

COLLECTIBLES TAX AND THE ART OF BUYING, RENTING, AND SELLING VIRTUAL LAND NFTS

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Virtual land non-fungible tokens (“NFTs”) used in the metaverse have been around for fewer than five years. As such, there is very little guidance from the Internal Revenue Service (“IRS”) regarding how transactions dealing in virtual land are taxed federally. This Note covers an introduction to NFTs and their underlying technology and development. Then, it addresses the differing tax implications of buying virtual land, renting virtual land (both from a landlord and tenant perspective), and selling virtual land. The IRS solicited public comments on how best to approach NFTs and various relevant considerations. But until the IRS establishes more detailed guidance, this Note argues that the look-through analysis should continue distinguishing between digital art NFTs and non-art NFTs, including virtual land NFTs. Additionally, this Note proposes solutions for future tax filing forms.

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INTRODUCTION

Non-fungible tokens (“NFTs”) burst into the digital marketplace in 2017 with the release of CryptoPunks, a 10,000-piece collection of digital pixel art.¹ But what exactly are NFTs? NFTs are crypto-assets, like Bitcoin, Ethereum,² and Dogecoin, but are distinguished from traditional cryptocurrency by their lack of fungibility.³ All Bitcoins, for example, are fungible, meaning that each Bitcoin is identical to every other Bitcoin, and thus all are completely interchangeable.⁴ Because NFTs are non-fungible, they are all unique and cannot be exchanged in the same way.⁵ This is true even if several NFTs are based on the same underlying work of art.⁶

Although most NFTs are used for digital art and collectibles,⁷ not all NFTs are digital art. For example, NFTs can serve as access to events and exclusive merchandise,⁸ or they can serve as virtual land upon which users can host their own events.⁹ They can also be videos, memes, tweets, and music, among other things.¹⁰ NFTs can serve even more potential functions in the future, such as recording real property transactions, facilitating automatic royalty payments, and preventing counterfeit sales.¹¹ This Note will focus specifically on virtual land NFTs and how various transactions trigger different tax treatments.

The key to so many NFT applications comes from the “token” part of “non-fungible token,” which refers to the “cryptographic tokens” that reside on a

1. Mason Marcobello, *CryptoPunks, CryptoCats and CryptoKitties: How They Started and How They're Going*, COINDESK, <https://www.coindesk.com/learn/cryptopunks-cryptocats-and-cryptokitties-how-they-started-and-how-theyre-going/> [<https://perma.cc/T5E6-5JUK>] (Apr. 9, 2024, 4:29 PM); *Explore Art NFTs*, OPENSEA, <https://opensea.io/category/art> (last visited Apr. 21, 2024). NFT projects are commonly grouped together in “collections” that are “created around a single theme but each with slight variation, often created algorithmically.” U.S. DEP’T OF TREASURY, CRYPTO-ASSETS: IMPLICATIONS FOR CONSUMERS, INVESTORS, AND BUSINESSES 23 (2022), https://home.treasury.gov/system/files/136/CryptoAsset_EO5.pdf [<https://perma.cc/C85H-KKBX>].

2. While the unit of this cryptocurrency is “Ether,” most people vocally refer to this cryptocurrency as “Ethereum.” For example, someone might say, “I just bought some Ethereum.” This Note will refer to Ether as “Ethereum” in the interest of simplicity. See Phoenix Angell, *ETH Vs. Ether Vs. Ethereum: What’s the Difference?*, SCREEN RANT (July 26, 2022), <https://screenrant.com/eth-ether-ethereum-differences/> [<https://perma.cc/B52F-FJTN>].

3. Carol R. Goforth, *How Nifty! But Are NFTs Securities, Commodities, or Something Else?*, 90 UMKC L. REV. 775, 777 (2022).

4. *Id.*

5. Gary P. Kohn, *NFTs and the Law*, 44 L.A. LAW. 18, 20 (2021).

6. Goforth, *supra* note 3, at 777.

7. U.S. DEP’T OF TREASURY, *supra* note 1, at 23.

8. *Id.* at 25.

9. See Ian Kane, *Top 10 Best Metaverse Virtual Worlds with Land NFTs*, DAPP RADAR (Oct. 12, 2023), <https://dappradar.com/blog/top-10-best-metaverse-virtual-worlds-with-land-nfts> [<https://perma.cc/TK3K-2XRN>].

10. Goforth, *supra* note 3, at 777.

11. U.S. DEP’T OF TREASURY, *supra* note 1, at 25.

blockchain.¹² A blockchain is a large database that is publicly accessible and transparent in its transaction records.¹³ It is the baseline for cryptocurrency systems because of its ability to record data, including ownership and transaction records,¹⁴ without the need for a third party, such as a bank.¹⁵ The database is composed of a network of computers physically located in different places, with each computer being a “node.”¹⁶ More than half of the nodes must agree to any change in the database records before that change can be recorded.¹⁷ This system is advantageous because if a hacker wanted to edit or destroy any database record, she would need to “simultaneously control and alter 51% or more of the copies of the blockchain” in order for that change to be solidified.¹⁸ Otherwise, all the nodes cross-reference each other and quickly pinpoint the altered record.¹⁹ If a record is cross-referenced and verified by more than half of the network, it gets placed in a “block.”²⁰ These blocks have exact timestamps of when they were created,²¹ so each successive block added creates a long “chain.”²² What results is “an irreversible timeline of data” in the form of a blockchain.²³

Blockchain technology was first proposed in 1991 as a means to record information in a way that cannot be altered or destroyed.²⁴ For example, typical record-keeping systems that house all of their data on computers under one roof are susceptible to data loss or corruption in the event of a power outage or fire; blockchain technology aimed to prevent these kinds of issues.²⁵ Despite years of planning, blockchain technology was not first applied until the launch of Bitcoin almost 20 years later in 2009.²⁶

NFTs are stored on the blockchain with a link to what the NFT represents, such as an image, music file, or video.²⁷ Therefore, each transaction involving the

12. Kohn, *supra* note 5, at 20. To learn more about how NFTs are originally created, or “minted,” see U.S. DEP’T OF TREASURY, *supra* note 1, at 24.

13. Kohn, *supra* note 5, at 20.

14. Goforth, *supra* note 3, at 777.

15. Adam Hayes, *Blockchain Facts: What Is It, How It Works, and How It Can Be Used*, INVESTOPEdia, <https://www.investopedia.com/terms/b/blockchain.asp> [https://perma.cc/5DDX-WHJQ] (Dec. 15, 2023).

16. Kohn, *supra* note 5, at 20; Hayes, *supra* note 15.

17. Kohn, *supra* note 5, at 20.

18. Hayes, *supra* note 15.

19. *Id.*

20. Kohn, *supra* note 5, at 20.

21. Hayes, *supra* note 15.

22. Kohn, *supra* note 5, at 20.

23. *What Do Blockchain and Cryptocurrency Have To Do With National Security?*, A.B.A. (Feb. 15, 2023), https://www.americanbar.org/groups/law_national_security/publications/aba-standing-committee-on-law-and-national-security-60th-anniversary-an-anthology/what-do-blockchain-and-cryptocurrency-have-to-do-with-national-security/ [https://perma.cc/R6NC-BXLK] (quoting Adam Hayes in an earlier version of *Blockchains Facts*).

24. Hayes, *supra* note 15.

25. *Id.*

26. *Id.*

27. *Hermès Int’l v. Rothschild*, 603 F. Supp. 3d 98, 100 (S.D.N.Y. 2022).

