction with the anonymity that crypto assets provide, and as a result, the tax evasion is allowed to happen unpunished.<sup>230</sup> To address the problem with anonymity, it would be ineffective to use “complex statistical analysis” methods to identify the owners of crypto assets.<sup>231</sup>

The European Union Commission announced its plan to ban cryptocurrency anonymity completely in response to financial crimes with a package of new reforms.<sup>232</sup> The EU currently has rules called “Know Your Customer” (KYS) implemented on other financial institutions, and the proposed law would expand the KYS provisions to all crypto assets.<sup>233</sup> The ban on the anonymity of crypto assets would require the discontinuation of anonymous crypt asset wallets, and service providers like crypto exchanges will be tasked with doing their due diligence on their users and be responsible for recording their users’ identities too.<sup>234</sup> The Travel Rule making crypto transactions traceable will also be applied.<sup>235</sup> In the U.S., the IRS could consider adopting a variation of this ban to whatever degree would best fit the situation in the U.S. to remove some of the anonymity surrounding crypto transactions. For example, like how the EU would be forcing service providers exchanging crypto on behalf of a customer to record the customer’s informa-

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228. *Id.* at 39.

229. Robby Houben & Alexander Snyers, *Cryptocurrencies and Blockchain Legal Context and Implications for Financial Crime, Money Laundering, and Tax Evasion*, EUROPEAN PARLIAMENT 1, 53 (July 2018) <https://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf> [<https://perma.cc/3THZ-BSLQ>].

230. *Id.*

231. Marian, *supra* note 24, at 45–46.

232. Naomi O’Leary, *EU to Ban Cryptocurrency Anonymity in Anti-Money Laundering Plan*, THE IRISH TIMES (July 20, 2021, 20:43), <https://www.irishtimes.com/business/economy/eu-to-ban-cryptocurrency-anonymity-in-anti-money-laundering-plan-1.4626129> [<https://perma.cc/V55M-VBD3>].

233. Tom Bateman, *EU Will Make Bitcoin Traceable and Ban Anonymous Crypto Wallets in Anti-Money Laundering Drive*, EURONEWS, <https://www.euronews.com/next/2021/07/21/eu-will-make-bitcoin-traceable-and-ban-anonymous-crypto-wallets-in-anti-money-laundering-d> [<https://perma.cc/34WJ-VBRR>] (last updated Aug. 26, 2021).

234. *Id.*

235. *Id.*

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tion, the IRS could require NFT auctioning or exchange platforms to record the information of the NFT's creator and buyers.

Having faced a loss of about \$93 million tax dollars from Japan-based entities failing to report their crypto gains, Japan is preparing a new system to combat the problem of crypto tax evasion.<sup>236</sup> The new system will give the National Tax Agency (NTA), Japan's official tax collection body, the authority to ask that crypto exchanges provide relevant revenue data, such as the names and addresses of their consumers.<sup>237</sup> Under this new system, failure to comply to the disclosure requirements for identification information will result in penalties imposed on the crypto exchanges and operators.<sup>238</sup> Japan and the EU have similar ideas regarding requesting information from crypto exchanges and providers, and the IRS could consider a similar system. The IRS should especially consider the penalty aspect of Japan's new information recording system as it is a way to motivate compliance and improve record-keeping from all participants in crypto asset transactions.

Besides anonymity, crypto assets are innately cross-border, meaning they can operate without any fixed jurisdiction where they could be taxed at the source.<sup>239</sup> This cross-border nature applies to the crypto market and crypto participants as well.<sup>240</sup> A worry is that crypto markets and participants can be in jurisdictions that have lax to no regulatory measures for illegal transactions and activities.<sup>241</sup> Addressing the problem of crypto assets lacking operational jurisdictions due to their cross-border nature will improve record-keeping and reporting requirements, allowing the IRS to regulate crypto earnings better. To do this, the IRS can draw inspiration from the situation in Gibraltar.

Gibraltar, located on the southern coast of Spain, is one of the world's most famous and popular tax havens.<sup>242</sup> In Gibraltar, taxpayers can find a variety of offshore services such as the "incorporation of offshore companies, banking, insurance and investment fund management", and such operations

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236. Helen Partz, *Japan: Tax Authorities Say Crypto Trades Owe Them \$93 Million*, COINTELEGRAPH (Jun. 5, 2019), <https://cointelegraph.com/news/japan-tax-authorities-say-crypto-traders-owe-them-93-million> [https://perma.cc/496T-XUAE].

