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Trying to "mint" the next Bored Ape?

What to know before you go NFT

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There's a good chance NFTs, or non-fungible tokens, are becoming more of a topic of discussion for leaders at organizations across industries. The global market for NFTs hit $22 billion in 2021,[1] compared with $100 million in 2020. And investor interest continues to grow: the blockchain and crypto sector attracted a record $30.2 billion in global investment in 2021[2]—up from $5.5 billion in 2020 and more than three times the previous record of $8.2 billion in 2018—making it the fastest-growing sector in fintech. What does that mean for companies looking to purchase, issue and invest in NFTs?

The value of digital assets: more than just digital art

For many potential investors, their first exposure to NFTs likely came through art. In March 2021, digital artist Beeple sold a piece of art, Everydays: The First 5,000 Days, for more than $69 million. More recently, purchases of NFTs from the Bored Ape Yacht Club helped usher in more mainstream understanding of NFTs as more than just digital art.[3] They can come with membership benefits, intellectual property rights, and other perks that affect valuation.

In 2022 companies from consumer goods to gaming and banking to brewing have already announced intentions to purchase and issue their own tokens.

While interest in NFTs continues to grow, boards and the finance and tax leaders of companies considering jumping into the NFT fray should strategize and carefully consider how they will account for and report on NFT investments.

Understand accounting considerations before taking the leap

As previously detailed in What to know before you go crypto,[4] since there are no generally accepted accounting principles in the United States (U.S. GAAP) specific to digital assets (including NFTs), an operating company that takes an investment position in digital assets may end up applying accounting guidance that was not written with digital assets in mind. It is critical for issuers and buyers to understand the legal and contractual nature of the target NFT to determine how to account for it.

Consider the following questions:

- Does the NFT represent the right to use certain intellectual property?
- What rights does the holder have?

1 Dan Milmo, "NFTs Market Hits $22bn as Craze Turns Digital Images into Assets," *Guardian,* December 16, 2021, https://www.theguardian.com/technology/2021/dec/16/nfts-market-hits-22bn-as-craze-turns-digital-images-into-assets.

2 KPMG International, *Pulse of Fintech H2'21*, January 2022, https://assets.kpmg/content/dam/kpmg/xx/pdf/2022/02/pulse-of-fintech-h2-21.pdf.

3 "The Balancing Act to Securely Sharing Content with NFTs," KPMG U.S. News and Perspectives, accessed February 18, 2022, https://info.kpmg.us/news-perspectives/technology-innovation/the-balancing-act-to-securely-sharing-content.html.

4 KPMG LLP, *What to Know Before You Go Crypto,* September 2021, https://info.kpmg.us/news-perspectives/advancing-the-profession/what-to-know-before-you-go-crypto.html.

For the buyer, the reality of purchasing a NFT is often not as straightforward as purchasing a physical asset. For example, when Twitter co-founder Jack Dorsey sold one of his tweets on the Valuables NFT platform, the platform characterized the NFT as "an autographed certificate of the tweet," making it clear that Dorsey did not transfer the copyright of the tweet to the buyer. Companies buying or selling NFTs should carefully evaluate what they are actually transacting, as the ownership of an NFT does not automatically equate to ownership of the underlying asset.

Is the NFT associated with an ongoing license or royalty arrangement?

Some NFTs allow for new ways for content creators to monetize their content, such as earning royalties on every subsequent sale of an NFT via smart contracts. This aspect of NFTs is of particular interest to businesses and content creators within the gaming and music sectors.[5]

Does the NFT provide the holder with contractual rights to additional goods or services?

NFTs can act as tickets or membership cards with online or real-life perks. Examples include exclusive access to concerts, networking events, merchandise sites, and online discussion groups. For an NFT buyer's accounting, it's important to know whether the purchase gives the buyer any more than an intangible asset, which would be subject to periodic impairment assessments, and whether part of the purchase price is a prepayment for certain other goods and services.