NFT is immutably documented and traceable.²⁸ It is important to note that even if the NFT represents an image, it is not an actual image file.²⁹ Instead, the NFT is merely a record on the blockchain indicating ownership of the image file.³⁰ This concept is comparable to how a deed represents ownership of a house but is not in fact the house.³¹

To store and access purchased NFTs, users need some way to store them, whether within an NFT marketplace or a digital wallet.³² While some NFT marketplaces provide a storage feature, many do not.³³ If users do not have storage in one of those marketplaces, they will need a digital wallet,³⁴ such as the commonly used Coinbase Wallet.³⁵ These wallets often need to support the Ethereum blockchain,³⁶ as this blockchain “is the most common . . . token platform for an NFT.”³⁷

The blockchain technology is what makes NFT buying and trading so easy; the transaction history is secure and transparent, making the “uniqueness” of each NFT readily verifiable.³⁸ This public transaction history, coupled with the uniqueness of each NFT, allows NFTs to hold monetary value that changes over time.³⁹ The U.S. Department of the Treasury estimates that in 2021, nearly \$40 billion of crypto-assets were sold and traded on NFT marketplaces.⁴⁰ In 2022, nearly the same amount of sales and trades occurred from May to September alone.⁴¹

The value in holding and selling NFTs became most apparent in 2017 when CryptoKitties, one of the first NFT projects ever launched,⁴² saw a “CryptoKitty” NFT fetch \$172,000.⁴³ Additionally, a different metaverse user created NFT replicas of Birkin handbags at “prices comparable to real-world Birkin handbags”⁴⁴—

28. *Id.* at 100–01.

29. Goforth, *supra* note 3, at 779.

30. *Id.*

31. *Id.*

32. U.S. DEP’T OF THE TREASURY, *supra* note 1, at 6, 24.

33. *Id.*

34. *See id.* at 6. These digital wallets can be a “software application, piece of hardware, or other device or service” used to store cryptographic keys that allow users to interact with blockchains to send and receive digital assets. *Id.*

35. *Best NFT Wallets for 2022*, ASCENT, <https://www.fool.com/the-ascend/cryptocurrency/best-nft-wallets/> [<https://perma.cc/D29E-9UJC>] (June 29, 2023).

36. *Id.*

37. Kohn, *supra* note 5, at 20.

38. *Id.* at 20–21.

39. *Hermès Int’l v. Rothschild*, 603 F. Supp. 3d 98, 100 (S.D.N.Y. 2022).

40. U.S. DEP’T OF THE TREASURY, *supra* note 1, at 24.

41. *Id.*

42. Goforth, *supra* note 3, at 775.

43. Brijesh Singh & Khushbu Jain, *Story of Cryptokitties, Art and NFTs*, DAILY GUARDIAN (May 20, 2021, 7:07 AM), <https://theguardian.com/story-of-cryptokitties-art-and-nfts/> [<https://perma.cc/2BYP-HTP8>].

44. *Hermès Int’l*, 603 F. Supp. 3d at 101.

“ranging from \$8,500 to over \$300,000.”⁴⁵ However, one of the highest value sales was digital artist Beeple’s sale of a single NFT representing the evolution of his 5,000 digital art pieces for \$69 million in 2021.⁴⁶ Later that year, anonymous digital artist Pak beat this record after their NFT creation “The Merge” fetched over \$91 million at auction.⁴⁷

Even celebrities see the value in NFTs. Kings of Leon, for example, sold a new album using NFTs that fetched over \$2 million.⁴⁸ Similarly, supermodel Kate Moss sold a video NFT of herself sleeping for \$17,000.⁴⁹ But celebrities are not just selling on the NFT market; they are purchasing, too. Justin Bieber hopped on the trend and purchased two NFTs from the famous Bored Ape Yacht Club collection for a total of nearly \$2 million.⁵⁰ Eminem also has an impressive collection of more than ten NFTs, one of which is part of the same Bored Ape Yacht Club collection as Bieber’s.⁵¹

Despite these high NFT investment returns, NFTs are actually more retail-friendly than many other crypto-assets because the majority of trades are worth less than \$10,000.⁵² Meanwhile, the cost of one Bitcoin has ranged between \$15,000 and \$73,000 since 2021.⁵³ Virtual land NFTs fell into this retail-friendly category, with average prices in two of the biggest virtual world platforms under \$1,000 in 2021.⁵⁴

Today, virtual land NFTs are soaring in popularity.⁵⁵ Virtual lands in general have technically been around for years, appearing in games like Second Life,

45. *Why Are Birkin Bags So Expensive? And Worth the Price*, MADISON AVE. COUTURE (Mar. 7, 2022), <https://madisonavenuecouture.com/blogs/news/why-are-birkin-bags-so-expensive-and-worth-the-price> [https://perma.cc/ADK4-2QA9].

46. Jacob Kastrenakes, *Beeple Sold an NFT for \$69 Million*, VERGE (Mar. 11, 2021, 8:09 AM), <https://www.theverge.com/2021/3/11/22325054/beeple-christies-nft-sale-cost-everydays-69-million> [https://perma.cc/Z28F-F4RJ].

47. Fang Block, *PAK’s NFT Artwork ‘The Merge’ Sells for \$91.8 Million*, BARRON’S (Dec. 7, 2021, 6:03 PM), <https://www.barrons.com/articles/paks-nft-artwork-the-merge-sells-for-91-8-million-01638918205> [https://perma.cc/QEW5-GZN2].

48. Goforth, *supra* note 3, at 778.

49. Nicolette Salmi, *13 Celebrities Who Have Joined the NFT Crypto Art Craze*, L’OFFICIEL (Nov. 27, 2022), <https://www.lofficielusa.com/pop-culture/celebrities-on-the-crypto-art-craze> [https://perma.cc/D4FF-HJZK].

50. Florence Muchai, *List of Celebrities that Hold NFTs and Crypto 2023*, CRYPTOPOLITAN (Feb. 15, 2023), <https://www.cryptopolitan.com/celebrities-that-hold-nfts-and-crypto-2023/> [https://perma.cc/VF9T-GSZD].

51. *Id.*

52. U.S. DEP’T OF THE TREASURY, *supra* note 1, at 23–24 (defining “retail-friendly” as “trades worth less than \$10,000”).

53. *Bitcoin*, COINDESK, <https://www.coindesk.com/price/bitcoin/> [https://perma.cc/L5VP-FLB6] (last visited Apr. 26, 2024) (using “ALL” when choosing time frame of reference).

54. Bernard Marr, *How To Buy Land & Real Estate in the Metaverse*, FORBES (Mar. 23, 2022, 2:18 AM), <https://www.forbes.com/sites/bernardmarr/2022/03/23/how-to-buy-land—real-estate-in-the-metaverse/?sh=3b48a364546e> [https://perma.cc/AE7G-BUZW].

55. *See Virtual Lands: The Future Trend of NFTs*, LCX (May 2, 2023), <https://www.lcx.com/virtual-lands-the-future-trend-of-nfts/> [https://perma.cc/RN9B-EGR5].

Habbo Hotel, and IMVU.⁵⁶ However, in those games, any virtual land existed within a closed platform.⁵⁷ Any money spent on virtual lands went directly to the game company rather than to the users.⁵⁸ On the other hand, when users buy an NFT, they own it directly and can often use it throughout various virtual world platforms.⁵⁹

Virtual land NFTs exist *solely* in the metaverse.⁶⁰ The metaverse is a virtual universe composed of many different virtual worlds at the same time.⁶¹ In each virtual world, users can create avatars⁶² and use them to play games, trade digital goods, and more.⁶³ While many aspects of these worlds are often free, to take advantage of the property and game building capabilities offered, users will need to buy virtual land⁶⁴—sometimes even on secondary markets.⁶⁵ For example, in the virtual world platform Decentraland, users can “navigate, build upon and monetize” their land.⁶⁶ In Somnium Space, users can add buildings, such as nightclubs, art galleries, and houses, to their land.⁶⁷ And in Treeverse, virtual land spaces allow users to teleport from other locations in the game to their own plot of land.⁶⁸ Many users will want to acquire a home in these worlds to “show off . . . possessions . . . have friends over to hang out,” and “express their personality online,”⁶⁹ much like a home in the real world.

While owning a private space in a virtual world sounds enticing to users interested in taking full advantage of a platform, users are largely left in the dark about what that ownership means. Users are susceptible to intellectual property

56. Kate Irwin, *What Is Virtual Land? How NFTs Are Shaping the Metaverse*, DECRYPT (Aug. 31, 2022), <https://decrypt.co/resources/what-is-virtual-land-how-nfts-are-shaping-the-metaverse> [https://perma.cc/42NG-DPFA].

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. Kane, *supra* note 9.

62. Leticia Melo, *What Is the Sandbox & How to Join the Metaverse*, DAPPRADAR (May 9, 2023), <https://dappradar.com/blog/what-is-the-sandbox-how-to-join-the-metaverse> [https://perma.cc/X3LW-KXEY].

