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From Bitcoins to NFTs

First it was bitcoins and now it seems that NFTs are gaining traction particularly in mainstream pop culture. You have only to look at the recent Super Bowl which featured an array of NFT projects.

What are NFTs?

NFT stands for non-fungible token. A non-fungible token is:

- a unit of data stored on a digital ledger
- unique and is not interchangeable
- a digital asset

What's the hype with NFTs?

These days almost anything digital can be an NFT – drawings, paintings, music, signed photos etc.

We pay a lot for a Picasso because he's not making any more of them and in fact the painting you bought is the only one of its kind in the world. The rarer a thing is the more value it has normally.

So if Pablo were alive today you could get him to create a work of art as an NFT and similarly it would be the only one of its kind in the world, uncopyable (well at least no more so than creating a print of a Picasso) and therefore similarly valuable.

The attraction appears to be from using the tech to sell digital art. You can use an NFT to represent an ownership interest in any tangible or intangible asset, even where you store the asset outside of a digital ledger.

Can an SMSF invest in NFTs?

There is no simple yes or no answer. The trustee will always need to consider the following key issues when determining whether to invest in an NFT:

1. whether the investment would satisfy the 'sole purpose test'; and
2. whether the investment strategy of the SMSF will be satisfied.

Does the investment satisfy the 'sole purpose test'?

The 'sole purpose test' will be satisfied if an SMSF's sole purpose is to provide retirement benefits for its members. However, difficulty may arise in trying to satisfy the sole purpose test as an SMSF cannot directly or indirectly provide financial assistance or benefits to its members prior to their retirement, including use of or access to the assets of the SMSF.

The ATO states that a cryptocurrency is more likely to have been acquired as a personal use asset if the cryptocurrency is acquired and used within a short period of time in comparison to a cryptocurrency being acquired and held for time before any such transaction is made.*

So an SMSF may be able to satisfy this requirement if the trustee is able to show that the NFT will not be used as a personal use asset by the trustee or the members of the SMSF and instead will be kept or mainly used as an investment.

The investment strategy of the SMSF

The current rules regarding an SMSF investment risk are based within the “investment covenants” framework in s 52B of the Superannuation Industry (Supervision) Act 1993 (Cth) (“SIS Act”).

The SMSF trustee will need to consider a number of aspects including the risk in making, holding and realising any investment, the likely return from an investment, diversification, liquidity, costs and tax consequences as part of its investment strategy.

As part of this framework, an SMSF trustee must exercise due diligence in relation to all investments made by the SMSF. The issue here is the risky nature of NFTs as an investment. The process to buy an NFT can be complicated as most NFTs need to be acquired using an Ethereum-compatible crypto-wallet. As with other types of cryptocurrencies, NFTs are also susceptible to scams and crypto hacks.

Investing in NFTs may not be a prudent SMSF investment, especially for those approaching retirement age, where stable income-generating assets and minimal risk of significant capital loss are important.

Generally, there is no intrinsic value linked to an NFT unlike a stock or a bond where you would already know the intrinsic value of that investment. A successful NFT is generally only as valuable as the next person who is willing to pay for it.

But there may be a role for NFTs as part of an otherwise appropriate strategy. For example the trustee may be able to argue that having less than 5% of the total fund’s assets invested in digital assets such as NFTs does not constitute a material risk for the fund and yet adds the potential to increase the fund’s overall investment performance. Whatever the decision, NFTs as an investment must be approved in an SMSFs investment strategy.

Note also that it may be necessary to amend an SMSFs trust deed in order to allow investment in digital assets such as NFTs.

*<https://www.ato.gov.au/general/gen/tax-treatment-of-crypto-currencies-in-australia>

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About Townsend Lawyers

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