
# NFTs: What consumer companies need to know

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**Guest speakers:** • Wendy Henry, Jarick Poulson, Chris Deans

**Sam:** Welcome to Consumer Speaks, a Deloitte podcast series where you'll hear industry specialists share their perspectives and insights on emerging topics impacting the consumer industry. I'm Sam Loughry, the leader of our Consumer Industry Audit & Assurance practice of Deloitte & Touche LLP. Today, we'll be discussing non-fungible tokens, better known as NFTs, and considerations for corporations as they evaluate and implement their digital asset strategies. We are at a key inflection point in the adoption of digital assets. In fact, the adoption rate of digital assets today is the same as it was for the internet in 1998, and consumer companies are increasingly getting involved. I'm joined by three people who spend their time helping companies think through the complexities of their digital asset strategies. With me are Wendy Henry, managing director and National Blockchain and Digital Asset lead within Deloitte Consulting LLP; Jarick Poulson, managing director in the Blockchain & Digital Asset practice within Deloitte Tax LLP; and Chris Deans, Audit & Assurance senior manager in the Blockchain & Digital Asset practice within Deloitte & Touche LLP. I want to thank each of you for joining the discussion. Wendy, let's get started with you. Can you help us understand the interest in digital assets like NFTs and why consumer companies are considering them?

**Wendy:** Sure, Sam, and thanks for having me today. This is one of my favorite topics to talk about. We are seeing an uptick in interest from consumer companies and companies at large in NFTs. I think most people are familiar with NFTs at some level, but what they think about is art, digital items used in gaming. I think what we're starting to see is that people are understanding the power behind NFTs, which is really bundling unique rights or attributes into a trusted digital asset. And, therefore, while it does support art, digital items that might be used in gaming, there's so much more that, from the perspective of consumer companies, they can now start to look at. It really translates into an ability to create something with a trusted digital ownership or be able to demonstrate authenticity in ways they haven't been able to do before. That provides the ability to create one-of-a-kind engagement with consumers, a really personalized experience. You can think about a sale of a digital item that's uniquely constructed for an individual or as a consumer purchases something, their ability to easily know about its authenticity, but also as they exchange that with someone else, maybe sell it, that authenticity is transferring and the purchaser on secondary markets also has that. But there's also other things that are happening. We're starting to see things like the issuance of NFTs to gain access to a specific event in special ways that they weren't able to before. So it's a very new and exciting way. I don't think we've seen all of the uses that we'll start to see as companies engage with consumers using NFTs.

**Sam:** Wendy, what are some of the considerations companies should have to determine if NFTs are right for their business?

**Wendy:** That's a great question. And I think it comes down to whether they are looking to increase consumer confidence. Are they looking to increase consumer engagement and/or satisfaction, or is there a need for them to increase their consumer conversion or loyalty? Because this really has a lot to do with their ability to influence their brand, loyalty to that brand, and potentially create new revenue streams. As they look at these new mechanisms for consumer engagement, we have to remember that not all consumers are created equal. We generally think of retail consumers that are going to purchase something, but there's also sports fans or communities that are aligned around a specific interest area. And they're going to engage differently than someone who is just a retail consumer buying an item they may need. So it's important that they look at their overarching strategy around consumers and consumer engagement, and then take a look at which of these types of NFTs make sense and the reason consumers have for engaging with those NFTs. As I said at the very beginning, what we're seeing are digital collectibles and goods, and this is getting tied to metaverses and virtual worlds. We're seeing a lot of brands starting to put things digitally into these virtual worlds so that consumers can purchase them. And that's in addition to art, music, and other types of collectibles that I think are most often associated with NFTs in the marketplace today, but we're also starting to see physical product authentication as a use case. This comes down to the authenticity of the product, which allows brands to address or overcome the risks of fraud that we see with many of the upscale versions of products today. We're seeing NFTs in gaming integration and the ability to be able to play-to-earn for functionality with rewards that really do hold value and are transferable or can be transferred between worlds in theory. And finally, what's most exciting are the use cases we're seeing that go beyond just a consumer purchasing something, but really hold new ways for consumers to engage. For example, think of sports teams, allowing fans now to engage with members of the teams in a whole new way that in the past, they haven't been able to do.