63. See *Explore Virtual World NFTs*, OPENSEA, <https://opensea.io/category/virtual-worlds> [https://perma.cc/4N6L-6MDW] (last visited Apr. 26, 2024).

64. Melo, *supra* note 62.

65. Kane, *supra* note 9.

66. *Id.*

67. *Id.*

68. Treeverse, *Treeverse Launch – Founders Plot NFTs*, MEDIUM (July 28, 2021), <https://medium.com/@treeverse/treeverse-launch-founders-plot-nfts-a05af0361e28> [https://perma.cc/MH8W-38VT].

69. Marr, *supra* note 54.

issues,⁷⁰ including copyright⁷¹ and trademark⁷² issues. Additionally, there are questions about whether NFTs should be regulated as securities by the U.S. Securities and Exchange Commission (“SEC”).⁷³ Moreover, the Internal Revenue Service (“IRS”), like the SEC, has not yet adequately addressed this technology and offers no concrete guidance as to how NFT transactions should be taxed,⁷⁴ including when NFTs are gifted to others.⁷⁵

This Note addresses some of the tax questions surrounding common virtual land NFT transactions.⁷⁶ Part I discusses an overview of federal taxation of capital assets and how this relates to purchasing virtual land NFTs. Part II is split into two Sections: Section A goes over the tax implications of being a virtual landlord renting out to other users, and Section B covers the tax implications of being the tenant renting another user’s land. Part III addresses the IRS’s proposed “look-through analysis” and argues that the sale of virtual land NFTs should be taxed as a capital asset rather than as a “collectible.” Part III then proposes solutions for tax filing forms based on how the IRS chooses to classify different types of NFTs.

I. CAPITAL ASSETS, CAPITAL GAINS, AND BUYING VIRTUAL LAND NFTS

The first step to buying virtual land NFTs is acquiring enough cryptocurrency to cover the cost.⁷⁷ Most NFTs must be purchased with cryptocurrency—Ethereum, SAND, and MANA are among the most popular.⁷⁸ Once users have cryptocurrency and are ready to purchase virtual land NFTs, they

70. See Kohn, *supra* note 5, at 21 (explaining that there is sometimes confusion over who owns the underlying rights of an NFT).

71. See Dan Artavev, *NFTs: Investing in Virtual Real Estate and Other Digital Assets*, ARTAEV L. (Apr. 21, 2022), <https://artaevatlaw.com/2022/04/21/nfts-investing/> [<https://perma.cc/A33M-VFHH>] (discussing how the copyright for an NFT is not usually transferred unless this transfer is explicitly stated in the contract and how not owning the copyright limits a user’s ability to “display, duplicate, or republish” the NFT’s content).

72. See *generally* Hermès Int’l v. Rothschild, 603 F. Supp. 3d 98 (S.D.N.Y. 2022) (holding that Hermès had enough factual allegations against a counterfeit NFT designer to constitute a trademark infringement claim).

73. Goforth, *supra* note 3, at 783.

74. Dan Wright, *NFT Taxation – An Introduction to the Federal Income Tax Implications of Creating or Investing in NFTs*, CLARK NUBER (Apr. 26, 2022), <https://clarknuber.com/articles/nft-taxation-an-introduction-to-the-federal-income-tax-implications-of-creating-or-investing-in-nfts/> [<https://perma.cc/R4CW-U7FD>]; Marcum LLP, *The ‘Real State’ of the Metaverse Real Estate*, COM. OBSERVER (Sept. 26, 2022, 8:00 AM), <https://commercialobserver.com/2022/09/the-real-state-of-the-metaverse-in-real-estate/> [<https://perma.cc/35NT-RJHY>].

75. James Royal, *NFT Tax Guide: 6 Top Tips for Non-Fungible Token Creators and Investors*, BANKRATE (Apr. 11, 2022), <https://www.bankrate.com/investing/nft-tax-guide-top-tips-for-non-fungible-token-creators-and-investors/> [<https://perma.cc/J77F-ZD2C>].

76. This Note tackles federal tax only—state tax considerations for NFTs are complex and even less guided at this point in time. See Eric Fader & Angela Acosta, *Sales Tax Issues with Crypto Transactions*, BDO (Mar. 24, 2022), <https://www.bdo.com/insights/tax/state-and-local-tax/sales-tax-issues-with-crypto-transactions> [<https://perma.cc/X3CP-46R2>].

77. Marr, *supra* note 54.

78. *Id.*

can do so in two different ways. One way is through a virtual world directly,⁷⁹ as most virtual worlds have their own marketplaces where virtual lands are listed.⁸⁰ Alternatively, users can use a third-party resale website.⁸¹

Because users are disposing of cryptocurrency to buy the virtual land NFTs, this is a taxable event. Taxable events happen when capital assets are disposed of, whether by trade or sale.⁸² The definition of capital asset includes so many types of property that the IRS has found it easier to define the term based on what capital assets are not.⁸³ Inventory and other items held “for sale to customers in a trade or business” are the types of things that are not considered capital assets.⁸⁴ Instead, examples of capital assets include investment properties⁸⁵ such as homes, cars, art, and more.⁸⁶ Pretty much anything a taxpayer owns “for personal or investment purposes” counts as a capital asset.⁸⁷ Therefore, not only is cryptocurrency a capital asset,⁸⁸ but NFTs kept for personal and investment uses are as well.⁸⁹

To calculate the applicable taxes arising from purchasing a virtual land NFT, users need to know the adjusted basis of their cryptocurrency that will be spent.⁹⁰ The adjusted basis is the sum of an asset’s basis and the cost of any subsequent improvements or allowable depreciations.⁹¹ Because improvements and allowable depreciations are inapplicable to cryptocurrency, the adjusted basis is just

79. *Id.*

80. Kane, *supra* note 9; *Hermès Int’l v. Rothschild*, 603 F. Supp. 3d 98, 100 (S.D.N.Y. 2022).

81. Marr, *supra* note 54.

82. Wright, *supra* note 74.

83. See I.R.C. § 1221(a).

84. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938. Note that this means if NFTs are held primarily for selling to customers, such as by artists selling their designed NFTs, these do not fall under capital assets. *Id.*

85. *Id.* at 3.

86. Alicia Tuovila, *What Is a Capital Asset? How It Works, with Example*, INVESTOPEDIA, <https://www.investopedia.com/terms/c/capitalasset.asp> [<https://perma.cc/F3TZ-BPMC>] (July 24, 2023).

87. *Topic No. 409 Capital Gains and Losses*, IRS, <https://www.irs.gov/taxtopics/tc409> [<https://perma.cc/WK8R-CC4Q>] (Jan. 30, 2024).

88. I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

89. *Digital Assets*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/digital-assets> [<https://perma.cc/8Q4E-MS2X>] (Apr. 25, 2024). The IRS technically classifies NFTs and cryptocurrency as “digital assets,” which are “any digital representation of value which is recorded on a cryptographically secured distribution ledger or similar technology.” Digital assets are meant to be treated the same as property, which is a capital asset. *Id.*

90. *Topic No. 703 Basis of Assets*, IRS, <https://www.irs.gov/taxtopics/tc703> [<https://perma.cc/TL7J-7LX3>] (Jan. 12, 2024).

91. *Id.* Furthermore, if property was paid for using debt obligations, other property, or services, those count towards the cost, as well. *Id.*

its original basis.⁹² This basis is usually the cost of the cryptocurrency to the user,⁹³ including not just the purchase price, but also any transaction fees,⁹⁴ sales tax,⁹⁵ brokerage commissions,⁹⁶ or other costs associated with the transaction. It is important to note that the basis may be different for cryptocurrency purchased at different times. For example, an investor may have purchased two Ethereum for \$500 each in 2019 and two Ethereum for \$750 each in 2020. If the investor chooses to then spend three of her Ethereum in 2022 on a virtual land NFT, she will need the basis calculations for each of the Ethereum spent.

