COLLYER BRISTOW

CRYPTO & DIGITAL ASSETS

NON-FUNGIBLE TOKENS

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NON-FUNGIBLE TOKENS

With nearly $41 billion spent on the non-fungible token ("NFT") marketplace in 2021, these crypto assets have proven to be hugely lucrative.[1] With an increase in demand for advice about digital assets, it is important to ask: what are NFTs? How are NFTs taxed during an individual's lifetime and subsequently on death? How can we ensure access for attorneys and personal representatives whilst guaranteeing security for these high-value assets?

WHAT IS A NON-FUNGIBLE TOKEN?

A non-fungible token is a digital unit of data which is stored on a public, digital ledger. The ledger is called a 'blockchain'. The blockchain records each transaction which in turn verifies the present owner of the NFT. Critically, NFTs are not interchangeable. Unlike currency or cryptocurrency which can be exchanged, for example a £100 note can be transferred for two £50 notes, a NFT retains its original form and cannot be replaced. In this way, NFTs are more akin to a piece of art; the value of art is contingent on the artist, the quality of the art, the material used, the overall market, etc. Ownership of a NFT is the difference between owning the original of Picasso's Guernica and owning a print. A NFT does not necessarily need to be art albeit art is the largest NFT market and somewhat easier to conceptualise. Anything can be converted into a NFT, for example, the YouTuber Logan Paul created Pokemon-style cards of himself as an NFT.

LIFETIME TAXATION

INCOME TAX ("IT")

The NFT marketplace provides a favourable platform for artists to sell directly to the consumer, thereby reducing costs for the artist. If HMRC find there to be trading activity, as determined by the "The Badges of Trade" test, then any profits will be subject to IT. Broadly, the more criteria, or badges, that are satisfied, the greater the likelihood of trading activity.[2]

For individuals interested in this market you'll be pleased to know investing in NFTs is not likely to constitute a trading activity. HMRC recognise the difficulty where assets are bought for purely personal use or enjoyment as one would with a painting.

The guidance identifies that the hope or expectation that the asset may accrete in value does not make the transaction a trading activity unless there are other significant indications of a trading intention.

CAPITAL GAINS TAX ("CGT")

HMRC's guidance states that crypto assets including NFTs are "digital" and therefore intangible, but count as a 'chargeable asset' for CGT if they're both capable of being owned and have a value that can be realised.[3] Therefore, gains arising from the sale of NFTs owned by UK residents will be chargeable to CGT. The Taxation of Capital Gains Act 1992 provides that certain types of costs may still be deducted.[4] Crypto assets including NFTs will benefit from an uplift to the date of death value on the owner's death.

Many NFTs are purchased with cryptocurrency and traded on exchanges which do not use pound sterling. For the purpose of accounting to HMRC, the value of any gain or loss must be converted into pounds sterling and an appropriate exchange rate must be established. Establishing an appropriate conversion rate to form a valuation applies to all forms of taxation mentioned in this article.

INHERITANCE TAX ("IHT")

HMRC guidance states that crypto assets will be property for the purposes of IHT. Once the appropriate conversion has been attributed to the NFT, for UK domiciled individuals the property would fall into the free estate and the usual IHT rate will apply (broadly, notwithstanding any applicable exemptions, IHT will be levied at 40% on all property over any available Nil Rate Bands).

INCAPACITY AND DEATH

NFT owners access the blockchain via a secure 'digital wallet' which can only be accessed using the user'scryptographic "key". These keys are either stored digitally in a file or saved onto a USB stick, a pin-protected hardware wallet (such as a Ledger or Trezor), or physically by writing them down on paper and stored in a safe. Without holding the cryptographic key it will not be possible to access the digital wallet. This may pose an issue for personal representatives and attorneys authorised under a Lasting Power of Attorney as without the key, the NFT cannot be retrieved.

In order to circumvent this issue, a regularly updated digital inventory identifying all digital assets including NFTs, usernames and keys would alert personal representatives and attorneys of the assets and accounts. A security recommendation would be to store the cryptographic key separately from the inventory.

It is essential for any attorneys and personal representatives to be made aware of any digital assets. As NFTs appear anonymous on the blockchain, there is a risk that attorneys and personal representatives may lose valuable assets if no access is provided. Additionally, while the speed of technological advances is much greater than the ability to legislate for such changes – NFTs are no exception to this – it is important to remain tax compliant with all crypto assets.

1 NFT Market Surpassed $40 Billion in 2021, New Estimate Shows - Bloomberg
2 BIM20205 - Meaning of trade: badges of trade: summary - HMRC internal manual - GOV.UK (www.gov.uk)
3 CRYPTO22050 - Cryptoassets for individuals: Capital Gains Tax: what is an asset - HMRC internal manual - GOV.UK (www.gov.uk)
4 Section 38 TCGA 1992

Bibliography

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