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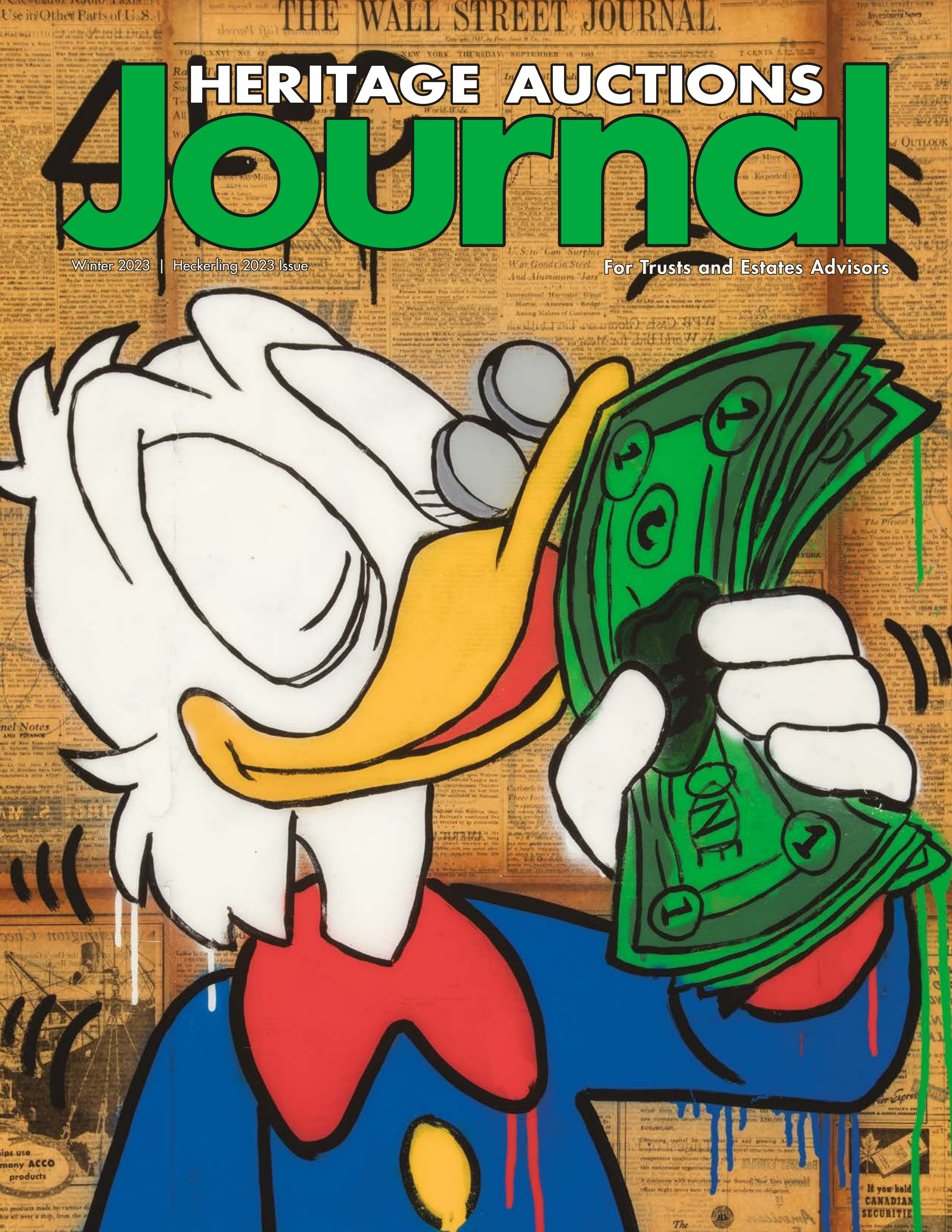
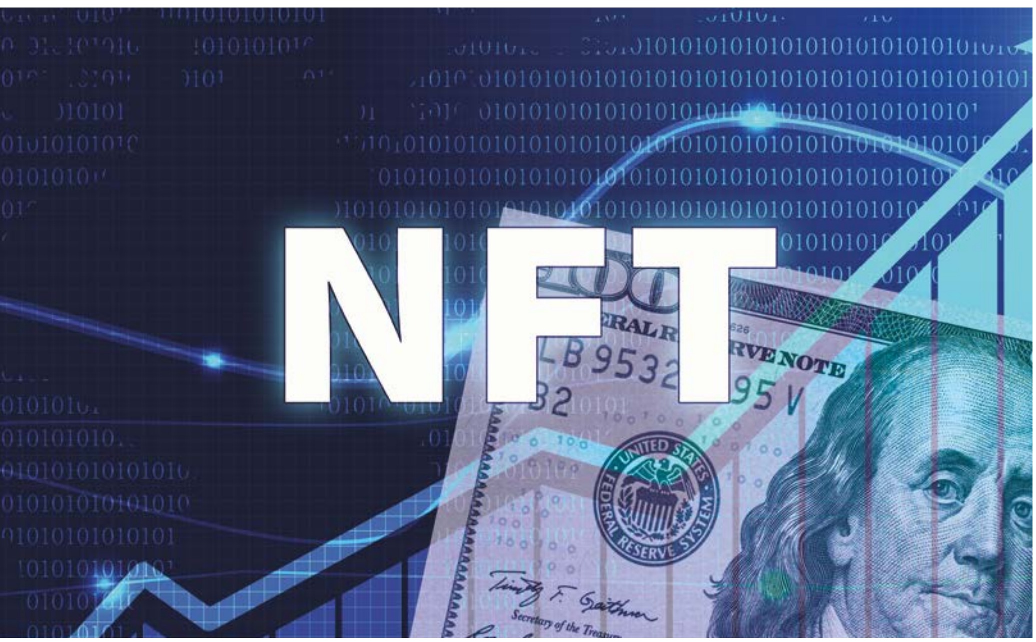