There are three main accounting methods to keep track of which cryptocurrency and bases are being used: First-In-First-Out (“FIFO”), Last-In-First-Out (“LIFO”), and Highest-In-First-Out (“HIFO”).⁹⁷ The FIFO method uses the bases of the oldest cryptocurrencies for each new purchase.⁹⁸ On the other hand, the LIFO method uses the most recently acquired cryptocurrency bases first.⁹⁹ Less common, the HIFO method uses the cryptocurrency with the highest bases first.¹⁰⁰ Whichever method users choose, they must keep it consistent;¹⁰¹ they can’t switch on a whim. However, if a user does not specify which method she uses, the default method is FIFO¹⁰² because the IRS prefers its fiscally conservative nature.¹⁰³ Most

92. *Id.*

93. *Id.* There are additional considerations while calculating basis, but this Note will not address them. See Justin Kuepper, *How to Calculate Crypto Cost Basis: All You Need to Know About Tracking Cost Basis Across Wallets and Exchange*, ZENLEDGER (May 29, 2022), <https://www.zenledger.io/blog/tracking-cost-basis-across-wallets-exchanges> [<https://perma.cc/WJ27-98Y2>] (problems with airdrops and forks); Will Kenton, *Step-Up in Basis: Definition, How It Works for Inherited Property*, INVESTOPEDIA, <https://www.investopedia.com/terms/s/stepupinbasis.asp> [<https://perma.cc/FRZ4-TZ5J>] (Feb. 28, 2024) (basis changes based on inheritance).

94. Anthony Diosdi, *The 2022 Guide to Income and Estate Taxation of Cryptocurrency and NFTs or Non-Fungible Tokens*, SF TAX COUNS. (Jan. 25, 2022), <https://sftaxcounsel.com/estate-taxation/> [<https://perma.cc/76TY-R37E>].

95. *Topic No. 703 Basis of Assets*, *supra* note 90.

96. Kuepper, *supra* note 93.

97. Diosdi, *supra* note 94. Users can also choose specific cryptocurrency by using its unique digital identifier or by identifying all currency in a specific wallet. *Id.* To take advantage of this option, users will need to show “(1) the date and time each unit was acquired, (2) [their] basis and the fair market value of each unit at the time it was acquired, (3) the date and time each unit was sold, exchanged, or otherwise disposed of, and (4) the fair market value of each unit when sold, exchanged, or disposed of, and the amount of money or the value of property received for each unit.” *Frequently Asked Questions on Virtual Currency Transactions*, IRS, <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions> [<https://perma.cc/82X2-V446>] (Aug. 18, 2023) (Q40).

98. Diosdi, *supra* note 94.

99. *Id.*

100. *Id.*

101. Kuepper, *supra* note 93. Note that users may want to choose the method at the beginning of accounting to prevent confusion later on.

102. Diosdi, *supra* note 94.

103. *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 97, at Q41; Kuepper, *supra* note 93.

users can find basis information by looking at their transaction records within their trading platform, like Coinbase.¹⁰⁴

Using the appropriate basis calculation, users can then determine if they will report a gain or a loss on their taxes.¹⁰⁵ To determine whether there is a taxable gain or loss, users need to look at the difference in value between the cryptocurrency's basis and the amount realized from the exchange for a virtual land NFT.¹⁰⁶ This means the difference between how much was originally spent on the cryptocurrency and the fair market value of the virtual land NFT at the time of the purchase. If the virtual land NFT is worth more than what was originally spent on cryptocurrency, the user will need to report a gain.¹⁰⁷ If the NFT is worth less, the user will need to report a loss.¹⁰⁸

Capital gains and losses require calculating “short-term” and “long-term” gains and losses.¹⁰⁹ A “short-term capital gain” occurs when an asset is sold or traded for more than its purchase price after having it for one year or less.¹¹⁰ Similarly, a “short-term capital loss” occurs when an asset is sold or traded for less than its purchase price after having it for one year or less.¹¹¹ On the other hand, a “long-term capital gain” occurs after the sale or trade of an asset for more than its purchase price when the asset was held for more than one year.¹¹² Likewise, a “long-term capital loss” is the same as a short-term capital loss, but the asset was held for more than a year.¹¹³ To calculate the length of time an asset was held before it was disposed of, users will count from the day after purchasing the cryptocurrency up to and including the day it was ultimately spent.¹¹⁴

Knowing short-term and long-term capital gains and losses is essential for calculating the “net capital gain.”¹¹⁵ Net capital gain determines the appropriate tax bracket for each user.¹¹⁶ First, users need to subtract short-term capital losses for the

104. *Cost basis: What Is It and How It Can Help You Calculate Your Crypto Taxes*, COINBASE, <https://www.coinbase.com/learn/your-crypto/knowning-your-cost-basis> [<https://perma.cc/KG9P-58CC>] (last visited Mar. 12, 2024). Please note that cryptocurrency can be traded without one of these sites, and therefore transaction information may not be recorded, but this Note will assume transactions are completed on record. *See* Diosdi, *supra* note 94.

105. *Topic No. 703 Basis of Assets*, *supra* note 90.

106. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

107. AQUI, *supra* note 84, at 3.

108. *Id.*

109. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

110. I.R.C. § 1222(1).

111. *Id.* § 1222(2).

112. *Id.* § 1222(3).

113. *Id.* § 1222(4); *Topic No. 409 Capital Gains and Losses*, *supra* note 87. There are exceptions to short-term and long-term calculations, such as when the asset was acquired by gift or from a decedent, or if it is patent property. *See Publication 544 (2023), Sales and Other Dispositions of Assets*, IRS, <https://www.irs.gov/publications/p544> [<https://perma.cc/7JD6-Q2JA>] (Feb. 5, 2024).

114. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

115. *See id.*

116. *See id.*

year from their short-term capital gains to find a net short-term capital gain.¹¹⁷ If the short-term losses exceed the short-term gains, this would be considered a net short-term capital loss.¹¹⁸ Next, this same calculation applies between long-term capital gains and long-term capital losses to find the net long-term capital gain or net long-term capital loss.¹¹⁹ The final step to find net capital gain for a given year is to subtract the net short-term capital loss from net long-term capital.

Users will use the short-term capital gain and net capital gain for tax calculations.¹²⁰ The calculated short-term capital gain is taxed at the same rates as ordinary income is taxed.¹²¹ This means that a taxpayer will pay between 10% and 37% of the short-term capital gain based on her total income, including wages.¹²² On the other hand, net capital gain tax rates are either 0%, 15%, or 20%.¹²³ Most users are in the 15% tax bracket for long-term sales of cryptocurrency because, as of 2023, this bracket applies to any single filer with a taxable income between \$44,625 and \$492,300.¹²⁴

Additionally, users will likely have an extra 3.8% net investment income tax on top of the capital gains tax.¹²⁵ This net investment income tax applies to individuals that realize “net gains from the disposition of property,”¹²⁶ like cryptocurrency. This net investment income tax affects the lesser of two options: the net investment income, which here would be the net gains from disposing of the cryptocurrency; or a gross income threshold that is based on the taxpayer’s filing status.¹²⁷ For a single person filing taxes, that threshold is an adjusted income of \$200,000.¹²⁸ On the other hand, for married taxpayers filing jointly, this threshold to qualify for the net investment income tax does not increase much, landing at just \$250,000.¹²⁹

117. I.R.C. § 1222(5).

118. *Id.* § 1222(6).

119. *Id.* § 1222(7)–(8). This calculation also includes losses carried over from previous years. Up to \$3,000 each year can be computed towards future tax returns, but this Note will not dive into these loss calculations. *Topic No. 409 Capital Gains and Losses*, *supra* note 87; Royal, *supra* note 75.

120. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

121. *Id.*

122. Erica York, *2022 Tax Brackets*, TAX FOUND. (Nov. 10, 2021), <https://taxfoundation.org/2022-tax-brackets/> [<https://perma.cc/Z3LX-DPKW>]; I.R.C. § 61.

123. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

124. *Id.* For single filers with less than \$44,625 taxable income, the rate is 0%. For single filers with a taxable income over \$492,300, that rate becomes 20%. Please note that these income thresholds change for different filing statuses. Furthermore, the thresholds and tax rates are subject to change with each new tax year. *Id.*

125. *Topic No. 559 Net Investment Income Tax*, IRS, <https://www.irs.gov/taxtopics/tc559> [<https://perma.cc/7ARV-EQXZ>] (Feb. 12, 2024).