For an NFT issuer's accounting, it's important to understand whether part of the sales price of an NFT must be deferred to account for ongoing obligations to the buyer, such as providing other goods and services associated with the sale.

Additionally, because NFTs can be of high value, and are sold and reside on the same ledgers as cryptocurrencies, both issuers and holders will need to consider appropriate internal controls around custody and the authorization and initiation of transactions.

Overall, the terms and conditions attached to the NFT are critical to both buyers and issuers in mapping different components of the transaction into appropriate financial accounting standards.

Taxing NFTs: an art, not a science

Just as there is no GAAP guidance for NFTs, there are no clear tax rules either. To date, the IRS has not issued guidance on NFTs, and no case law exists to help guide practitioners, buyers, or issuers. Since an NFT can represent almost anything, including art, a manuscript, a concert ticket, or real estate, the tax consequences will depend on the substance of the particular transaction.

With respect to art-like NFTs, the sale of an NFT by its creator will generally be taxable as ordinary income. Moreover, if the creator has a trade or business creating NFTs or similar property, the income will also be subject to self-employment tax. And, depending on the state involved, sales tax could also be due on the sale. Any embedded royalty agreement may also produce further ordinary income for the NFT creator.

For the NFT purchaser, there may be tax consequences on purchase and sale. For example, purchasing the NFT itself with cryptocurrency is a taxable exchange of the cryptocurrency.[6] Selling the NFT will likely subject the seller to capital gains tax, which will come at a higher tax rate if the NFT is considered a collectible. The 3.8% net investment income tax may also apply.

Internal controls

Because of the lack of robust accounting and tax guidance specific to NFTs, issuers that are required to report on internal controls should carefully consider the processes that are in place with respect to creating, holding, buying, and selling NFTs; how these activities are reflected in the financial statements of the issuer; and how relevant information regarding these transactions is maintained as evidence to support the proper execution of the controls.

Given the existence of different exchanges on which NFT transactions can be executed, controls related to the determination of principal market and approach to valuation could present additional challenges for issuers. How the NFTs are "held" by the issuer could also introduce the need to consider internal controls related to service organizations (e.g., custodians) to ensure the safekeeping of owned NFTs. The changing legal and regulatory landscape will likely place additional emphasis on monitoring the controls necessary to identify and comply with the changing requirements.

5 Gavin Bridge, "How NFTs Will Disrupt Gaming and Music in 2022," *Variety,* November 23, 2021, https://variety.com/vip/how-nfts-will-disrupt-gaming-and-music-in-2022-1235107376/.

6 Internal Revenue Service, *Notice 2014-21,* https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

New regulatory frameworks are likely

Regulators, including both the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), are interested in the rapidly evolving NFT ecosystem. One emerging area of legal and regulatory interpretation is under what circumstances an NFT would be considered a security and subject to SEC regulation.[7] If some NFTs are securities, that raises regulatory questions for those NFT issuers, as well as marketplaces where NFTs are bought and sold.

Although guidance is evolving, businesses exploring how to make use of this innovative technology to engage customers and drive stakeholder value should be prepared to transact in a thoughtful way. For issuers and buyers, the crucial step is to fully understand the implication of NFT activities on their business, case-by-case, industry-by-industry.

Remember, consider these questions and accounting considerations before taking the leap:

- Does the NFT represent the right to use certain intellectual property?
- What rights does the holder have?
- Is the NFT associated with an ongoing license or royalty arrangement?
- Does the NFT provide the holder with contractual rights to additional goods or services?

7 Sophie Kiderlin, "The SEC's 'Crypto Mom' Hester Peirce says selling fractionalized NFTs could be illegal," *Markets Insider,* March 26, 2021, https://markets.businessinsider.com/currencies/news/sec-crypto-mom-hester-peirce-selling-nft-fragments-illegal-2021-3-1030250153.

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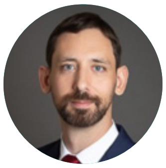

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