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NFTS: DIGGING DEEPER

A REGULATORY AND TAX PERSPECTIVE

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1. Introduction

In this article, we pry open two superficially simple questions concerning the definition of a non-fungible token or 'NFT': first, what types of assets do NFTs typically reference? And second, what does 'fungible' actually mean? We then demonstrate how these are crucial questions from a legal perspective, with significant regulatory and tax implications.

2. What is Being Tokenised?

The Law Society has defined an NFT as a unique, non-divisible token, often linked to an object that uses blockchain technology to record ownership and validate authenticity.[1] This much appears to be generally accepted.

The kinds of object to which an NFT might be linked, however, is not always made clear. Many sources focus exclusively on digital information assets including digital artwork, music, or video content. This is likely because this is the space in which the value and number of NFTs has soared (Beeple comes to mind), as NFTs have introduced artificial scarcity, clear provenance and the potential for resale royalties to the digital markets.[2]

But looking beyond this, it is possible to purchase NFTs of assets such as real estate, wine and gold bullion. Viewed through this lens, NFTs mark a staging post in a longstanding conversation regarding blockchain's ability to optimise record-keeping processes, like those involved in the transfer of land. And, functioning as 'deeds' to an asset, some of the legal questions that NFTs pose - such as how you effect the transfer of an underlying asset in addition to the transfer of a token - have been live for a number of years.

The picture can be complicated still further, as ownership of NFTs can be fractionalised. There has even been conversation about future NFTs being linked to financial assets, including shares.

These latter two points surface questions about fungibility. Do assets associated with NFTs need to be non-fungible in order to make the NFT non-fungible? Certainly, much is often made of off-chain assets linked to NFTs being unique, whether that is a piece of art or a particular bottle of wine. Or, is it the NFT itself that is non-fungible because - under standards such as ERC-721 on Ethereum, which helped propel NFTs to fame - it has a unique digital ID and is not divisible? Does fractionalised ownership change this analysis? And, while we are here, what does 'fungible' even mean?

3. Pinning Down Fungibility

Fungibility can be a slippery concept. The Oxford English Dictionary describes a fungible good as one that has been contracted for and that can be replaced by another identical item without breaking the terms of the contract; that is, goods that are interchangeable or replaceable. Other definitions place further emphasis on the good in question being divisible.

In some cases, the fungibility of an item is clear: it is well understood that banknotes are fungible, for example. Gold, when not bent into a pleasing shape, is touted as an example of a fungible good, as is corn and wine.[3]

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[1] The Law Society (January 2022), *Blockchain: Legal & Regulatory Guidance (Second Edition)*, p. 86. Available at https://www.lawsociety.org.uk/topics/research/blockchain-legal-and-regulatory-guidance-second-edition.

[2] Ranson, I. (26 May 2021), 'A Digital Picture is Worth a Thousand Ether: NFTs and Digital Art', The Lens. Available at https://thelens.slaughterandmay.com/post/102gz5n/a-digital-picture-is-worth-a-thousand-ether-nfts-and-digital-art.

[3] *Halsbury's Laws of England* (2019, 5th ed.), vol. 2, paragraph 1834.

A distinction can be drawn between items that are fungible because, by their nature, they are indistinguishable, and those that are fungible because they are treated as fungible in a particular context.[4] So, for example, two issues of securities with the same terms that form part of a single series will not be identical (they have different issue dates) but may still be commercially fungible because they are treated by the market as interchangeable.[5] By contrast, it has been argued that individuals may treat money as less fungible than it actually is depending on the context in which it is received, in a phenomenon referred to as 'mental accounting'.[6]

This suggests that fungibility may be context-specific, and that 'real-life' behaviour may rub up against legal conceptions of fungibility (conversations around which often arise in the context of trust law).

So, an assessment of what is fungible, or not fungible, is not always straightforward. This is no better illustrated than by bitcoin, a cryptocurrency that is often reflexively presented as a fungible contrast to the unfungible NFT (presumably because a bitcoin does not have a unique identifier, and is nominally intended to be used as a means of exchange).

Because bitcoin transactions are public, if pseudonymous, some have argued that bitcoins are not fungible; that bitcoins associated with a 'clean' transaction history will be worth more than those associated with a 'dirty' history of nefarious transactions. Bitcoins as a category of goods, under this analysis, are not interchangeable.

This problem is not new: under the previous technology paradigm, similar questions were asked about whether suspicious 'tainted' payments into bank accounts impacted fungibility.[7] But it illustrates the point that whether something is 'fungible', or not, is complex. And, refocussing attention on NFTs, pinpointing what makes an NFT non-fungible, might not be simple.

