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# NFT BUYERS AND SELLERS BEWARE: THE SEC AND IRS HAVE SOME THOUGHTS

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On Monday, August 28, 2023, the U.S. Securities and Exchange Commission issued its first-ever enforcement action regarding NFTs, charging a media and entertainment company, Impact Theory, with selling NFTs as unregistered investments and denying its investors the protections provided through the registration of securities. The SEC determined Impact Theory's NFTs were investments because of the company's promises that purchasers would profit if the company's sale of NFTs was successful.

But what are NFTs exactly, beyond being an internet buzzword? NFT stands for "non-fungible token" which does not clear up any confusion for most people. An NFT offers the opportunity to own a digital file. Some analogize an NFT to an original work of art. There may be copies made, but the owner of the NFT owns the original piece. The originality of the NFT is maintained by blockchain. The value of an NFT is in the eye of the beholder, much like tangible art pieces. That beholder can be whoever has millions to spend, like the purchaser of a video NFT made by artist Beeple titled "Beeple's Everydays: The First 5000 Days" that sold for 69 million dollars at Christie's Auction House's first NFT auction in March 2021.[1]

The subject of the SEC's enforcement action, Impact Theory, sold three tiers of NFTs called Founder's Keys in an offering from October to December 2021. According to the SEC order, the SEC found that Impact Theory encouraged purchasers to approach the NFTs as an investment, by making statements that Impact Theory was "trying to be the next Disney" and that the NFTs would offer a "tremendous value" if the offering was successful.[2] These statements, according to the SEC, influenced buyers to believe they would profit from purchasing Impact Theory's NFTs.

For the first time, the SEC determined that Impact Theory's sale of NFTs was an investment contract requiring registration under provisions of the Securities Act of 1933. Impact Theory agreed to a cease and desist order and was ordered to pay over 6.1 million dollars in disgorgement, prejudgment interest, and a civil penalty while also destroying any Founder's Keys in their possession or control.

This order has rattled many NFT sellers and owners who are now concerned that NFTs will be treated as investment contracts and will require registration with the SEC. Along those lines, two SEC commissioners dissented and expressed concern over how NFTs fit into investment regulation.[3] The dissenting commissioners argued that these NFTs were not within the SEC's jurisdiction, stating "[w]e do not routinely bring enforcement actions against people that sell watches, paintings, or collectibles along with vague promises to build the brand and thus increase the resale value of those tangible items."

The dissenters disagreed with the SEC's order on the grounds that Impact Theory's NFTs were not investment contracts under the *Howey* test. *Howey* was the seminal case that determined what constitutes an "investment contract" by considering "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[4]

The SEC found Impact Theory's NFTs to be investment contracts because of the company's promises of profit to those who purchased the Founder's Keys, such as claiming they were "trying to build the next Disney." The SEC dissenters disagreed that such statements were enough to pull these NFTs into the SEC's jurisdiction as investment contracts and emphasized that "any attempt to use this enforcement action as precedent is fraught with difficulty." Notably, the SEC did not find all NFTs to be investment contracts, just Impact Theory's Founder's Keys after conducting a fact intensive inquiry.

This SEC enforcement action continues the trend of ambiguous direction from federal agencies. In March 2023, the IRS announced in notice 2023-27 that it intends to issue future guidance regarding taxing certain NFTs as collectibles under section 408(m) of the Internal Revenue Code using a "look-through analysis" by considering the character of the NFT.[5] If the NFT is akin to owning a work of art or gem, it would be considered a collectible compared to the "right to use or develop a 'plot of land' in a virtual environment" which would not be considered a collectible under the Internal Revenue Code.

The SEC's action and the IRS's notice of future guidance indicates that NFTs will not offer certainty for NFT sellers or owners. Instead, NFTs may become traps for the unwary, especially for those who make promises about an NFT's future value.

[1] Christie's, Digital Art & NFTs, https://www.christies.com/en/events/digital-art-and-nfts/overview

[2] In the Matter of Impact Theory, LLC Respondent., Release No. 11226 (Aug. 28, 2023), https://www.sec.gov/news/press-release/2023-163.

[3] NFTs & the SEC: Statement on Impact Theory, LLC (Aug. 28, 2023), https://www.sec.gov/news/statement/peirce-uyeda-statement-nft-082823.

[4] S.E.C. v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

[5] I.R.S. Notice 2023-27, 2023-15 I.R.B. 634, https://www.irs.gov/pub/irs-drop/n-23-27.pdf.

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