237. *Id.*

238. *Id.*

239. Houben, *supra* note 229, at 54.

240. *Id.*

241. *Id.*

242. John Mac Ghlionn, *Europe's Biggest Tax Haven is About to Become a Cryptocurrency Hub*, TRT WORLD (Dec. 31, 2021), <https://www.trtworld.com/magazine/europe-s-biggest-tax-haven-is-about-to-become-a-cryptocurrency-hub-53182#:~:text=Europe's%20biggest%20tax%20haven%20is%20about%20to%20become%20a%20cryptocurrency%20hub> [https://perma.cc/PQL3-99E9].

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are so closely intertwined with Gibraltar's economy that the offshore financial sector is a significant pillar in Gibraltar's economy.<sup>243</sup> The UK and Spain entered an international agreement to increase tax cooperation between Spain and Gibraltar to combat tax evasion through tax residency.<sup>244</sup> The international treaty lays out a framework of rules for resolving conflicts over tax residency and enables administrative cooperation between Spain and Gibraltar through the mutual sharing of relevant transaction information and the creation of a Joint Committee that will resolve disputes that may arise.<sup>245</sup> After the agreement, Gibraltar's government has been taking measures to license, regulate, and increase oversight over the foreign crypto-savvy tax evaders and money launders attracted to Gibraltar.<sup>246</sup> Gibraltar has now revamped its tax and information-sharing policies, requiring intermediaries to collect identifying information on crypto participants, "maintain records, and share reports" to deter tax crimes.<sup>247</sup> The situation between Gibraltar and the UK is like that between Puerto Rico and the U.S., as Gibraltar is a British Overseas Territory in the same way Puerto Rico is a U.S. territory.<sup>248</sup> The IRS can look to the international treaty between the UK and Spain and possibly consider encouraging tax and administrative cooperation with Puerto Rico with rules for resolving conflicts over tax residency through transactional transparency, information sharing, and an administrative, regulatory body to resolve disputes that can arise from the differing tax policies found in the U.S. and Puerto Rico.

Finally, crypto assets are difficult to regulate because of their independence from governmental or financial institutions.<sup>249</sup> This is especially complicated because of the lack of a central intermediary, like an issuer, that the government or any financial institution can regulate.<sup>250</sup> To combat the problem of tax evasion, it is important to consider how the U.S. government can

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243. *Id.*

244. Foreign, Commonwealth & Development Office, *International Agreement on Taxation and the Protection of Financial Interests Between the UK and Spain Regarding Gibraltar: Statement on Entry into Force*, GOV.UK (Mar. 13, 2021), <https://www.gov.uk/government/news/statement-on-entry-into-force-of-the-international-agreement-on-taxation-and-the-protection-of-financial-interests-between-the-uk-and-spain-regarding#:~:text=IT%20provides%20rules%20for%20resolving,explicitly%20for%20over%20300%20years> [https://perma.cc/VE4J-VQ24].

245. *Id.*

246. Ghlionn, *supra* note 242.

247. *Id.*

248. *Id.*

249. Marian, *supra* note 24, at 42.

250. Houben, *supra* note 229, at 54.

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be actively involved in crypto transactions to regulate them.<sup>251</sup> Japan, a country with extensive regulatory guidelines concerning crypto assets, can provide ideas that the IRS can consider to address this problem.

Japan does not have one regulatory body that oversees and regulates all usage of blockchain-based assets.<sup>252</sup> Rather, crypto assets are regulated based on their function and use, which determines their “legal status.”<sup>253</sup> For example, Japan has a Payment Services Act regulating cryptocurrencies and utility tokens, while the Crypto Asset Exchange Services regulate businesses involved in the buying, selling, or exchanging of crypto assets.<sup>254</sup> The Financial Instruments and Exchange Act regulates “security tokens,” the tokenized form of shares, bonds, or fund interests.<sup>255</sup> NFTs, the most newly developed crypto asset addressed, have no economic function as they are unique and, therefore, are not regulated under Japan’s current regulatory framework.<sup>256</sup> However, in 2022, Japan has been leaning towards regulating NFTs just like it regulates other crypto assets.<sup>257</sup> Prime Minister Fumio Kishida has taken a stance to focus on blockchain and the NFT space in the Japanese economy as part of her “national growth strategy.”<sup>258</sup> To do so, Japan has put together a NFT policy task force to studying blockchain technology and all NFT-related business operations and how they interact with the government’s position on digitalization and strategy.<sup>259</sup>

In the U.S., several governmental agencies such as the Securities and Exchange Commission, the Commodity Futures Trading Commission, the IRS, and the Financial Crimes Enforcement Network are attempting to regulate the world of crypto assets.<sup>260</sup> There is no standardized definition of

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251. See Marian, *supra* note 24, at 42.