Tangible or Intangible?

When it comes to determining the fair market value of NFTs, uncertainty remains

By Fredrick B. Weber

A non-fungible token (NFT) is a unique digital identifier that cannot be copied, substituted or subdivided; that is recorded in a blockchain; and that is used to certify authenticity and ownership of a specific digital asset and specific rights relating to that asset. NFTs themselves are intangible assets. However, they are typically attached to tangible assets such as artwork, music, video clips, tweets and video game avatars that exist in both the digital and real worlds. The items or works to which NFTs have been attached are often accessible to anyone with an internet connection, which makes them easy to copy. However, because each NFT is unique, NFTs are becoming sought after as collectibles. In some cases, individual NFTs, or "digital collectibles," have sold for millions of dollars.



NFTs – like their digital cousins, virtual currencies – are traded on the blockchain, and information about prior transactions involving specific NFTs is accessible to the public. While the IRS has provided formal guidance on the estate tax treatment of virtual currency, there has been no guidance on how to calculate the fair market value of NFTs for estate and gift tax purposes. Nevertheless, fiduciaries will need to determine and report the fair market value of NFTs that are includible in the estate of an NFT owner who has died, as well as for lifetime gifts of NFTs to individuals, to trusts or to charity. (Reg. § 20.2031-1(b).) "Fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." (Reg. § 20.2031-1(b).)

Like marketable securities and virtual currency, NFTs are intangible assets. However, because each individual NFT is unique and separately identifiable from similar or even the same tokenized works, NFTs are likely more analogous to artwork and other items of tangible personal property when it comes to determining their fair market value. The regulations regarding the estate tax valuation of artwork and tangible personal property state that "articles having marked artistic or intrinsic value" that exceeds $3,000 must be appraised by qualified experts. (Reg. § 20.2031-6(b).) The required written appraisals need to be attached to the federal estate tax return or to the federal gift tax return for lifetime gifts. Each written appraisal report must include an itemized list of the property that is the subject of the appraisal and detailed descriptions of each item of property and its separate estate or gift tax value. Each appraisal must also state the valuation methodology, include a detailed and specific statement of the appraiser's qualifications, and affirm that the appraiser is an independent and disinterested party with respect to the property that is the subject of the appraisal. (Reg. § 20.2031-6(d).) The regulations go on to state that "expert appraisers" must be "reputable and of recognized competency to appraise the particular class of property involved." (*Id.*)

