NON-FUNGIBLE TOKENS

Digital art frenzy raises questions about taxes and law enforcement

BY CAITLIN REILLY
CQ-Roll Call

The sale last month of a digital piece of art for a near-record price raises new questions about a technology the financial sector sees as offering great opportunity.

Christie's auctioned the artwork for $69 million and recorded the transaction on a public blockchain as a "non-fungible token," or NFT. The digital collage incorporating 5,000 separate digital images was created by Beeple, whose real name is Mike Winkelmann, and can be seen on the auction house website.

Nancy Kaszerman/ZUMA Wire

The Christie's Auction House sale of a digital artwork for $69 million last month illustrated the frenzied interest in non-fungible tokens.

The price exemplifies the frenzy involving non-fungible tokens, which rely on the same technology that powers cryptocurrencies, including bitcoin and ether. The tokens are unique records that represent another asset. Unlike cash or cryptocurrency, a non-fungible token isn't completely interchangeable with another.

The flurry in activity and soaring prices of non-fungible tokens are raising questions for federal officials about whether the assets are susceptible to money laundering, manipulation or tax evasion. The art world's experience may also give federal regulators a hint of challenges in the future — as well as a tool to address those challenges. One area of vulnerability is blockchains where both cryptocurrencies and non-fungible tokens are bought and sold.

Tim Carpenter, who oversees the FBI's art crime team, said the scope of the money laundering problem in the art industry is "enormous."

"Criminal enterprises have long looked at the art market as a useful place to hide their illicit proceeds," he said. "It stems largely from the fact that the art market is almost completely unregulated."

Carpenter spoke with CQ Roll Call about using art to launder money in general and wasn't authorized to speak about NFTs specifically.

The frenzy in NFTs has seen Twitter CEO Jack Dorsey selling his first tweet as an NFT for $2.9 million and football player Rob Gronkowski selling more than 300 collectible cards for about $1.6 million total. In February, an animated GIF of the cartoon "Nyan Cat" fetched more than $500,000 as a token.

Marketplaces where the tokens are created, bought and sold saw a combined trading volume of $342 million in February, up from $12 million in December, according to the blockchain application tracker DappRadar.

Money laundering

Auction houses selling art don't face the same know-your-customer and anti-money laundering regulations that banks and financial institutions do. That makes them an attractive vehicle for obscuring the illicit origins of funds.

Skyrocketing prices and easy movement across borders also make non-fungible tokens attractive commodities through which to launder wealth, Carpenter said.

Josh White, an assistant professor of finance at Vanderbilt University, said the anonymity offered by non-fungible tokens may raise some of the same money laundering issues as the physical art world. White was an economist for the Securities and Exchange Commission from 2012 to 2014 and had later stints as visiting scholar and consultant to the agency.

"Blockchain is by nature both visible and anonymous," he said. "If I were moving money from the drug trades or any kind of illegal activity, the cryptocurrency space and the NFT space by relation is definitely a way that you can move assets in a large way, in an anonymous way, to try to circumvent some of the banking rules that we've put in place to identify this type of stuff."

The potential use of non-fungible tokens for illicit activity likely drives some of the demand for and, by extension, the value of non-fungible tokens, he said. non-fungible tokens that trade on blockchains, such as Ethereum, that also support a cryptocurrency provide an additional layer of anonymity because users can buy tokens with cryptocurrencies they also own anonymously, White said.

Even for a crook, the non-fungible token isn't risk-free, as its value could drop. If a criminal buys a van Gogh painting to launder money or trade illegally, the artwork will still be valuable years from now, White said.

"But the token, you don't really know," he said. "What if the speculative market comes to a halt? What if there's no more demand for NFTs? The value could go to zero really quickly, whereas the value for the van Gogh is still there."

Manipulative trading

Whether non-fungible tokens have a long-term role in illegal transactions depends on how easy they are to trade and how stable their prices are.

In the meantime, they're more likely to attract people trying to manipulate prices than money launderers, White said. He cited similarities between the emerging non-fungible token market and the penny stock pump-and-dump schemes he investigated at the SEC.

"No matter what new technology comes along, a lot of the fraud is the same," he said.

Manipulators would draw in other investors by creating the appearance of liquidity or demand for a penny stock by passing the assets among accounts controlled by the same group of people through "wash trades."

"For the NFTs, you could see the exact same thing," White said. An individual could trade an NFT among different cryptocurrency accounts he or she controls to attract buyers.

The emerging cryptocurrency sector has largely kept its eye on the SEC and the Commodity Futures Trading Commission in its fledgling years, but investigation of this type of manipulative trading would likely fall to the Justice Department, White said, noting that, unlike penny stocks, non-fungible tokens aren't securities. The department may partner with Treasury's Financial Crimes Enforcement Network if a scheme involves banks, or with the CFTC if it incorporates derivatives.

White said investigators looking for manipulation in non-fungible token markets have an advantage: the blockchain itself, which should reveal whether the same accounts pass a token back and forth even if account owners are anonymous.

Tracking tax evasion

Michelle Hutchens, assistant professor of accountancy at the Gies College of Business in Champaign, Ill., said the public digital record of a blockchain would also help the IRS track the movement of wealth and uncover tax evasion.

"There are certain areas of the economy where potentially tax evasion or avoidance is easier because the wealth is less trackable," she said, adding that there's no equivalent public record of transactions in the cash economy or for tangible art.

"With the appropriate tools, transactions of non-fungible tokens are definitely traceable," she said in an interview, calling it a "tight paper trail."

The IRS is "keenly aware" of the use of blockchain to move wealth and is investing in the skills needed to trace those trades, she said.

Custody and customs

Wasim Ahmad, chief cryptocurrency officer at the digital asset storage and security firm Vault12 Inc., said non-fungible tokens raise questions about the nature of custody when it comes to digital assets and the corresponding tax implications. The issue is a familiar one in the securities markets.

Ahmad corrected what he called a misconception about non-fungible tokens, saying in an interview that the tokens and the digital art they represent are often conflated.

"They're talking about the NFT, which is the record of the art, and they're talking about the art itself as if it's all one thing, and it's not one thing," he said. "The NFT is much more like a receipt."

The tax question is whether owners of non-fungible tokens should have access to the same tax havens that collectors of physical art have. They can delay or avoid some taxes by storing the art in warehouses called freeports that exist outside national jurisdictions.

"If you purchase something and it goes straight to a freeport and you don't receive it, you don't pay certain duties and taxes," he said. "There isn't a digital equivalent of that."

Ahmad said he's exploring whether a digital freeport is needed and how that would work legally.

Solve these puzzles on C4

SOLUTION TO TODAY'S SUDOKU

SOLUTION:

6	5	2	8	1	7	9	3	4
7	3	9	5	6	4	8	1	2
8	1	4	9	2	3	6	5	7
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9	2	5	1	7	8	4	6	3
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4/25

SOLUTION TO TODAY'S JUMBLE

JUMBLE®

Answer:

SHAKEN VERIFY OUTING
ACCEPT IMPOSE GRASSY

Isaac Watts wrote more than 700 hymns. There were many people who —

SANG HIS PRAISES

NYT CROSSWORD SOLUTION

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LAT CROSSWORD SOLUTION

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