252. Takeshi Nagase, Tomoyuki Tanaka & Takato Fukui, *Blockchain & Cryptocurrency Laws and Regulations 2022 Japan*, GLOBAL LEGAL INSIGHTS, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/japan> [<https://perma.cc/XJ45-L3YC>] (last visited Sept. 8, 2022).

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.*

257. Tim Alper, *Japanese Ruling Party Launches NFT Task Force, Eye New Growth in the Sector*, CRYPTO NEWS (Jan. 28, 2022, 5:27 AM), <https://cryptonews.com/news/japanese-ruling-party-launches-nft-task-force-eyes-new-growth-sector.htm> [<https://perma.cc/YAF4-E2LB>].

258. *Id.*

259. *Id.*

260. Joe Dewey, *Blockchain & Cryptocurrency Laws and Regulations 2022 USA*, GLOBAL LEGAL INSIGHTS (2022), <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/usa> [<https://perma.cc/JB9D-HZY5>] (last visited Sept. 8, 2022).

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cryptocurrencies, however, leaving different jurisdictions to devise their own definitions of cryptocurrencies with varying degrees of broadness.<sup>261</sup> U.S. agencies should regulate crypto assets the same way Japan has been, by classifying them based on their usage and then assigning them to be regulated by a specific government agency. This way, the crypto assets can be regulated more specifically by the governmental agency specializing in dealing with that particular usage method. For NFTs, in particular, the U.S. tax framework already understands an NFT's life cycle. Similar to Japan's method of classification and agency assignments, the IRS could assign governmental agencies to regulate specific taxable events in an NFT's life cycle.

## V. CONCLUSION

Cryptocurrencies and NFTs have captured widespread attention in the past several decades as they have revolutionized the financial world. Cryptocurrencies are digital, encrypted, and decentralized mediums of exchange that have allowed transactions and usage to go unregulated by any government or financial institution. NFTs, unlike cryptocurrencies, are non-fungible but are considered intangible property rather than currencies like cryptocurrencies. Using the blockchain technology that is the heart and defining characteristic of cryptocurrencies, NFTs have been a new source of investment and moneymaking in the digital art world, eliminating many of the problems faced by the traditional art world.

No matter how popular cryptocurrencies and NFTs have become because of their convenient and private nature, they are not immune from the U.S. tax code. While cryptocurrency taxation was shrouded in mystery for some time, in 2014, the IRS issued Notice 2014-21, addressing how virtual currencies must be taxed. However, NFTs—still relatively new to the scene—have not received any specific tax guidance, leaving taxpayers to do their best to apply general tax principles found in the tax framework of cryptocurrencies. The NFT tax framework analyzed in this paper provides a broad overview of how NFTs can be taxed based on how other crypto assets are taxed, but there are still many issues and questions that need coverage by the IRS. Going forward, more tax guidance will be beneficial in helping taxpayers report their gains or losses from NFT transactions. However, even with more tax guidance on how crypto assets should be taxed, simply defining what is a taxable event or determining the classification of tax gains or losses from crypto asset transactions is not enough to combat a growing problem of crypto asset safe havens and crypto tax evasion.

The U.S. faces a massive tax gap caused by unreported gains from crypto assets. Despite this, it is difficult for the U.S. government, the IRS, and other governmental agencies to regulate crypto assets and keep precious tax dollars from going unreported because crypto assets are now starting to replace traditional tax havens and tax evasion methods by becoming tax

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261. *Id.*

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havens and mediums of tax evasion due to their intrinsic characteristics that make them attractive in the first place. To address the problem, the U.S. and its tax regulatory authorities should look to international tax regimes for ideas and examples of how to address its tax haven and evasion problem. For example, Japan and the EU have taken a stance against the anonymity and require that crypto assets must improve recordkeeping. The UK encouraged its territory, Gibraltar, to overhaul its tax policies to stop being a tax haven for crypto assets, and Japan allowed its regulatory agencies to be involved in controlling crypto assets by categorizing a crypto asset by its usage and assigning it to the agency that specializes in handling such usage. Though these strategies employed by foreign tax regimes are not subject to the same U.S. political climate and factors that could hinder their application, they are worth considering because the operation of crypto assets within real economies is infinite and will continue to grow.