

# Trading NFTs in a futuristic world

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he acronym NFT rolls off the tongue as smoothly as well-frothed milk atop a cappuccino. But what is it? Why the hype? Is it regulated? If there is a gain from the holding or trading of it, would the taxman come knocking?

Non-fungible tokens (NFTs) are a class of “asset” that is embedded with unique identification codes and metadata, and exist on a blockchain. NFTs are used as a digital representation or certification of ownership of an asset. Each NFT has a feature or information that is specific to it, that is one of a kind (as opposed to products that may be infinite) and one NFT cannot be exchanged with another NFT for equal value (since each is unique and each would hold a different value).

As the NFT is created on the blockchain platform, there is room to shape the features of the asset. NFTs have been used to represent ownership of virtual real estate; minted to represent lifetime concert passes; or used as a representation of limited-edition merchandise that can then be “worn” by Line avatars walking around a virtual world.

These developments, albeit exciting, have also raised a multitude of legal questions surrounding the regulation of creating or minting NFTs, as well as the securitisation and the taxation of NFTs. Regulators around the world have scrambled to fully grasp the characterisation of different NFTs in order to fit them into pre-existing regulations.

It is important to appreciate that NFTs are purchased for many different reasons: as investments, as property to be enjoyed for pleasure (for example, art/music), and for trading purposes as a retail business operation. As the world of NFTs draws more attention and investments, the question that often arises is: Is it legal to trade in NFTs in the first place?

In Malaysia, securities can only legally be offered via a Malaysian-registered digital asset exchange (DAX) or otherwise with the approval of the Securities Commission Malaysia (SC). Being a regulated DAX would raise further regulatory obligations such as Know-Your-Customer checks and anti-money laundering compliance. Therefore, where the NFT is cast as an investment or security, it would be prudent to consider whether financial services regulations would apply. The appropriate approach would be to consider the underlying characterisation of the NFT to be created or traded, and ascertain if the NFTs carry the hallmarks of being a “security”.

Given the malleable nature of NFTs, creators have sought to mint tokens with a digital representation that is wrapped with a bundle of rights — for example, a token that represents a specific area within a forest with the right to vote at token holder meetings to acquire further land around the forest as part of an afforestation initiative, and gaining a yield on the sale of carbon credits that are accredited from the afforestation initiative. As a result of this,

the analysis of whether securities laws or other laws would apply begin to grow in complexity.

What about the tax treatment of the trading and creating of NFTs? Despite the absence of official tax guidelines on NFTs, the Inland Revenue Board of Malaysia (IRB) has already indicated its intentions to tax income earned through NFTs.

As of early 2021, the IRB has required cryptocurrency investors who trade assets on DAXs to declare their gains via their annual income tax declaration. The IRB clarified that determining whether the profit from an activity is taxable would require an analysis on a case-by-case basis to determine if there is a specific pattern of trade, or badges of trade. This rule can easily be applied in an NFT context.

Tax issues may be different for the different players involved in the trading of NFTs. When an NFT creator mints an NFT and sells it, the creator may derive income that may be subject to income tax. For a Malaysian NFT creator, the tax implications will be different depending on whether the income is Malaysian-sourced income or foreign-sourced income received in Malaysia. Given that NFTs are sold digitally on the NFT marketplace, where would the income be sourced since the NFT marketplace exists on the World Wide Web?

Foreign-sourced income was exempted from Malaysian income tax until changes

were disclosed during the Budget 2022 announcement. Since then, the Ministry of Finance has agreed to exempt all types of foreign-sourced income for individuals for a period of five years until 2026, subject to certain conditions (which are yet to be confirmed). After 2026, foreign-sourced income earned by individuals may be subject to Malaysian income tax, unless further exemptions are granted. Given the rise of the NFT market, this will be a persisting issue in the future.

NFTs are usually resold from a primary to a secondary purchaser, and so on. Some NFT creators may structure these sales on the blockchain to collect royalty payments on every subsequent sale, typically using the mechanism of a smart contract. The royalty or licence fee income will be subject to tax for the NFT creator. The secondary purchaser will need to consider if any withholding tax would apply on the payment for the NFTs, especially when the NFT creator is a non-resident.

NFTs are purchased for many different reasons. Depending on the different intentions for the purchasing and subsequently selling of NFTs, and the length of time the NFTs are held, these sales may raise either capital gains tax or income tax liabilities. Where the gains are capital in nature, there is currently no capital gains tax in Malaysia; however, where the gain is characterised as income in nature, income tax will be applicable.

NFT marketplaces typically earn money through charging listing or handling fees, or commission on the minting of NFTs on the marketplace platform, and such income will be subject to corporate income tax. Even though the NFT marketplace may be located outside Malaysia, the Malaysian service tax regime is broad enough to impose the liability to register and charge service tax if the services fall under the imported digital services regime where the services are provided to Malaysian consumers and meet the registration threshold.

Evidently, the complexity surrounding the constantly evolving metaverse does and will continue to raise interesting legal and tax questions and considerations. Although it may be a whole new “playground”, legal and tax issues are bound to follow and existing rules will need to be adapted to apply to this new and developing area. ■



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