126. *Id.*

127. Diana Wierbicki et al., *NFTs: Collectibles or Not?*, WITHERSWORLDWIDE (Sept. 22, 2021), <https://www.withersworldwide.com/en-gb/insight/nfts-collectibles-or-not> [<https://perma.cc/VP3E-R6P4>].

128. *Topic No. 559 Net Investment Income Tax*, *supra* note 125.

129. *Id.*

In summary, when users purchase a virtual land NFT with cryptocurrency, the sale triggers a taxable event. Users must pay taxes on the difference between the fair market value of the NFT and cryptocurrency's original purchase price. To calculate this, users will need to know their bases in their cryptocurrency and what accounting method they will consistently use for tax purposes. Finally, any net short-term capital gains will be taxed at ordinary income tax rates, and any net capital gains will be taxed at either 0%, 15%, or 20%.

II. LANDLORDS, INCOME, AND RENTING VIRTUAL LAND NFTS

A. Renting Out Your Own Virtual Property to Others

Once a user purchases a virtual land NFT, the user may want to use that NFT as a virtual rental property. The virtual land could be used for anything from houses and apartments to virtual malls and offices.¹³⁰ Many users choose this option for the same reasons people rent out real property in the real world—to make money while the value of the virtual land appreciates.¹³¹ Renting to individuals can be lucrative due to the number of users who want to participate in virtual worlds but are not ready to spend the money for their own virtual land NFTs.¹³² Renting to companies can be even more lucrative, as “[c]ompanies are willing to pay more to be in the right space.”¹³³ Either way, users will find that renting out their virtual properties is a way to dabble in real estate without dealing with property inspections, zoning restrictions, or other real-world issues.¹³⁴

Users might have questions about how any rental proceeds are taxed. Intuitively, users might think that capital gains taxes apply here because a capital asset, the virtual land NFT, is being rented in exchange for another capital asset, cryptocurrency. However, the IRS has answered this question already: these rental proceeds are considered ordinary gross income.¹³⁵

Under the federal tax code, gross income is “all income from whatever sourced derived, including . . . rents.”¹³⁶ The rent computed towards gross income includes any rent received for the use of personal property.¹³⁷ Ordinarily, personal

130. Kristi Waterworth, *3 Benefits to Becoming a Landlord in the Metaverse*, MOTLEY FOOL (Dec. 20, 2021, 10:30 AM), <https://www.fool.com/real-estate/2021/12/20/3-benefits-to-becoming-a-landlord-in-the-metaverse/> [<https://perma.cc/AK42-DM4J>].

131. *Id.*

132. *Id.*

133. Nate Berg, *Inside the Lucrative Business of a Metaverse Landlord, Where Monthly Rent Can Hit \$60,000 Per Property*, FAST CO. (May 9, 2022), <https://www.fastcompany.com/90749937/inside-the-lucrative-business-of-a-metaverse-landlord-where-monthly-rent-can-hit-60000-per-property> [<https://perma.cc/7VY6-WEJM>]. Big brands, such as McDonalds, Pepsi, and Formula One, have been entering the metaverse and paying to lease spaces so that they can promote their businesses. *Large Brands to Buy and Rent Real Estate on the Metaverse*, PAYPERS (May 16, 2022, 2:43 PM), <https://thepayers.com/cryptocurrencies/large-brands-to-buy-and-rent-real-estate-on-the-metaverse-1256357> [<https://perma.cc/9TMW-NLPS>].

134. Waterworth, *supra* note 130.

135. See I.R.C. § 61(a)(5). See also AQUI, *supra* note 84, at 5.

136. I.R.C. § 61(a)(5).

137. 26 C.F.R. § 1.61-8(a).

property that can be rented is tangible, such as an office building, power tools, or a car. However, the IRS acknowledges that personal property can be either tangible or intangible,¹³⁸ and virtual land NFTs would be a perfect example of intangible personal property.¹³⁹ The gross income statute does not specify that rent must be from the use of *tangible* personal property.¹⁴⁰ Accordingly, virtual land NFTs should still fall under the definition of rent. Furthermore, courts have determined that rent payments do not have to be in the form of fiat currency.¹⁴¹ Therefore, that the landlord is receiving rental payments in the form of cryptocurrency will not affect the payment's status as income.

To accurately calculate the income received for rent, users will need to know the fair market value, measured in U.S. dollars, of the cryptocurrency on the day it was received.¹⁴² One way to do this is to check the exchange rate for that cryptocurrency based on market supply and demand.¹⁴³ Then, users can use that rate to convert the cryptocurrency value to U.S. dollars.¹⁴⁴ For example, users can find market value charts—sometimes down to the minute—at sites like CoinDesk.¹⁴⁵ Users calculating a market value from more than 24 hours ago must adjust the start date and end date to both be the same date: the date the cryptocurrency was received.¹⁴⁶ This enables a one-day view of the value broken into 15-minute increments.¹⁴⁷ If users are able to check the charts the same day they receive the cryptocurrency, using the “1 Hour” or “4 Hour” feature can break the values down to one minute increments.¹⁴⁸

Using the market value at the time the rent in cryptocurrency was received, users can calculate their expected tax brackets.¹⁴⁹ Because rent payments are included in gross income tax calculations, the percentages will be 10%, 12%, 22%, 24%, 32%, 35%, or 37%.¹⁵⁰ The distinction between gross income brackets and capital gains brackets is important because if users mistakenly count rent payments towards capital gains calculations, which are usually just 15%, the IRS could issue

138. *Id.* § 1.1031(a)-2(b), (c).

139. See Kathryn S. Windsor, *When is a Collectible Not a “Collectible”? NFTs and Internal Revenue Code Section 408(M)(2)*, PRAC. TAX LAW., May 2022, at 17, 19.

140. Compare I.R.C. § 1.61-8(a) (“use of personal property”), with I.R.C. § 408(m)(2)(F) (“any other *tangible* personal property . . .”) (emphasis added).

141. See *Est. of Gavin v. United States*, 113 F.3d 802, 809 (8th Cir. 1997) (“Regardless of whether rent is paid in cash or in crops and livestock, it is still income . . .”). Fiat currency refers to “[t]he coin and paper money . . . issued by a government’s central bank.” *Digital Assets*, *supra* note 89.

142. AQUI, *supra* note 84, at 2–3.

143. *Id.* at 3.

144. *Id.*

145. See *Ethereum*, COINDESK, <https://www.coindesk.com/price/ethereum/> [<https://perma.cc/8MYL-MMYU>] (last visited Feb 21, 2024).

146. *Id.*

147. *Id.*

148. *Id.*

149. See AQUI, *supra* note 84, at 2–3.

150. York, *supra* note 122.

reporting fines or other penalties for underreporting.¹⁵¹ Lastly, users must keep in mind that they will be subjected to the additional 3.8% net investment income tax.¹⁵² This tax will apply to whichever amount is less: the user's net investment income, which specifically includes income from rents, or the excess of gross income and the user's filing status.¹⁵³

B. Renting Virtual Property Owned by Someone Else

There are many different reasons why a user may wish to rent, as opposed to own, virtual property in a virtual world platform. For example, a user may just be "meta curious" and unwilling to invest in a pricey asset that they could end up not wanting or using.¹⁵⁴ Additionally, the purchase price might be a barrier for many users because prices can be in the tens of thousands of dollars.¹⁵⁵ Or perhaps users have their own virtual land NFT but want to temporarily experience access to coveted virtual real estate.¹⁵⁶ Furthermore, users looking to grow a business in the metaverse may rent space, either indefinitely or while waiting to be in a position to buy their own virtual land NFTs.

No matter why users choose to rent virtual land NFTs, they will need to know how to treat these types of transactions for tax purposes. Users may not realize that by renting a virtual property paid for in cryptocurrency, they will be paying not only the price of the rental, but the cost of any capital gains tax.¹⁵⁷ Because users will be disposing of cryptocurrency to pay for the rental, capital gains taxes will apply.¹⁵⁸ Users will need the bases for their cryptocurrency spent and its fair market value at the time of the sale to calculate just how much gain or loss was realized.¹⁵⁹ Then, users will need to anticipate being taxed on that amount based on the appropriate tax bracket.¹⁶⁰

III. COLLECTIBLES, ART, AND SELLING VIRTUAL LAND NFTS

After enjoying a virtual land NFT, users may have different reasons for wanting to sell the property. They may want to make a profit, spend less time in a

151. Kuepper, *supra* note 93. For a single person in 2023, tax brackets for capital gains were 15% up to an income of \$492,300, whereas an income of just \$41,775 was enough to put a taxpayer in the 22% bracket for gross income. Similarly, a taxpayer with a gross income of \$492,300 would be in the 35% bracket. *Topic No. 409 Capital Gains and Losses*, *supra* note 87; York, *supra* note 122.

