YPOG Article:
NFT tax uncertainty for corporations and shareholders

Berlin, February 11, 2022 | Dr. Dajo Sanning

Overview

As NFTs have tremendously risen in popularity over the last year, tax authorities around the globe are starting to take a particular interest in this novel asset class. NFTs present novel challenges for taxpayers and tax authorities alike, such as the accounting for "link rot". The German Ministry of Finance issued a draft guideline on crypto taxation last year. However, the draft has yet to be finalized and does not include guidelines on NFTs. In the absence of clear guidelines, some NFT-related tax issues may be addresses as follows:

1. How do German tax regimes account for non-fungible tokens (NFTs)?

There are no special tax provisions that pertain to NFTs. However, the provisions of the German Income Tax Act (GITA) have given some guidance on their taxation. In particular, gains from the transfer of NFTs against consideration should be taxable if the NFT has been sold within one year after the purchase, but this should only apply to taxpayers who hold their NFTs as a private asset.

If a corporation sells an NFT, gains should be taxable regardless of the holding period. This basic tax treatment also applies to fungible tokens (ie, regular cryptocurrencies such as Bitcoin). However, there remains uncertainty regarding specific tax issues. As NFTs are links stored on a blockchain to digital image files that are hosted on the internet, they are potentially subject to "link rot" (ie, the digital image file may not be hosted forever and the link could end up creating 404-errors, which are common across the Internet). Therefore, the corresponding NFT could lose its value in such cases. The question then arises as to whether the "loss" of the NFT will be tax effective, thereby reducing the owner's tax base.

The Ministry of Finance recently issued a draft proposal for tax guidelines with a binding effect on (local) tax authorities. The draft proposal focuses on cryptocurrencies, however, and makes no reference to NFTs. This has introduced additional uncertainty regarding NFTs. While they may be added to the proposed guidelines in the future, their current taxation remains unclear.

2. How are partnerships, their partners, corporations and shareholders affected in this regard?

This current uncertainty affects both corporations and their shareholders as well as partnerships and their partners. For partners of tax-transparent (flow-through) partnerships, the above income taxation and the associated uncertainties are generally the same as for direct owners of NFTs. For corporations, accounting-related questions may arise. Among others, the question of how to account for the "link rot" problem should be addressed allowing for a (partial) write-down, which should have a tax-reducing effect. However, this has not been decided upon by tax authorities or the courts. Questions regarding write-downs may also arise if the NFT market collapsed or if the value of (particular) NFTs became permanently impaired.

3. What are "other assets" within the scope of corporate tax and why is this category relevant to NFTs?

"Other assets" within the meaning of section 23(1) no 2 of the GITA refers to privately held assets other than real estate. They can pertain to any taxable asset, which is defined as:

Things, rights or actual conditions, concrete possibilities or advantages for the business, the obtaining of which the merchant incurs some cost, which may be subject to valuation and can at least be transferred with the business.

Therefore, "other assets" can refer to a number of assets including intangible assets such as NFTs. They can subject the transfer of privately held NFTs to taxation. It is the qualification as an "asset" within the above definition that subjects gain from the transfer of NFTs to taxation.

4. What action needs to be taken to provide NFT-specific tax legislation?

It is unlikely that NFT-specific legislation will be passed. However, the recent draft proposal by the German Ministry of Finance should be amended to include NFT-specific guidance. The risk associated with link rot is a unique "feature" of NFTs that requires specific guidance, in particular with regard to write-downs, depending on whether NFTs are held as business assets or whether the corresponding decrease in value will be tax effective if NFTs are held as private assets.

The guidance should include references to the assessment of taxable gains from the transfer of NFTs. Since NFTs will regularly be traded in Ethereum or Solana, disposal gains will not be denominated in euros. Therefore, questions regarding the exchange rate that may be different across crypto exchanges become relevant.

Outlook

YPOG's Fintech/DLT and Tax practice group will continue to closely monitor new developments in the area of crypto taxation and advise clients on best practices for their game changing business models

We are happy to support you and open for further exchange.

Your contact at YPOG:

Dr. Dajo Sanning
Associate, Berlin/Hamburg

+49 40 6077281 107
+49 151 40228779
dajo.sanning@ypog.law