Some say that an NFT's unique digital ID makes it non-fungible; but each banknote also has a unique serial number, as indeed does each bitcoin create an indelible transactional provenance. Could there be circumstances under which, in practice, groups or categories of NFTs are treated as fungible?

Others look to the unique nature of the associated asset: but what happens when ownership is fractionalised? Still others place emphasis on the fact that NFTs cannot be divided. Perhaps this is safer ground, subject to input from technology specialists.

These questions regarding associated assets and fungibility are more than purely academic, and have tangible legal and regulatory consequences.

4. Why Does This Matter? A Regulatory Perspective

Associated assets

In taking a deeper dive into the varied types of assets that may be linked to an NFT, we are warned that this is not a homogenous asset class. Whether activities including issuing, buying, selling, advising on or storing NFTs fall within the regulatory perimeter will depend on the particular NFT and what it links to, helping to determine where it lands within the FCA's taxonomy established in 2019.

Under this taxonomy, NFTs, as cryptoassets, will be regulated as a 'security token' if they amount to a specified investment under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (including those that are financial instruments under MiFID II), or as an 'e-money' token if they amount to e-money under the Electronic Money Regulations 2011.[8] A new regulated category of 'stable tokens' is expected to be announced this year, capturing stablecoins, which aim to maintain stability in their price, typically in relation to stable assets such as fiat currency.[9] Practitioners and market participants should be particularly alive to these issues where ownership is fractionalised.

Fungibility

Fungibility, or lack thereof, is a precarious fault line for the purposes of regulation. Building on the analysis

[4] Fuller, G. (2012), *The Law and Practice of International Capital Markets*. London: LexisNexis UK, p. 45.

[5] *Ibid*.

[6] Thaler, R.H. (1999), 'Mental Accounting Matters', *J. Behav. Dec. Making*, 12: 193–206.

[7] NCA (July 2020), *SARs Regime Good Practice: FAQs*. Available at https://nationalcrimeagency.gov.uk/who-we-are/publications/462-sars-faq-july-2020/file.

[8] FCA (July 2019), *Guidance on Cryptoassets: Policy Statement PS19/22*. Available at https://www.fca.org.uk/publication/policy/ps19-22.pdf.

[9] HM Treasury (January 2021), *UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence*, pp 5–6. Available at https://www.gov.uk/government/consultations/uk-regulatory-approach-to-cryptoassets-and-stablecoins-consultation-and-call-for-evidence.

above, this is illustrated by recent proposals to expand the financial promotions regime to capture 'qualifying cryptoassets', which are explicitly defined as fungible.[10]

Through this definition, HMT sought to carve-out NFTs from the financial promotion regime (at least for now). This was on the basis that fungibility is a characteristic that 'makes a cryptoasset significantly more likely to give rise to consumer protection concerns', and that NFTs may represent a wide array of different assets that might constitute non-financial services products.[11]

But, as respondents to HMT's consultation on this topic made clear, regulating on the basis of fungibility may not always produce sensible results. They observed that new NFTs have emerged that blur the boundary between financial services products and digital collector items (both may be purchased and sold purely for speculative purposes, provoking similar risks).[12] Concerns were also raised that fungible tokens could be 'wrapped' inside NFTs in order to bypass the regime, and that there is little certainty that NFTs will always stay non-fungible.

This echoes the question, raised earlier, of whether there are circumstances under which certain groups of NFTs could be considered fungible: the boundary between fungible and non-fungible may, in practice, be permeable. Equally, is it possible that cryptoassets that are meant to fall squarely within the financial promotions regime, such as bitcoin, could be construed as non-fungible?

5. Why Does This Matter? A Tax Perspective

Associated assets

As with the regulatory treatment, it is more likely that the tax treatment of NFTs will depend on the characteristics of the particular NFT and its linked asset. Whilst tax authorities have, generally speaking, developed more or less comprehensive policies in relation to the taxation of cryptocurrencies, the taxation of NFTs has so far been left comparatively unexplored. For instance, the paragraph in HMRC's Cryptoassets Manual (the 'Manual') that discusses what cryptoassets are does not even include NFTs in its list of 'main types of cryptoassets',[13] indicating that the views expressed in the Manual may not necessarily apply to NFTs except where they are explicitly referred to.

For example, if traditional conveyancing processes were replaced with a digital process whereby an NFT representing ownership of the actual physical land or building in England or Northern Ireland (rather than a digital equivalent as has been offered in relation to luxury properties) [14] was transferred, one would expect that stamp duty land tax ('SDLT') would become payable. Whilst this prediction may appear to be at odds with statements in the Manual that 'SDLT will not be payable',[15] it rather serves to illustrate the limitations of the current guidance, as these statements explicitly apply only to the transfer of exchange tokens (such as bitcoin), which would seem very different from NFTs and their potential use cases.