**Sam:** Wendy, there's some great examples. Let's shift gears a little bit and discuss some of the potential implications when using digital assets. Jarick, I want to turn to you. What are you seeing on the tax side?

**Jarick:** Thanks, Sam. Tax is certainly interesting around NFTs. Well, partly because to date we don't have any guidance from US Treasury or the IRS specific to NFTs. What we do have though is preliminary guidance around digital assets and, of course, a host of tax law that can be analogous to NFTs. And as Wendy has pointed out already, one of the interesting things about NFTs is the countless applications they have. So since an NFT is a shell that enables transfer of ownership or access to rights, whatever is embedded within the NFT is used to determine how it's treated for tax purposes or even other regulatory purposes, like securities laws in accounting. And so whenever we start thinking about tax and we put that lens on an NFT, we have to first look at what it represents, what rights are transferred to its holder. An NFT could be a general perpetual right to use an image. And so if we put a tax lens on that, we ask, "OK, is that a license or a transfer property that NFT could be rights to an online community, a club membership, maybe a subscription service?" And so if I'm the one selling that NFT, is that income to me taxed immediately, or is that some kind of deferred income that I can tax over the time that I'm providing service? Many applications, when we start thinking about that and we have to first define what that is, and then we can put the lens of income tax on it. And then of course there's other lenses within tax when we get to indirect tax. Are there sales and use tax implications and VAT internationally? And again, that same process of first defining what it is leads us to being able to answer whether there are those different transactional taxes that would be applied to it. And that same concept then applies to withholding. Like, if I'm an NFT marketplace and I'm facilitating the transfers of these NFTs from one person to another, and what exactly is my role and my obligation with respect to indirect tax or maybe withholding obligations or information reporting? Do I have an obligation to provide 1099s, for example, to those who are transferring NFTs on my marketplace? And it gets very interesting because the way that NFTs can be transferred is very different from our typical credit card transaction, where the actual mechanism to transfer an NFT and the rules around it can be embedded in what's called a smart contract. So even if I'm an NFT marketplace, I'm potentially a step removed from the actual execution because the smart contract is the one that actually executes the transfer. And so it definitely makes the analysis a little more complicated with respect to my obligation as an NFT marketplace.

**Sam:** Jarick, sounds like there's some interesting things to come in the tax front. Chris, I wanted to turn to you because there's also potential accounting considerations for issuers of NFTs.

**Chris:** Yep, definitely. To start there's no authoritative accounting guidance specific for NFTs, and similar to how Jarick described from the tax perspective, since an NFT is really just a vessel, you know, that represents something else, it's important to start by understanding the rights that it represents. So some additional examples could be the right to display art, the full ownership over a piece of music, or even the ownership of a piece of real estate. Whatever the NFT represents will ultimately drive the accounting treatment. So while most cryptocurrencies are accounted for as intangible assets, NFTs could have a wide range of accounting treatments. One common accounting challenge for issuers, and especially marketplaces, is determining if gross versus net revenue recognition is appropriate. The guidance will tell you to look at who is primarily responsible for fulfillment, who has inventory risk, and who has price discretion, but it's still not always straightforward. We've seen NFT accounting conclusions change on very subtle differences, such as one sentence within a contract. It's natural to think first building the business and then figuring out the appropriate accounting. But I'd say in this space, it's especially important to bring in your accountants from the very beginning, because those minor changes in contract, funds flow, and even the design of the platform can have significant accounting implications.

**Sam:** Chris, thanks for providing the accounting considerations. Earlier, we heard about potential strategies for using digital assets. Are there any challenges that companies could face when issuing NFTs? Wendy, I'll start with you.