152. *Topic No. 559 Net Investment Income Tax*, *supra* note 125.

153. *Id.*

154. Waterworth, *supra* note 130.

155. *Id.*

156. Users are often willing to pay extra to experience the best areas. For example, one NFT investor spent nearly half a million dollars to purchase the virtual plot directly located next to that of artist Snoop Dogg. Will Lavin, *NFT Collector Spends \$450,000 To Live as Snoop Dogg's Virtual Neighbour*, NME (Dec. 8, 2021), <https://www.nme.com/news/music/nft-collector-spends-450000-to-live-as-snoop-doggs-virtual-neighbour-3114160> [<https://perma.cc/6ZUQ-LQDP>].

157. *See supra* Part I.

158. *See supra* Part I.

159. *See supra* Part I, Section II.A.

160. *See supra* Part I.

virtual world, or sell to buy a more valuable virtual asset. Regardless of the reasons why a user might sell a virtual property, there will be tax consequences.¹⁶¹ The main issue that arises when selling a virtual land NFT is whether that property will be considered a capital gain or a “collectible” for tax purposes.¹⁶²

A collectible under the tax code refers to any work of art, rug or antique, metal or gem, stamp or coin, alcoholic beverage, or any other tangible personal property specified by the IRS.¹⁶³ Collectibles are categorized separately from other types of property due to their intrinsic value, which can come from the “scarcity, uniqueness, or popularity” of an item.¹⁶⁴ This distinction between collectible status and capital gains status is critical because collectibles held for more than one year may be taxed at rates up to 28% for net gain, whereas capital gains have a maximum tax of just 20% for net gain.¹⁶⁵ The distinction between collectibles and capital gains does not apply to short-term gains or losses from NFT sales because NFTs held for one year or less will be taxed at ordinary income rates.¹⁶⁶

Tax professionals are split on how to advise clients who invest in NFTs.¹⁶⁷ The predominant view seems to be that NFTs should be classified as collectibles.¹⁶⁸ On the other hand, some tax experts think NFTs should generally be treated like capital assets instead, with only some NFTs meeting the definition of “collectible”;¹⁶⁹ they see NFTs as no different than stocks or land.¹⁷⁰ Despite this split, there are two reasons why virtual land NFTs should not be treated as collectibles: virtual land NFTs are not art, and they are not tangible property.

A. Virtual Land NFTs Do Not Qualify as “Art”

To determine whether virtual land NFTs should be considered art, the first step is to establish where the definition is coming from.¹⁷¹ Under the collectibles statute, a collectible refers to “any work of art,” but the IRS does not elaborate further on how to classify which collectibles are art.¹⁷² Therefore, this Section will evaluate why virtual land NFTs do not meet the definitions of art not only under an ordinary dictionary definition but also under two areas of law that frequently deal with art: copyright law and customs law.

161. This Note does not apply to NFT creators who are selling their work in the course of business. Those creators will have different tax implications. *See* Wright, *supra* note 74.

162. Diosdi, *supra* note 94. The IRS began soliciting comments about how to classify different types of NFTs in 2023. *See IRS Issues Guidance, Seeks Comments on Nonfungible Tokens*, IRS [hereinafter IR-2023-50], <https://www.irs.gov/newsroom/irs-issues-guidance-seeks-comments-on-nonfungible-tokens> [<https://perma.cc/TSK9-Y8CL>] (Feb. 23, 2024).

163. I.R.C. § 408(m)(2).

164. Windsor, *supra* note 139, at 19.

165. *Topic No. 409 Capital Gains and Losses*, *supra* note 87; I.R.C. § 1(h)(5)(A).

166. *Topic No. 409 Capital Gains and Losses*, *supra* note 87.

167. *See* Royal, *supra* note 75.

168. *Id.*

169. Wright, *supra* note 74.

170. *Id.*

171. LEONARD D. DUBOFF ET AL., *ART LAW IN A NUTSHELL* 8 (6th ed. 2021).

172. I.R.C. § 408(m)(2)(A).

According to the *Merriam-Webster* dictionary, a “work of art” is either a “product of one of the fine arts” or “something giving high aesthetic satisfaction to the viewer.”¹⁷³ “Fine art” is further defined as “an activity requiring a fine skill” or “art . . . concerned primarily with the creation of beautiful objects.”¹⁷⁴

Virtual land NFTs do not fit under any of the definitions listed by the dictionary. First, building onto virtual land NFTs is not an activity that requires a “fine skill.” Otherwise, this feature would not be accessible to average users playing in virtual world platforms. Similarly, buildings added to virtual land NFTs, or even virtual land NFTs themselves before any building process has begun, are not created with the purpose of being “beautiful objects.” Instead, users primarily employ virtual land NFTs to show off possessions and have a place to use as a home, office, club, store, or other structure.¹⁷⁵ Therefore, virtual land NFTs do not meet the *Merriam-Webster* definition of “work of art.” As for whether the NFT properties give “high aesthetic satisfaction to the viewer,” the structures created resemble real-world houses.¹⁷⁶ Thus, they do not give any higher aesthetic satisfaction than real-world properties displayed in magazines, which do not qualify as art under copyright law.


Copyright law has its own set of rules to determine when something can be considered art. There are two relevant definitions: “pictorial, graphic, and sculptural works” and “architectural work.”¹⁷⁷ Pictorial, graphic, and sculptural works refer to two- and three-dimensional works of fine, graphic, and applied art.¹⁷⁸ When incorporated with a piece that also boasts utility, these works lose the artistic designation.¹⁷⁹ Artistic designs can only be copyrighted on functional pieces if the design is “physically and conceptually separate” from the piece itself.¹⁸⁰ As for architectural works, the architectural design is required by statute to be “embodied in [a] tangible medium of expression.”¹⁸¹

Virtual land NFTs do not meet the definitions of pictorial, graphic, and sculptural works or architectural works in the copyright field. First, it appears that virtual land NFTs and any structures thereon fit into the criteria of three-dimensional

173. *Work of Art*, MERRIAM-WEBSTER DICTIONARY, <https://www.merriam-webster.com/dictionary/work%20of%20art> [<https://perma.cc/X76P-36NP>] (last visited Apr. 25, 2024).

174. *Fine Art*, MERRIAM-WEBSTER DICTIONARY, <https://www.merriam-webster.com/dictionary/fine%20arts> [<https://perma.cc/L5G7-EV8R>] (last visited Apr. 25, 2024).

175. Marr, *supra* note 54.

176. See Arisu, *Sandbox Island – A-Frame Beach House Speed Build*  Roblox *Adopt Me!*, YOUTUBE (Mar. 5, 2022), <https://www.youtube.com/watch?v=o1Uet9Sc5OU> [<https://perma.cc/DE97-R85U>].

177. 17 U.S.C. § 101.

178. *Id.* They also include photographs, prints and art reproductions, maps, globes, charts, diagrams, models, and technical drawings. *Id.*

179. *Id.*

180. DUBOFF ET AL., *supra* note 171, at 309.

181. 17 U.S.C. § 101.

graphic or applied art.¹⁸² However, because the virtual land NFTs serve a useful purpose, any features that make the structures particularly pleasing to look at would have to be physically and conceptually separate to be considered art.¹⁸³ This is a nearly impossible ask, as any such design or feature would likely be affixed to the structure in some way, much like in real-world architecture. Finally, although an architectural works designation may seem particularly relevant to structures on virtual land NFTs, given that the statute explicitly requires a tangible medium, it will not apply to architectural works in the metaverse, no matter how unique the design.