Given that, at its most basic, an NFT could be said to be merely a representation of a person's ownership of an underlying asset, one might be tempted to state simply that the tax treatment of the NFT should follow that of the underlying asset. Whilst this statement may turn out to be correct as a general proposition, it also serves to obscure many technical issues that will have to be explored.

One further layer of complexity may be the fact that holders may effectively transfer control of an NFT by passing on the private key, without actually effecting a transfer of the NFT on the blockchain. How might a transfer of the private key without the transfer of the NFT then be treated? Arguably, transferring a private key effectively transfers beneficial ownership (meaning, broadly, the right to benefit from the NFT) and tax consequences should be triggered as if the ownership of the NFT had formally been transferred. Alternative views might be that sharing a private key merely gives a measure of control or that it should be regarded as an irrelevance in the same way as sharing the login details of one's share deposit account should not in and of itself transfer any beneficial entitlement to its contents. Without express law or guidance on the point, it seems likely that the intentions of the parties would be key to

[10] HM Treasury (July 2020), *Cryptoasset promotions: consultation*. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902891/Cryptoasset_promotions_consultation.pdf.

[11] HM Treasury (January 2022), *Cryptoasset promotions: consultation response*. Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1047232/Cryptoasset_Financial_Promotions_Response.pdf.

[12] *Ibid.*, p. 11.

[13] HMRC Cryptoassets Manual, paragraph CRYPTO010100.

[14] https://www.fineandcountry.com/uk/property-for-sale/leatherhead-oxshott/kt22-0pb/2413345.

[15] HMRC Cryptoassets Manual, paragraph CRYPTO44250 and CRYPTO24000.

establishing whether or not beneficial title has transferred - and therefore whether tax arises - in accordance with normal contract law principles.

NFTs may also do more than simply evidence ownership of an existing asset. The underlying code could, for instance, provide that, whenever the NFT is transferred, a percentage of the price is automatically transferred to the creator. Would the seller's taxable gain fall to be reduced accordingly? How would the payment be treated in the creator's hands? Tax authorities may also start to wonder whether the code could instead (or additionally) provide that an amount on account of tax is automatically withheld and accounted for. Where NFTs are paid for in a cryptocurrency, would this require tax authorities to accept payments in that cryptocurrency? Imposing a requirement on those minting cryptoassets to include such code - and, given the anonymous nature of cryptoasset transactions and difficulties in establishing the taxing location, administering the withholding tax - may also require a level of international cooperation in respect of the underlying rules and their administration that one would have historically thought virtually impossible. That said, the fact that in excess of 100 countries have reached political agreement on, amongst others, a global minimum tax would seem to indicate that it may not be entirely out of reach.[16]

Fungibility

Fungibility also has important consequences for the tax treatment of an asset. The UK capital gains tax ('CGT') regime permits assets to be treated as a single 'pool' where those assets 'are of a nature to be dealt in without identifying the particular assets disposed of or acquired'.[17] That cryptocurrency coins have an identifiable transaction history is not necessarily fatal to such pooling. Such coins should, for these purposes, be regarded as fungible in the same way as shares of the same class in a company (which are probably the most common type of pooled assets). Each share has its own number, and its transactions are recorded on a ledger, but the legislation expressly permits pooling of such shares.

It is probable that HMRC will generally be right in their anticipation that NFTs will simply not be pooled.[18] There could, however, be circumstances, in which certain NFTs, while 'non-fungible' in name, are treated as fungible in practice, in which case the analysis will be less clear. For instance, NFTs representing identical quantities and qualities of a fungible underlying asset (such as gold bullion) would seem inherently to be assets 'of a nature to be dealt in without identifying the particular assets disposed of or acquired'. Others may need to be characterised based on market trends that are yet to emerge.

6. Conclusion

Through digging deeper into the constituent elements of an NFT, several key points have emerged: the definition of an 'NFT' - like that of a 'cryptoasset' - is at present so broad that it cannot sensibly be used as a starting point for a regulatory or tax characterisation. As NFTs start to proliferate, and new markets and ecosystems germinate around them, we might well expect the concept to be deployed and experimentally repurposed in ever broader contexts, some of which will be harmless but others will bear risks and implications that regulators and taxing authorities will wish to scrutinise. And there would certainly be risks in predicating any regulatory regime on the concept of fungibility, the frailty of which we have detailed here.

Interrogation of these fundamental points should help arm legislators, regulators and practitioners, as they begin to grapple in earnest with the legal and regulatory issues posed by NFTs.

[16] https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.

[17] Section 104(3)(ii) Taxation of Chargeable Gains Act 1992.

[18] HMRC Cryptoassets Manual, paragraph CRYPTO22200.

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