**Wendy:** Thanks, Sam. I think there's a couple of questions that any company has to answer. What is the media that's being licensed or used, what's the nature of the NFT, and to Jarick's and Chris's comments earlier, what's the company's role in the deal? Once they start to answer those questions, there's really three distinct ways that they can start to issue an NFT. The quickest is to strike a licensing deal with one of the NFT platforms, a third-party service. Of course, that does relinquish control at a higher level, but you will get your NFT into circulation very quickly. The second one is to use an existing platform and you mint your NFTs on that platform. The final one, which is the more difficult one, but gives you the most control is to create your own NFT platform. I think the other thing that gets lost is that there are viable use cases where NFTs can be embedded in a custom application that the company develops. So you have to think about how fast do you want to go to market? How much ownership do you want to retain, as well as what control over what happens with that asset? Of course, remember that there are tax and accounting implications here too. Also consider whether or not it makes sense to embed these into some of your core applications.

**Chris:** I would also add that the crypto infrastructure is being built out currently. Thus, it can be challenging to find the right service providers to meet your needs or face the burden of having to develop solutions in house. Currently, interoperability is a key struggle and while we're making great strides, each company has to consider their needs to be able to communicate and connect with all the relevant parties. We're seeing a lot of this infrastructure being refined that will make it easier for mass adoption and future applications, but there still may be headwinds in the near future for early adopters.

**Jarick:** And that's a great point, Chris, and headwinds exist in the regulatory environment as well, along with the infrastructure to practically address them. One example is US states and international jurisdictions have yet to provide guidance around transaction taxes, such as sales and use stacks and VAT. But there are very likely some of those states and jurisdictions that would say NFTs fall within their current taxable frameworks. But the challenge with the way many NFTs are sold today is the location of the buyer is unknown. So knowing how to approach transaction tax obligations is a hurdle. Other non-tax regulatory bodies, such as the SEC, have yet to say anything specific to NFTs. But we see the law firms that we partner with addressing these risks based on existing law that's relevant to the rights that are embedded in NFTs.

**Sam:** I want to kind of wrap up here with a question on what companies should be thinking about as next steps as they develop or launch an NFT.

**Wendy:** I can jump in from the strategy part of it, which is it really does have to align with your strategy. I think what we see, it's very easy with some respects to just issue an NFT, but you have to think through what is the purpose? What are you trying to accomplish? What's the monetization schema for it? And you have to think primary and secondary markets in many cases. What are you trying to get from your consumers, right? Is there engagement? Is there feedback? And then if that's the case, how are you going to design the NFT to not only help you achieve that, but be able to measure that? So those are some of the things that we encourage customers to think about more broadly before jumping in and creating any given specific NFTs.

**Jarick:** Wendy, you make such a great point about the way you want to think about this strategically as you get into it. And of course, it is helpful at that time when you're designing your NFT, you want to think about, what are the tax implications or the accounting implications? Because if you get ahead of that topic, then you may have an opportunity to craft your terms and conditions or your user agreement in a way that can make that analysis more clear or get to the type of tax treatment that you are intending to have. Also, as we wrap up here, and we haven't had a lot of time to delve into all these topics, if you are interested in further information[1] around NFTs, we have a POV that was recently published. So check that out at deloitte.com.

**Sam:** Well, that's our time for today. Thank you, Wendy, Jarick, and Chris, for joining the discussion and providing your insights. As you're heard from today's guests, digital asset strategies come in a wide variety and can have significant complexities. For more information on blockchain and digital assets, as well as other consumer insights, please visit our website at deloitte.com or email me at sloughry@deloitte.com. Thank you for listening to Consumer Speaks, sponsored by Deloitte's Audit & Assurance business. Until next time, take care.

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1 Deloitte, *How to make blockchain and NFTs work for your company*, 2022