

LEGAL UPDATE

IRS Issues Guidance on Nonfungible Tokens (NFTs) in IRAs and Tax-Qualified Individual Account Plans

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Unlike ERISA, the Internal Revenue Code (Code) places almost no restrictions on the manner in which plan assets of individual retirement plans or tax-qualified defined contribution plans can be invested. Certain types of investments may generate unrelated business taxable income or debt-financed income, but those types of investments are not prohibited under the Code. However, an exception to that general rule applies to collectibles.

Code Section 408(m)(1) treats the acquisition by an IRA of a collectible as a distribution from the IRA equal to the cost to the IRA of the collectible. The distribution would be taxable as ordinary income, and if received prior to age 59½, would be subject to the 10 percent tax on early distributions. This same treatment applies to collectibles acquired by an individually-directed account under a tax-qualified plan. Under Code Section 408(m)(2), collectibles include a work of art; a rug or antique; any metal or gem; any stamp or coin; an alcoholic beverage; and any other tangible personal property specified by the Treasury Department (none to date). Code Section 408(m)(3) excludes certain coins and bullion from the definition of collectibles. There has been limited guidance from both the IRS and the courts on the interpretation of this Code Section. As Code Sections go, however, Section 408(m) is relatively straightforward.

With cryptocurrency becoming a mainstream item, the status of NFTs as collectibles under Code Section 408(m) became one of the many issues that IRS is required to address, along with the treatment of cryptocurrency under the Code, and the IRS has provided preliminary guidance on the issue in Notice 2023-27. The guidance is restricted to issues under Code Section 408(m) and does not comment upon or otherwise address the Department of Labor's 2022 guidance regarding cryptocurrency.

In Notice 2023-27, the IRS explains that NFT ownership may provide the holder with a right with respect to an

asset that is not a digital file, such as the right to attend a ticketed event, or may certify ownership of a physical item or some other particular item. The Notice refers to the right that an NFT provides, or the ownership of an asset that the NFT certifies, as the NFT's "associated right or asset." The IRS then indicates that pending issuance of guidance on the treatment of NFTs as collectibles, the IRS will apply a look-through analysis, under which the NFT's underlying right or asset will be analyzed for status as a collectible.

The IRS provided some examples illustrating how its analysis would be applied. For instance, if an NFT certifies ownership of a gem, the NFT would be treated as a collectible because gems are treated as collectibles under Code Section 408(m). In contrast, if an NFT certifies ownership of a right to use or develop a "plot of land" in a virtual environment, the NFT generally would not constitute a collectible. The IRS also stated that if the NFT's associated right or asset is a digital file, the extent to which a digital file might constitute a "work of art" under Code Section 408(m), which would make it a collectible, is a matter that IRS is considering.

Even if some NFTs would not be treated as collectibles by the IRS, not every IRA custodian or trustee will choose to offer them. When NFTs that are not collectibles are offered as an IRA or plan investment, IRA owners and plan participants should carefully review the terms of the IRA custodial or trust agreements to ensure they fully understand how these assets will be treated under the agreements.

Any guidance from the IRS and DOL regarding NFTs and other electronic forms of ownership and currency is welcome as IRA owners and plan participants seek to diversify into these new asset forms.

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