Lastly, customs law has “some of the most important and well-developed definitions” of art in the legal sphere.¹⁸⁴ Under customs law, art refers to original paintings and drawings, among other categories.¹⁸⁵ To decide if an object should be considered art, courts look at the object’s appearance and purpose, the maker’s occupation, and how many exist in the series, if applicable.¹⁸⁶ Additionally, most courts hold that if the art has “any functional characteristics, it is precluded from being classified as a work of art.”¹⁸⁷ Functional objects, such as kitchenware and vases, are therefore excluded from the definition of art, even when beautifully crafted by a famous artist.¹⁸⁸

It is unlikely that virtual land NFTs would fit the legal definition of art as developed by customs law. Although customs law assesses tangible property, the factors courts use to identify art can theoretically be applied to both tangible and intangible property. First, virtual land NFTs do not look like traditional pieces of art; they may look like plots of land, houses, or buildings.¹⁸⁹ The user who makes a structure situated on a virtual land NFT will likely not be a professional virtual land architect or engineer. Virtual world platforms are made for regular people looking to escape the real world for a while. Furthermore, users do not make structures on virtual lands for aesthetic purposes only—the structures also have functional purposes like housing, storage, rental space, and more.¹⁹⁰

182. As previously discussed, virtual land NFTs should not be considered “fine art.” See *Fine Art*, *supra* note 174. As for graphic art, this is often a subset of applied art. Applied art is “the application . . . of artistic design to utilitarian objects,” which can include “computer graphics.” *Applied Art*, ENCYC. ART EDUC., <http://www.visual-arts-cork.com/definitions/applied-art.htm> [https://perma.cc/N5HA-LHWN] (last visited Feb. 22, 2024).

183. DUBOFF ET AL., *supra* note 171, at 309.

184. *Id.* at 1. Having a specific set of definitions of art differentiates which pieces can or cannot enter the United States duty-free. *Id.*

185. *Id.* at 4–5. It also refers to collages and decorative plaques; original prints, engravings, and lithographs; sculptures and statuary; postage stamps; collectors’ pieces; and antiques. *Id.*

186. *Id.* at 1.

187. *Id.* at 7.

188. *Id.* at 8. *But see* G. Heileman Brewing Co. v. United States, 14 Ct. Int’l Trade 614, 617, 622 (1990) (holding that decorative beer steins were “art” rather than “mugs and other steins” because they were made to be collector’s items and would be chipped, stained, and discolored if used as steins).

189. See *Arisu*, *supra* note 176.

190. *Marr*, *supra* note 54.

For the reasons set forth in this Section, virtual land NFTs should not be considered collectibles for tax purposes. Regardless of which interpretation of art is used, these types of NFTs do not fall within any of the definitions. They are not works of art in the plain meaning of the term because no fine skill is required to create them, and they are not made for the purpose of being art. Similarly, virtual land NFTs are not any more pleasing than real-world architecture in general. Next, they are not art as defined by customs law because any artistic or pleasing aspects are outweighed by factors like the lack of expertise required for users and the predominantly utilitarian function of the structures. Lastly, virtual land NFTs do not fit in the copyright definition for a similar reason—any artistic design elements cannot be physically or conceptually separated from the structure itself. Therefore, these types of NFTs should be taxed according to regular capital gains percentages.

This is not to say that all types of NFTs should be excluded from the definitions of art. Some NFTs are “clearly works of art,”¹⁹¹ such as CryptoPunks’s 10,000-piece NFT collection comprised of pixelated portraits.¹⁹² The government implemented a collectibles tax with the purpose of disincentivizing the buying and selling of collector’s items, as those do not usually help the economy stay afloat.¹⁹³ Instead, the government wanted to encourage consumers to spend more money on items that would support the economy.¹⁹⁴ Before NFTs, investors had no reason to spend money purchasing digital art because there was no way to tell whether a piece was original or not.¹⁹⁵ Thus, it makes sense that digital art NFTs fit in the collectibles tax because the art actually retains or increases in value.¹⁹⁶

B. Collectibles Only Include Tangible Assets

Whether or not virtual land NFTs should be considered collectibles is purely a matter of statutory construction.¹⁹⁷ Under the collectibles statute, a collectible refers to: “(A) any work of art, (B) any rug or antique, (C) any metal or gem, (D) any stamp or coin, (E) any alcoholic beverage, or (F) any other tangible personal property specified by the Secretary for purposes of this subsection.”¹⁹⁸ Using a plain language reading of the statute, intangible assets likely do not fall under the definition of a collectible.¹⁹⁹ Specifically, in item (F) of the statute, the use

191. Wierbicki et al., *supra* note 127.

192. *See* Marcobello, *supra* note 1.

193. Dan Moskowitz, *How Collectibles Are Taxed*, INVESTOPEDIA, <https://www.investopedia.com/articles/personal-finance/061715/how-are-collectibles-taxed.asp> [<https://perma.cc/EJ6A-MT79>] (Nov. 28, 2023).

194. *Id.*

195. *See* Jex Exmundo, *Quantum: The Story Behind the World’s First NFT*, NFT NOW (Mar. 21, 2023), <https://nftnow.com/art/quantum-the-first-piece-of-nft-art-ever-created/> [<https://perma.cc/MW4T-EGLK>] (“[T]here was no way to verify the creator and ownership history of digital works.”). For purposes of this Note, “digital art” refers to art produced using digital technology and can include examples such as animations, digital paintings and drawings, videos, and more.

196. *See id.*

197. *See* Wierbicki et al., *supra* note 127.

198. I.R.C. § 408(m)(2).

199. Windsor, *supra* note 139, at 19.

of “other” seems to imply that the categories of collectibles in the preceding items are also tangible property.²⁰⁰

The tangibility requirement for collectibles is particularly persuasive when examining the other items listed aside from art. First, item (B) refers to rugs or antiques.²⁰¹ While there could be NFTs of the image of a rug, this would not be a digital rug; it would just be an NFT image.²⁰² Similarly, almost by definition, if something is old enough to be considered antique, it is certainly not a digital item.²⁰³ Thus, at least with current technology, there is no way for item (B) to refer to anything other than tangible rugs and antiques. Next, item (C) refers to metals and gems.²⁰⁴ Much like the categories of item (B), there are currently no digital metals or digital gems. This makes the categories from item (C) impliedly tangible as well.

Item (D) determines that “any stamp or coin” is considered a collectible.²⁰⁵ At first, it might seem like cryptocurrency could fall under the coin designation. However, the IRS has already established that cryptocurrency is treated as general property rather than as a collectible.²⁰⁶ Plus, the IRS has identified some exceptions, including gold, silver, and platinum coins of certain weights and coins issued under the laws of any state.²⁰⁷ The fact that excluded coins have specific weight requirements and that no governments in the United States issue digital currency means these excluded categories are also impliedly tangible.²⁰⁸ Furthermore, there are presently no digital stamps that could be applied to send mail. Therefore, this item category also refers to tangible property. Lastly, item (E), including alcoholic beverages,²⁰⁹ does not have a digital equivalent at this time.

Thus, if virtual land NFTs are not excluded under the definition of “work of art,” then they should be excluded for being intangible under the plain language reading of the collectibles statute. Although the statute does not specify that art must be tangible to be taxed at the higher bracket, this is a reasonable conclusion based on the plain language of item (F) and the intangibility of items (B)–(E). Because none of the non-art collectible categories refer to intangible property either, intangible virtual land NFTs should not be eligible for the collectibles tax under the art category.

200. Wierbicki et al., *supra* note 127.

201. I.R.C. § 408(m)(2)(B).

202. Goforth, *supra* note 3, at 779.

203. Items must be at least 100 years old to qualify as antique. *See What’s The Difference Between “Antique” & “Vintage”?*, FARGO ANTIQUES & REPURPOSED MKT. (Apr. 18, 2018), <https://www.farmantiques.net/blog/whats-the-difference-between-antique-vintage> [<https://perma.cc/54YA-GCPD>].

204. I.R.C. § 408(m)(2)(C).

205. I.R.C. § 408(m)(2)(D).

206. AQUI, *supra* note 84, at 2.

207. *Issue Snapshot – Investments in Collectibles in Individually-Directed Qualified Plan Accounts*, IRS, <https://www.irs.gov/retirement-plans/investments-in-collectibles-in-individually-directed-qualified-plan-accounts> [<https://perma.cc/8CDL-Z9FL>] (Apr. 8, 2024).