If the analogy to artwork and other tangible personal property is appropriate for determining the fair market value of NFTs for estate and gift tax purposes, it is far from perfect. In most cases in which professional appraisers are needed to determine the fair market value of tangible property for federal estate tax or gift tax purposes, fiduciaries and practitioners often find that there are experts and specialists for nearly every type of tangible personal property imag-

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inable, even for some of the rarest and most obscure collectibles. In addition to fine art, jewelry and antiques, there are professional appraisers with deep and specific expertise in rare books, sports memorabilia, stamps and coins, classic cars, fine wine, old toys, Christmas tree ornaments and even vintage advertising signs, to name a few.

Unlike NFTs (which have only existed since 2014 and did not begin trading in earnest until 2017), most types of tangible personal property that require estate and gift tax appraisals have existed in one form or another for generations and often have unique physical characteristics that are recognizable and detectible to seasoned and experienced experts who must also authenticate them in order to value them. In addition, the markets for most types of tangible property, including the smallest and most obscure of those markets, produce data (both historical and current) that, when analyzed by experienced valuation specialists, can be used to support the finding of a fair market value that is objectively accurate, or at least defensible, for federal estate and gift tax purposes.

Because NFTs are so new, there is not nearly as much market data available as there is for fine art, jewelry and other non-digital collectibles. The relatively short history of NFTs would also indicate that there cannot (yet) be a lot of professional appraisers with enough experience to hold themselves out as qualified NFT valuation experts. While that is likely to change over time as the NFT industry continues to grow, identifying and securing qualified valuation experts to appraise NFTs for estate and gift tax purposes is likely to create significant challenges for planners and fiduciaries for the foreseeable future.

While each NFT has unique digital characteristics that make it distinguishable from other NFTs, NFTs also possess certain characteristics that make them very different from tangible or physical collectibles. An NFT is a one-of-a-kind digital token, but the real-world image, video clip or object to which that unique digital token is attached may be easily accessed or even replicated by anyone with an internet connection.

The fair market value of an NFT will also be affected by the terms of the smart contract that governed the initial sale (and all subsequent sales or transfers) of the NFT by the creator to the initial buyer. A smart contract is programming or data that exists within the blockchain and enables the network to store information about NFT transactions. The smart contract is designed to keep the information about the transaction accessible and transparent while at the same time preventing anyone from changing or modifying it. Because the smart contract is a software application that is created when the NFT is created or “minted,” it is programmed to include the specific rights that are being sold to the current or future buyers to verify the authenticity of the NFT, to prevent counterfeiting, to facilitate future sales or transfers of the NFT, and to facilitate creator royalty payments, among many other things. Accordingly, obtaining the fair market value of an NFT will require a valuation expert who can review, understand and evaluate the terms of the smart contract that is attached to the NFT.

Even though NFTs are intangible and traded on public exchanges, calculating the fair market value of any asset requires the valuation expert to look to the most relevant market or the market in which the asset is most commonly sold to the public. For NFTs, finding the most relevant market will be determined by, among other things, the specific nature of the NFT, the online marketplace on which the NFT may be listed, the terms of the smart contract to which it is attached, *and* perhaps also on historic and current data about sales of comparable NFTs.

These characteristics, along with an increasing amount of data accumulating daily from auctions and other sales of NFTs, support the argument that NFTs should be valued for estate and gift tax purposes in a manner that is like the method for valuing fine art and collectibles. However, unless and until the IRS issues formal guidance on how to value NFTs for estate and gift tax purposes, the proper valuation method for NFTs will remain uncertain.

Guest Contributor:
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