208. 31 U.S.C. § 5112(a).

209. I.R.C. § 408(m)(2)(E).

C. The Solution

The solution to making sure virtual land NFTs are appropriately taxed depends on how the IRS views the relationship between collectibles and NFTs in general. The IRS solicited comments from the public starting in March 2023 to better understand NFTs, collectibles, and any relevant considerations for taxation.²¹⁰ Until the IRS makes a final determination, it plans to temporarily assess NFTs using a “look-through analysis.”²¹¹ In this analysis, if an NFT’s associated right or asset falls within an enumerated collectible category, it will be taxed as a collectible.²¹² For example, an NFT certifying ownership of a gem would be a collectible because gems are expressly taxed as such.²¹³ Similarly, the IRS predicted that a virtual land NFT would not be a collectible because there is no applicable category in the collectibles statute.²¹⁴ However, the IRS has not yet identified how it may differentiate when an NFT is a “work of art” and when it is not.²¹⁵

If, upon reflecting on the comment submissions from the public, the IRS decides to exclude all types of NFTs from the collectibles tax based on the reading that collectibles must be tangible property, users likely will follow the most recently updated IRS guidelines. These guidelines, which are applicable to taxes filed in 2022 and later, ask if users received, sold, exchanged, gifted, or otherwise disposed of a digital asset such as an NFT.²¹⁶

On the other hand, if the IRS rejects the requirement that collectibles be tangible, then the IRS should amend the question again for future tax filing forms. The amendment should separate the digital asset question into two parts: one asking whether the taxpayer received, sold, or exchanged any digital art NFTs and one asking whether the taxpayer received, sold, or exchanged any non-art NFTs, which would include virtual land NFTs. This way, the two categories of NFTs can each receive the appropriate tax applications. When the IRS decided to use the “look-through analysis” in the interim, it provided no mention of how NFT owners could notify the IRS as to which types of NFTs were received, sold, exchanged, or gifted.²¹⁷

Thus, if the digital asset question were amended to distinguish NFT types, users would need to keep more detailed records of each transaction based on current IRS guidelines. IRS guidelines require maintenance of records containing

210. IR-2023-50, *supra* note 162.

211. *Id.*

212. *Id.*

213. *Id.*

214. *Notice 2023-27 Treatment of Certain Nonfungible Tokens as Collectibles*, IRS 3 [hereinafter *Notice 2023-27*], <https://www.irs.gov/pub/foia/ig/sbse/notice-2023-27-nft-as-collectibles.pdf> [<https://perma.cc/>].
DY2V-C6SG] (last visited Apr. 25, 2024).

215. *Id.* The IRS solicited comments until June 19, 2023. *Id.* at 4. As of December 2023, the IRS has not published any updates for the next year of tax returns.

216. *IRS: Updates To Question on Digital Assets; Taxpayers Should Continue To Report All Digital Asset Income*, IRS, <https://www.irs.gov/newsroom/irs-updates-to-question-on-digital-assets-taxpayers-should-continue-to-report-all-digital-asset-income> [<https://perma.cc/6VVZ-FEX7>] (Jan. 24, 2024).

217. *See Notice 2023-27*, *supra* note 214.

information including “receipts, sales, exchanges, or other dispositions” for virtual currency transactions,²¹⁸ but these categories can be easily mapped to NFTs. Because some NFTs could reasonably be considered a collectible and others—like virtual land NFTs—would not be collectibles, an extra detail for each transaction in a user’s records should be added. Then, NFTs could be taxed “on a case-by-case basis.”²¹⁹ Art and other collectibles-eligible NFT transactions could be taxed at collectibles tax rates,²²⁰ and non-collectible NFT transactions could be taxed at capital gains rates.²²¹

CONCLUSION

The purpose of this Note is to make sure that users who are entering the realms of digital assets—in particular, engaging in transactions involving virtual land NFTs—are aware of the tax consequences at each stage of the transaction. Having an idea of what taxes might be required and which tax brackets would be appropriate helps users better plan for tax season and avoid accidentally underreporting.²²² This is especially relevant in the coming years now that the IRS is specifically seeking out digital asset reporting compliance.²²³ Since 2019, the IRS has sent thousands of warning letters to digital asset holders instructing them to properly report their earnings or face penalties, and maybe even criminal investigations.²²⁴

To maintain compliance with IRS regulations, when users are ready to make that first leap into the metaverse, they will need to know the tax implications of purchasing a virtual land NFT. Because virtual land NFTs are typically purchased with cryptocurrency, this disposition of cryptocurrency will trigger a taxable event

218. *Frequently Asked Questions on Virtual Currency Transactions*, *supra* note 97, at Q46. Associated fees should be documented, as well, so that appropriate basis can be calculated. Wright, *supra* note 74.

219. Diosdi, *supra* note 94.

220. Wright, *supra* note 74.

221. Wierbicki et al., *supra* note 127.

222. *See* AQUI, *supra* note 84, at 6. Underpayments, including from transactions involving digital assets like cryptocurrency and NFTs, can be subject to penalties under various IRS statutes. *Id.* Specifically, users can have “accuracy-related penalties” under I.R.C. § 6662 and “failure to report” penalties under I.R.C. §§ 6721 and 6722. *Id.* For accuracy-related penalties, there is an additional 20% tax on the amount underpaid if the underpayment was due to “[n]egligence or disregard of rules or regulations,” “[a]ny substantial understatement of income tax,” or several other error sources. § 6662. For failure to report penalties, the minimum penalty imposed ranges from \$50–\$500 based on the circumstances, with \$500 applying to intentional disregard for filing requirements. § 6721. These penalties can go all the way up to millions of dollars. *Id.* These same penalty amounts apply to errors under § 6722, as well. § 6722.

223. Diosdi, *supra* note 94.

224. Kuepper, *supra* note 93; *IRS Has Begun Sending Letters to Virtual Currency Owners Advising Them To Pay Back Taxes, File Amended Returns; Part of Agency’s Larger Efforts*, IRS, <https://www.irs.gov/newsroom/irs-has-begun-sending-letters-to-virtual-currency-owners-advising-them-to-pay-back-taxes-file-amended-returns-part-of-agencys-larger-efforts> [<https://perma.cc/WCP5-KZRN>] (Dec. 19, 2023). On the plus side, taxpayers who are able to show noncompliance with the filing requirements due to a reasonable cause will have penalty relief available to them. AQUI, *supra* note 84, at 6.

resulting in a gain or loss. To calculate any gain or loss, users will need to know their bases in the cryptocurrency and determine an accounting method to use consistently. Then, using calculations based on how long the cryptocurrency was held before being spent, users can find their net capital gain and short-term capital gains. The net capital gains will be taxed at capital gain rates, and the short-term capital gains will be taxed at ordinary income rates. There is also likely a net investment income tax that applies to these transactions.

Additionally, if users want to either rent out their own virtual land NFTs or rent a virtual property from another user, they need to be mindful of the tax consequences. This is especially confusing because both these types of transactions come with different tax treatments. First, if users want to rent their virtual properties out to other users, they need to include those earnings in their ordinary gross income. Because users are likely being compensated in the form of cryptocurrency, the fair market value of that cryptocurrency is calculated towards the gross income. This is in addition to the applicable net investment income tax. On the other hand, users wishing to rent out someone else's virtual property will have to follow the same capital gains rules as for purchasing a virtual land NFT. This is because they are usually disposing of cryptocurrency when paying the cost of the rental.

Lastly, users need to think about tax consequences when selling a virtual land NFT. This step is particularly challenging due to the lack of guidance from the IRS while it analyzes comments submitted by the public. The proceeds from the sale could either be considered capital gains or gains from collectibles. Most likely, virtual land NFTs will not be expected to fall under the collectibles statute due to virtual land NFTs not being art in any plain or legal sense. Instead, it might be the best option for the IRS to develop new questions on future tax filing forms about transactions involving art NFTs and those involving non-art NFTs, such as virtual properties.

Overall, the IRS is taking steps in the right direction by slowly addressing new trends in technology that might be taxable. But to truly prevent any confusion among taxpayers, it needs to speed up its decisions on tax treatment so users can pay their taxes correctly the first time.